The RMA Journal®

The Journal of Enterprise Risk Management

June 2013

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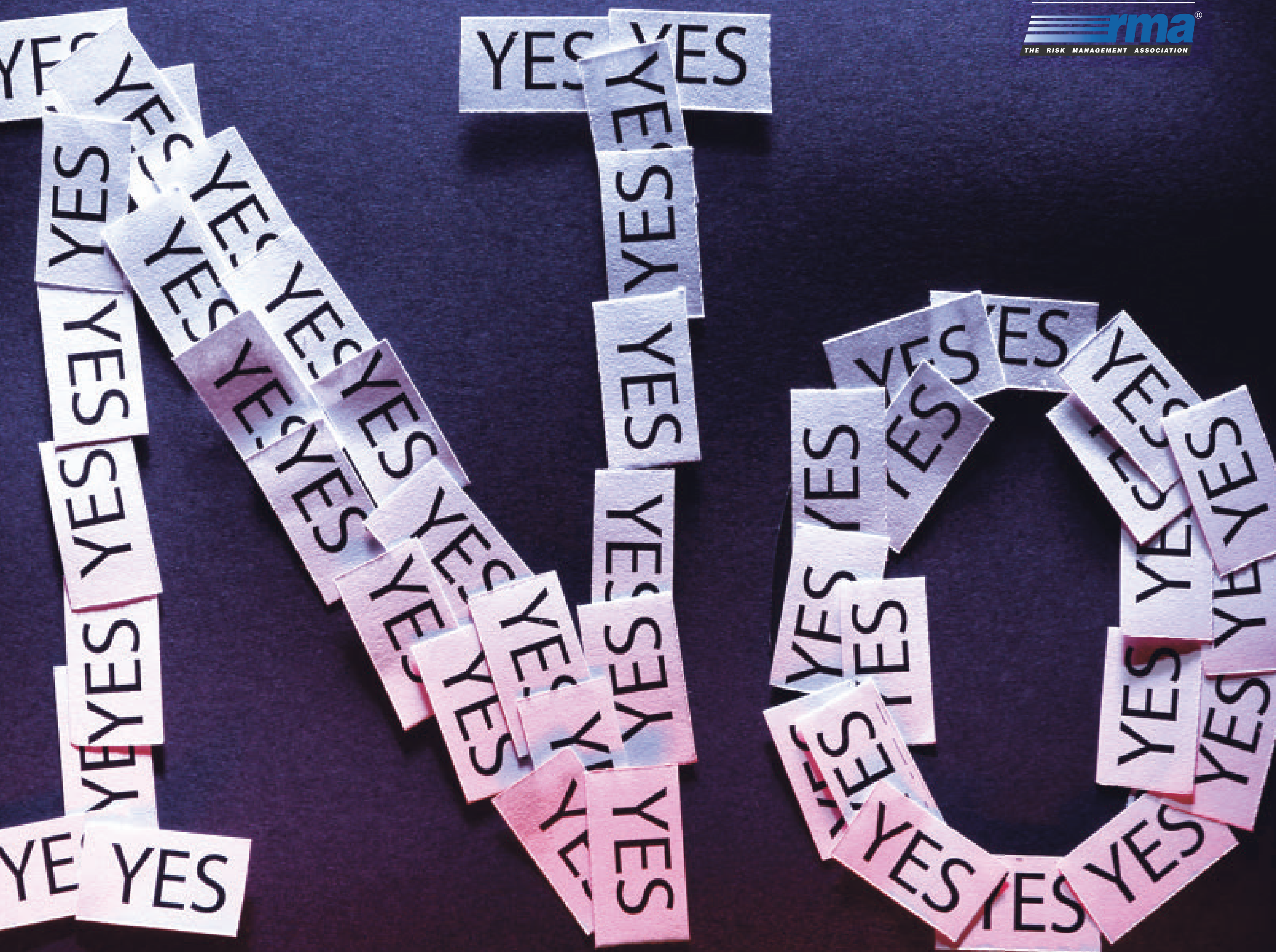

