

# POSSIBILITIES

INSIGHTS FOR FINANCIAL INSTITUTIONS

MAY 2017

## Create an Internal Audit with More Value

In this time of constant change and business disruptions, the cost of a breakdown in even one internal control in a high-risk area has the potential to be quite significant. Think about the potential impact of a control not functioning as intended within your loan or finance departments. But how do you monitor your internal controls in both an effective and efficient manner? Your internal audit function is likely the best tool you have for monitoring whether your controls are in place and functioning as intended.

### Benefits of Internal Audit

The benefits of a strong internal audit function go well beyond mitigating breakdowns in controls that may have significant financial and operational impacts on your institution:

- Regardless of an institution's size, regulators expect the board of directors and senior management to be responsible for ensuring an effective internal control system, including an internal audit function.<sup>1</sup>
- The preparation and use of a documented risk assessment and linking your annual internal audit plan directly to it ensures your internal audit time and resources are spent in the most economical and efficient manner, and that you are getting the most value.
- An independent internal audit function, reporting directly to the board of directors, gives you greater confidence in your controls. Internal audit personnel provide a level of objective evaluation that other management functions may not.
- Internal audit testing and observations can help to identify inefficiencies and duplication in processes.
- For organizations in states where a directors' examination is required, internal audit procedures can be layered on top of these requirements to reduce overall costs and improve the overall value of the work.

### Options to Fit Your Organization

A strong internal audit department can take one of many forms, depending on your size, shape, and available resources:

- Outsourced – The entire internal audit cycle is outsourced to a third party. You'll have access to industry expertise and best practices, variable costs replace fixed staffing costs, and independence is ensured. Your current internal audit personnel's time can then be allocated to core banking functions where they can provide more value.
- Co-sourced – A third party works with your internal audit personnel to provide additional hours or special expertise, as needed. You will still have access to best practices.
- Internal – Your internal audit personnel complete all internal audit functions. The benefits of utilizing internal personnel include familiarity with the organization and its policies and procedures, no engagement letters/contracts, and ongoing communication with management. A third party may still advise your internal personnel.

The costs resulting from a breakdown in controls have the potential to be higher than the costs of maintaining a strong internal audit department. Developing a strong, risk-based internal audit function will help you to monitor your internal controls and resolve the fear of the unknown.

<sup>1</sup>*Interagency Policy Statement on the Internal Audit Function and Its Outsourcing*



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CPAs & BUSINESS ADVISORS

# THE DIRECTORS' CORNER

## The Community Bank Director's Role in Interest Rate Risk Management

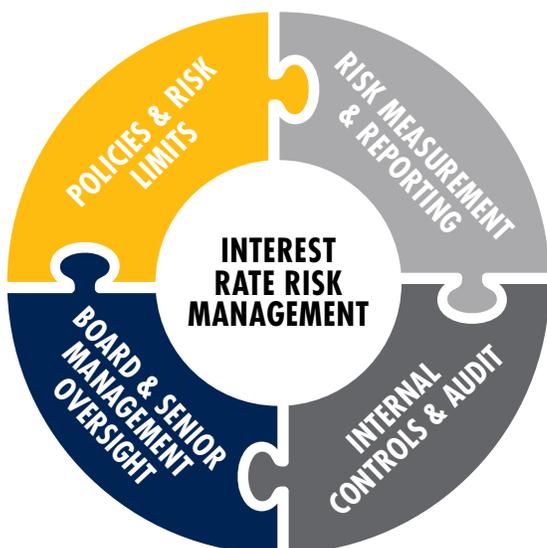
Several years ago, a bank director was quoted as saying “Being a bank director is like being a pilot of an aircraft. It’s years of boredom and seconds of terror.” And while that may have been true at the time, the quote from Yogi Berra, “The future ain’t what it used to be,” speaks to the state of banking today, including the increasing responsibility of community bank boards of directors. In today’s banking space, every bank director has to be confident they understand their overarching responsibility, part of which includes comprehending and overseeing the bank’s exposure to fluctuating interest rates.

### Exposed to Risk

Given banks are in the business of investing short-term deposits in long-term loans, they are inherently exposed to some degree of interest rate risk (IRR). This warrants a risk management program enabling the bank’s directorship and management team to effectively identify, measure, monitor and control this exposure. The diligence and resources devoted to this program should be consistent with the risk and complexity of the bank’s asset and liability mix.

While there are IRR management practices all banks should prudently implement, community banks are not necessarily required to have the same level of sophisticated practices mandated at larger, more complex banking organizations. The graphic below highlights the four fundamental elements for every institution’s IRR management program:

### Four key elements of a risk management program for interest rate risk



### What Directors Need to Know

While many community bank directors have limited exposure to IRR in their own professional careers, they—more than ever—need to have a basic knowledge of the key elements. A few of these elements include understanding the various types of IRR, how the bank’s balance sheet activities can impact its IRR exposure, and how risk measurement reports are used to identify risk exposure. Having this background enables the board to establish quality policies, risk limits, and management governance systems, which results in its effective oversight of IRR.

### Directors Bear Responsibility

Although the responsibility of measuring and monitoring risk can be delegated to bank management and/or board committees (such as an asset/liability management committee or ALCO), all board members are held accountable for the institution’s IRR in the eyes of the regulatory bodies. As part of the examination process, bank examiners assess the board’s engagement in all of the bank’s risk management activities, including IRR. This evaluation encompasses the board’s capacity to appropriately define its risk tolerance, establish appropriate IRR controls, allocate resources to executing established risk management strategies, and hold senior management accountable for implementing board-approved policies.

In light of the current interest rate environment and greater regulatory pressure to have effective practices in place for managing IRR, it’s increasingly important for you, as board members, to understand how and when rate changes begin to impact your bank’s financial condition. To accomplish this, your bank needs an IRR risk management program that allows you and your senior management team to be proactive rather than reactive to rate changes.

Doing nothing is no longer a sustainable strategy in today’s banking industry, but making dramatic changes to your current IRR strategy isn’t necessarily required either. With a sound oversight structure in place, you can effectively steer the bank through whatever challenges may lie ahead.



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# ADA Compliance – It's Not Just About Buildings

Many of us take for granted our hearing, our eyesight, and our freedom of mobility. Put yourself in the position of a person who is visually impaired and try to navigate a website or mobile app. The accessibility of your website could make the difference between someone doing business with you or going elsewhere.

## Websites Neglected

Financial institutions have been sensitive to the accessibility of their physical places of businesses and ATMs by making the necessary accommodations so that all customers can have access and feel comfortable. But many have ignored the possibility that not everyone may be able to navigate their website because of its specific design elements.

## Lawsuits Threatened

Title III of the Americans with Disabilities Act (ADA) prohibits discrimination on the basis of disability in public places. We most often think of public places as physical buildings; however, in this information age, this concept has also been expanded to websites. Despite the absence of finalized laws related to website accessibility, financial institutions and other businesses have been threatened with lawsuits unless they comply. The Department of Justice is scheduled to issue final guidance on the topic in 2018, but until then, you can refer to the World Wide Web Consortium's Web Content Accessibility Guidelines (WCAG) to help develop a compliant website.

## Steps to Take Now

While we wait for final rules on the topic, there are some things you can do to be proactive and hopefully help your organization avoid possible litigation:

- Conduct a self-assessment of your website. In addition to comparing it to requirements outlined in Title III of the ADA and in the WCAG, the U.S. Department of Health and Human Services has provided a list of things to consider on its website, [www.hhs.gov](http://www.hhs.gov).
- Check your website for weaknesses with AChecker (<http://achecker.ca>).
- Review contracts with vendors you use to host your website and other electronic services for their commitment to ADA compliance.
- If you happen to be a target for a potential lawsuit, don't ignore it.

With some planning and conscious due diligence, you can provide an environment of accessibility regardless of a customer's ability.



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# Before You Open That Attachment: Creating a Policy for Avoiding Hackers

Here's a reason to address social media through acceptable use policies in the workplace. The following was published at KnowBe4.com by Stu Sjowerman and is shared here with his permission:

*Bad guys are doing research on you personally using social media and finding out where and when you (might) travel for business.*

*Next, they craft an email especially for you with an airline reservation or receipt that looks just like the real thing, sent with a spoofed "From" email address that also looks legit.*

*Sometimes, they even have links in this email that go to a website that looks identical to the real airline, but is fake. They try to do two things: 1) try to steal your company username and password, and 2) try to trick you into opening the attachment which could be a PDF or DOCX. If you click on the link or open the attachment, your workstation will possibly get infected with malware that allows the bad guys to hack into your network.*