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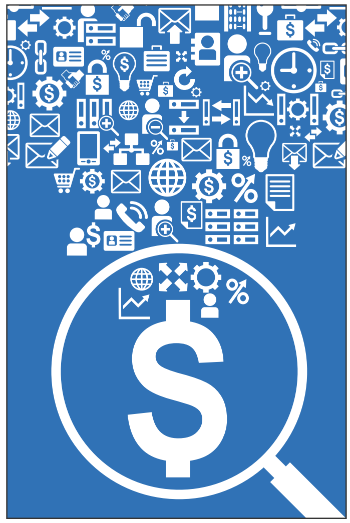

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Calendar of Events

RMA Services | www.rmahq.org

For a complete listing of educational opportunities, please visit the RMA website, www.rmahq.org.

JUNE 2013

Health Care Lending Forum
June 6-7, 2013
Philadelphia, Pennsylvania

Advanced Risk Management Practices in Asset Management Activities
June 10-11, 2013
New York, New York

Best Practices in Asset/ Liability Management: A Focus on Liquidity and Market Risk
June 10-11, 2013
Chicago, Illinois

Credit Department Management Forum
June 10-11, 2013
Baltimore, Maryland

Introduction to Securities Lending
June 11, 2013
Chicago, Illinois

Understanding Credit Derivatives and Structured Products
June12-13, 2013
New York, New York

Commercial Real Estate Lending Forum
June 20-21, 2013
Chicago, Illinois

Loan Review Department Managers Forum
June 20-21, 2013
Chicago, Illinois

Operational Risk Management Discussion Group
June 25-26, 2013
Las Vegas, Nevada

JULY–NOVEMBER 2013

Credit Portfolio Management Workshop
July 24-25, 2013
Philadelphia, Pennsylvania

Operational Risk Management Discussion Group
September 10-11, 2013
Chicago, Illinois

Model Risk Management Best Practices
September 19-20, 2013
New York, New York

Market Risk Models: How to Effectively Use Them to Measure and Manage Market Risk
October 14-15, 2013
New York, New York

RMA Conference on Securities Lending
October 14-17, 2013
Boca Raton, Florida

Stress Testing Liquidity for Banks
October 16, 2013
New York, New York

Modeling Treasury Banking Books: Best Practices
October 17-18, 2013
New York, New York

Operational Risk Management Discussion Group
October 22-23, 2013
San Francisco, California

Sovereign Risk: Evaluating Country Risk
November 6, 2013
New York, New York

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November 7-8, 2013
New York, New York

RMA Annual Risk Management Conference
November 17-19, 2013
Philadelphia, Pennsylvania

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RMA Is Customized for You

RMA was formed almost 100 years ago because credit professionals wanted an association through which they could exchange credit information. Today, of course, credit risk is only one of many risks that can severely impact a bank. RMA has evolved through the decades to help risk professionals manage risk across the entire enterprise. Our members' roles and their needs have changed, and they continue to change at a pace our founders would have thought as unimaginable as a bank with an asset size of $500 billion.

What our past and present members have in common is the value they derive from RMA membership. Whether you're new to the profession, in mid-career, or hold a senior leadership position at your bank, you joined RMA because it offers an opportunity for you to learn, to associate with colleagues with similar interests, to develop leadership skills, and to advance your career.

While many of our members are centered exclusively on credit risk disciplines, others focus their attention on the many operational risks that confront banks. Still others are vigilant about market risk issues, especially in this low-interest-rate environment. Community bank members sometimes perform all of these functions, while large-bank members often have responsibility for a single specialized area. We also have a sizable membership that works in the securities lending niche.

I assure you that RMA wants to serve all risk professionals by providing you with information, services, and products that are relevant to you, regardless of the asset size of your bank or the length of your resume. We recognize that there are many ways to receive information today, and we want to be sure we deliver what you need in the format most convenient for you.