*Remember, if you want to check any airline reservations or flight status, open your browser and type the website name in the address bar or use a bookmark that you yourself set earlier. Do not click on links in emails to go to websites.*

## Have a Policy Ready

With online web-browsing and social media activities a daily norm, we recommend your policies advise employees and customers on best security practices while using social media and email. For example:

- Personal social media accounts (Facebook, Google, Twitter) should be locked down with maximum privacy settings applied to prevent open access to personally identifiable information such as birthdates, location, activities, etc.
- Check with the sender before opening an attachment, even if the email appears to be from another employee or trusted source.
- Do not send confidential data, such as credit card data, customer names, email addresses, and social security numbers through non-encrypted transfer methods. For example, don't perform online mobile banking over public Wi-Fi networks.

Contact a risk advisory specialist for more information and/or policy development guidance.



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# Getting the Grade – A New Consumer Compliance Rating System



You can look forward to a new compliance rating system with your next consumer compliance exam. In November 2016, the Federal Financial Institutions Examination Council (FFIEC) issued an updated Uniform Interagency Consumer Compliance Rating System (CC Rating System). The new rating system was developed to better align with changes that have occurred since the release of the original rating system established in 1980 and takes into consideration the new tailored, risk-based exam approach.

The FFIEC member agencies (CFPB, FDIC, Federal Reserve, NCUA, OCC, and SLC) will apply the new rating system to consumer compliance exams beginning March 31, 2017. The new rating system promises not to generate new examiner expectations or increase the regulatory burden for financial institutions.

## Details of the New System

The new system is designed with an emphasis on evaluating a financial institution's Compliance Management System (CMS). It creates a comprehensive, consistent framework for all member agencies to apply, focusing on consumer protection, self-identification, and proactively addressing compliance issues.

The rating system is based on a five-point scale, with "1" being the highest/best rating and "5" reflecting a critically deficient program. The new exam rating system will focus less on transactional testing and more on the financial institution's CMS, paying particular attention to practices that may cause consumer harm. The new rating system will be applied to all institutions regardless of size, allowing examiners to tailor their activities based on the size, complexity, and risk profile of the institution.

## Guiding Principles

The new CC Rating System was designed based on four key principles:

- *Risk-Based* – Emphasize that a financial institution's CMS will vary based on the size, complexity and risk profile of the organization. Even though the same framework will be applied to all financial institutions, it is not meant to be a one-size fits all.
- *Transparent* – Create uniform rating categories to promote consistency across member agencies.
- *Actionable* – Communicate areas of strength and appropriately emphasize areas for improvement.
- *Incent Compliance* – Encourage institutions to establish a strong CMS that focuses on preventing consumer harm, prompt identification and correction of weaknesses.

The CC Rating System is split into three categories and includes specific assessment factors within each category:

- *Board and Management Oversight* - This should include oversight and commitment to the CMS, effectively support change management, driven both internally and externally, identify and manage risks, and detect and correct weaknesses. Along with this, your board should periodically evaluate your financial institution's needs to ensure sufficient resources are allocated to the compliance program. If third parties are used to supplement your bank's compliance program, there should be on-going due diligence of these vendors.
- *Compliance Program* – This should contain policies and procedures designed for your organization, a training program tailored to staff responsibilities, effective monitoring aimed at identifying potential violations or weaknesses, and a process for addressing consumer complaints.
- *Violations of Law and Consumer Harm* – These are rated based on the root cause, severity and impact of consumer harm created, the duration of the violation, and the pervasiveness of the violation. Identifying violations and correcting them is key, but more important is ensuring prior exam recommendations have been addressed.

There seems to be some common themes throughout the foundation of the new CC Rating System—consumer harm, self-identification and corrective action. It goes without saying that if you have a strong CMS that includes board and management oversight, policies and procedures, training, and monitoring with effective corrective action, your next compliance exam should go well.



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# What Qualifies as a Tax-Exempt Instrument?

Financial institutions have historically been one of the largest purchasers of tax-exempt debt instruments. In addition, many institutions underwrite loans that qualify for tax-exempt treatment. Even with potential tax reform on the horizon, tax-exempt debt instruments likely will continue to be an integral part of many financial institutions' investment strategies. With that said, one of the most frequent questions that arises regarding tax-exempt debt instruments is, what qualifies for tax-exempt treatment?

## Tax-Exempt Notes Versus Bonds

The statutory exemption provided in IRC §103 applies to interest on any state or local bond. However, a state or local bond is defined as an obligation of a state or political subdivision of the state (the term "state" includes the District of Columbia and any possession of the United States). Furthermore, an obligation must be documented or embodied in some written instrument executed by the state or a political subdivision thereof, in the exercise of its borrowing power. Therefore, for tax purposes there is no distinction between tax-exempt notes and tax-exempt bonds.

## Role of Sovereign Power

The first question a financial institution must determine is whether the issuer is a political subdivision of a state. The term political subdivision denotes any division of a state or local governmental unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit.

The three generally acknowledged sovereign powers of states are the power to tax, the power of eminent domain, and the power to police. It is not necessary that all three of these be delegated; however, possession of only an insubstantial amount of any or all sovereign powers is insufficient. All of the facts and circumstances must be taken into consideration, including the public purposes of the entity and its control by the government.

## Nonprofits and Churches

One common misconception is that a loan made to a nonprofit would be considered tax-exempt. However, loans made to these types of organizations are not considered tax-exempt and thus the interest earned on these instruments is taxable.



## Impact of Discounts

Knowing whether a bond or a loan will be treated as tax-exempt is vital when weighing the benefits of such instruments against their alternatives. Additionally, it is important to know the impact of discounts on municipal securities. As many readers are well aware, in a rising rate environment, bonds priced at discounts are more common. If securities are purchased at a discount on the issue date (original issue discount bonds), the difference between the purchase price and the par value is accreted into income and is treated as tax-exempt income. On the other hand, if municipal securities are purchased at a discount subsequent to the issue date, the discount accretion is typically taxed as ordinary income. Therefore, a municipal security purchased at a discount may not have the same tax savings as one purchased at par value. This is important to consider when an institution is comparing the tax equivalent yield of different investment options.

Please contact your tax advisor as your financial institution encounters questions regarding investments in tax exempt obligations.



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# Compliance Corner

## COMPLIANCE HELPLINE AVAILABLE TO CLIENTS

Clients appreciate our Compliance Helpline, which is staffed by compliance professionals who have an average of 18 years of industry experience. These professionals respond to questions immediately, or within 24 hours if research is needed.

The Compliance Helpline can be reached Monday through Friday 8 a.m. – 5 p.m. at:

**855.239.8676**  
**compliancehelp@eidebailly.com**

# COMPLIANCE HELPLINE Q&A

**Q: What should I be doing in preparation for the upcoming BSA beneficial ownership requirements?**

**A: Start an implementation plan that includes the following:**

- Update BSA, OFAC, CIP and any other applicable policies.
- Update written procedures for new account opening, CTR, OFAC, SAR and any other applicable procedures.
- Update forms, such as signature cards, new account worksheets and the new certification form.

- Review core system changes and updates including the ability to collect additional CDD information.
- Develop training materials and schedule training for the staff.

The BSA Beneficial Ownership Rule is required on covered entity accounts opened on or after May 11, 2018. ■

*We recommend you refer to your specific state's statutes for requirements required in your state.*