Whether you prefer an instructor-led classroom environment, a Webinar, or an audio conference, we do our best to meet your needs. For those who prefer reading electronically, we rolled out *The RMA Journal* app a few months ago.

Along the lines of electronic communications, RMA has made a commitment to cut down on the number of e-mails we send to our members by offering you the opportunity to receive only those that are relevant to you. With our new opt-in or opt-out program, you can let us know which topics are of most interest to you.

To manage your e-mail preferences, simply log onto www.rmahq.org. Scroll down to "My Membership" and then to the last bullet, "Manage My Communications Methods." You can also manage your preferences by using the link to that page that's built into every e-mail you receive from us. Our goal is customize your RMA experience, making sure our communication with you is tailored to your own needs and interests.

Finally, I want to conclude this letter by encouraging you to attend our Annual Risk Management Conference in November. We'll be celebrating a century of promoting sound risk management and discussing some of the challenges facing the industry today. More details will follow. Be sure to check our website. ❖

Bill Githens

Bill Githens, CRC | RMA President and CEO
bgithens@rmahq.org

The RMA Journal, April 2013 | J. Tol Broome Jr., CRC

Tol Broome's article in the April 2013 issue of *The RMA Journal* ("King Kong Versus Godzilla: Developing Effective Relationships Between Lenders and Credit Officers") was excellent! I forwarded it to everyone in our region as recommended reading. I have gotten a lot of great feedback from both King Kongs and Godzillas. Thanks to Tol for the direct, yet insightful, approach to the dynamic tension we experience each day.

Adam Jackson
BB&T
Charlotte, North Carolina

As a member of the faculty of the Graduate School of Banking and instructor at several other bank schools, Tol Broome's article struck home with me.

I've been on both sides, created credit administration departments, and had to break the stereotype of "hunters and skinners." I try to teach the same points for both sides and demonstrate pitfalls that easily entrap and defeat the common goal.

Tol's article was a great read, made great points, and had a message for both lenders and underwriters.

Shrinking silos takes daily practice of mutual respect and support for the most effective loan decisions. His article addressed the topic with a fun flair…kudos to Tol!

Michael Wear, CRC
First National Bank of Omaha
Omaha, Nebraska

The RMA Journal, April 2013 | Dev Strischek

I have just read the interview Dev Strischek did with the AICPA's Robert Durak about the new financial reporting frameworks ("AICPA Proposes New Financial Reporting Framework for Small and Midsize Companies," April 2013). I just want to mention that Dev's question on page 16 about loan agreement covenants is particularly relevant.

Community banks that I work with have loan agreements, which require that financial statement information be according to GAAP. I believe that all use LaserPro for loan agreements. Unfortunately, sometimes the GAAP requirement is included even when the only financial statements to be submitted are tax returns, company-prepared financial statements, and self-prepared personal financial statements. Thus, the GAAP requirement may leave some borrowers always out of compliance. I do not know how the documentation vendors and banks will deal with the loan agreement aspects of the new frameworks, although the documentation providers probably should be brought into the discussion.

Mark Zoeller
Zoeller Credit Risk Services
Coursegold, California

The RMA Journal, April 2013 | G. Jason Goddard

Thank you for Jason Goddard's informative article on lending to hotels in the April 2013 issue ("Hotels: The Fifth Food Group"). I am currently looking at a construction/perm deal for a hotel developer/owner and this information will help with my analysis.

Chris Clemmons
Carolina Bank
Greensboro, North Carolina

Thank you for your article on hotel lending. It is a tremendous value-add for my team.

Keith A. Covington
Wells Fargo Bank
Birmingham, Alabama

Correction: In the April issue article, "Only Cash Pays Loans: Let Us Count the Ways to Measure Cash Flow" by John Barrickman and Christine Corso, a calculation in Table 2 was mislabeled "Traditional Cash Flow" when it should have been "EBIDA." Also, a paragraph was omitted toward the end of the article that addressed using UCA in a debt service coverage calculation. A corrected version of this article appears on RMA's website. We apologize for any confusion resulting from this error.