## COMPLIANCE REMINDERS/DUE DATES

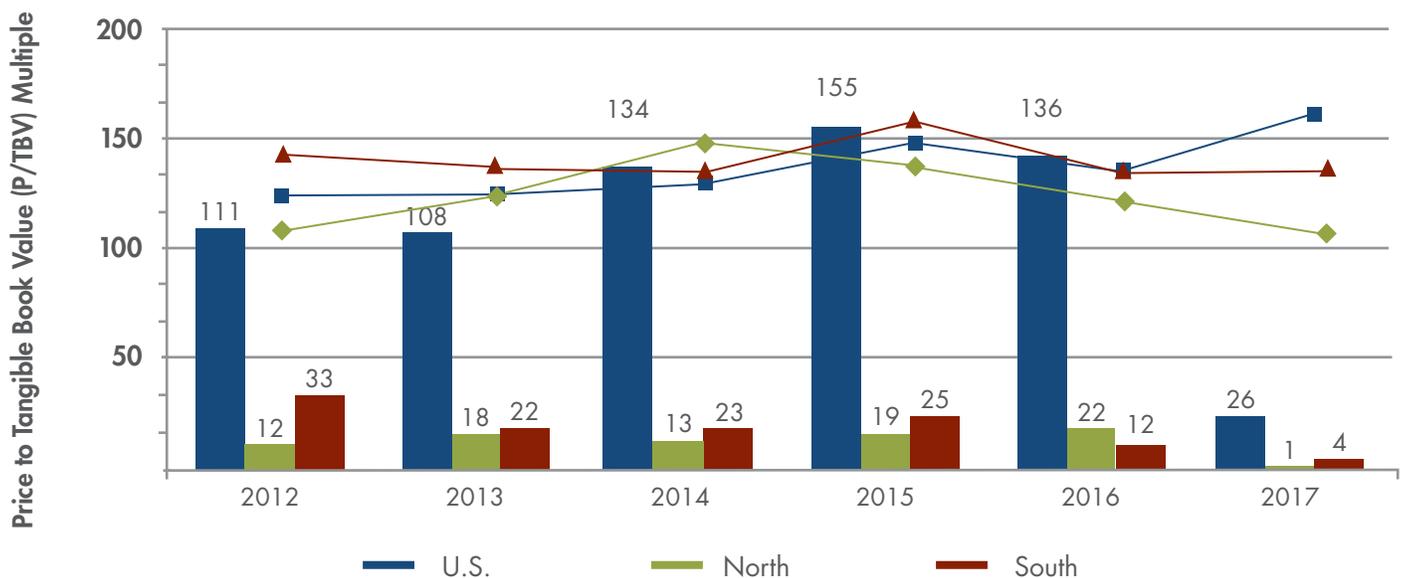
	Regulation	Description
March 31, 2017	FFIEC – Call Report	The FFIEC approved changes to the call report for eligible small institutions. To be eligible for the new forms, institutions must have only domestic offices and total assets of less than \$1 billion. Institutions may use the new forms beginning with the March 31, 2017, or June 30, 2017, report dates. They may also choose to introduce the new forms on the March 31, 2018, report date if implementation is not possible in 2017.
	FFIEC – Interagency Consumer Compliance Rating System	The FFIEC has finalized guidance setting forth a revised uniform interagency consumer compliance rating system (CCRS). The revised rating system uses a scale of 1 through 5, with 1 representing the highest rating and lowest degree of supervisory concern and 5 representing the lowest rating and most critically deficient level of performance and thus the highest degree of supervisory concern. Implementation of the revised rating system for consumer compliance examinations began March 31, 2017.

# M&A Corner

The following data was compiled from information provided by SNL Financial LC. The data includes all completed transactions reported with pricing information available for the time period January 1, 2012, through March 31, 2017. The data for the North category includes all completed transactions reported with pricing information available in Iowa, Idaho, Minnesota, Montana, Nebraska, North Dakota, Oregon, South Dakota,

Washington, Wisconsin and Wyoming. The data for the South category includes all completed transactions reported with pricing information available in Arizona, Colorado, Kansas, Nevada, New Mexico, Oklahoma, Texas and Utah. The data did not include any government assisted transactions, branch acquisitions, or savings banks/thrift transactions.

## Bank Transaction Data U.S., North and South Regions 1/1/2012 – 3/31/2017



The bar graphs represent the number of transactions for which we have pricing data. In addition to the transactions summarized in the chart, there were 426 transactions in the U.S. since the beginning of 2012 for which pricing data was not included. Of those, 150 transactions were in the North region and 102 were in the South region.

	North	South
Geography	The database reported transactions in Iowa, Nebraska, North Dakota, Oregon, and Wisconsin.*	The eight transactions in 2017 were from Kansas (6) and Texas (2).*
Target Size	Four of the seven banks sold so far in 2017 had assets less than \$100 million.*	The largest target of the database transactions for 2017 had \$185 million of assets.*
Multiples	Although the average multiple for 2017 appears low, remember that only one transaction hit the database.	The limited data suggest multiples may be holding steady from 2016.

\*includes transactions for which pricing data was not available.



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## New Financial Institution Partners at Eide Bailly

We would like to congratulate the following financial institutions service group professionals for being accepted into the partnership at Eide Bailly on May 1.



### **Blake Crow**

Expertise: Tax planning and consulting  
Office: Sioux Falls, South Dakota



### **Tom Fogerty**

Expertise: Audit, accounting and consulting  
Office: Sioux Falls, South Dakota



### **Debbie Potter**

Expertise: Tax compliance, business advisory and consulting  
Office: Billings, Montana



### **Mitch Rasmussen**

Expertise: Audit, accounting and consulting  
Office: Spokane, Washington