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Letters to the Editor

The RMA Journal *welcomes letters from our readers. Letters can be e-mailed to* kbeans@rmahq.org, *or mailed to Kathleen M. Beans, Editor,* The RMA Journal, *1801 Market Street, Suite 300, Philadelphia, PA 19103. We look forward to hearing from you.*

May 2013 issue of The RMA Journal

The RMA Journal®
The Journal of Enterprise Risk Management

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The RMA Journal

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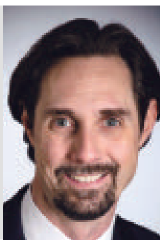
(His article can be found on page 64)

John Cassis, CRC, is a special assets workout officer for Wells Fargo Bank in Fort Lauderdale, Florida. He is also a member of the Editorial Advisory Board of *The RMA Journal*.

(His article can be found on page 18)



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(His article can be found on page 46)

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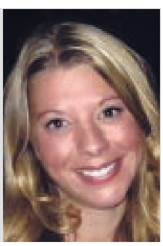
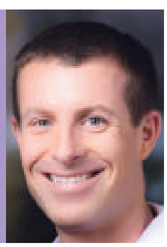
(His article can be found on page 38)



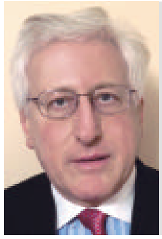
Erin Hubbard is director of marketing and implementation manager, St. Meyer & Hubbard.

(Her article can be found on page 34)



Jack Huntress is managing director, residential services, Environmental Data Resources.

(His article can be found on page 38)

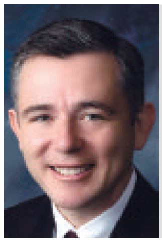


Robert Kennedy recently retired from the Federal Reserve Bank of Atlanta after 28 years of service.

(His article can be found on page 64)

George R. Mann is managing director, Collateral Evaluation Services LLC.

(His article can be found on page 46)



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(His article can be found on page 26)

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(His article can be found on page 12)

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(His article can be found on page 58)

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(His articles can be found on pages 52 and 72)

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(His article can be found on page 74)

Loan Officer Compensation and Bank Performance

Investing wisely in loan officer compensation can pay dividends for community banks.

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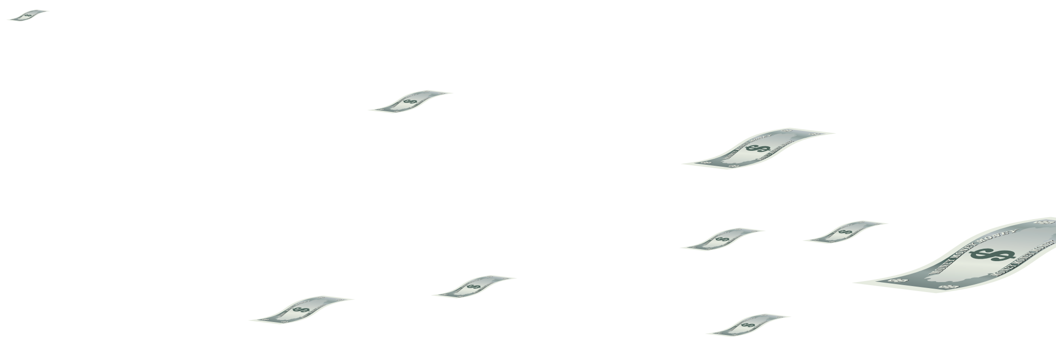

BY JAMES E. MCNULTY AND AIGBE AKHIGBE

FOR COMMUNITY BANKS, the human capital of loan officers and their credit judgment are a major source of value creation. Loan officers lending to small and medium-size businesses should identify and fund positive net-present-value projects—and reject the others. In doing so, loan officers create revenue for the bank and the business, minimize loan losses, and generate economic growth in the local area.

Given their skill requirements, compensating and retaining qualified lenders is a constant challenge for community banks. In November 2012, the *Wall Street Journal* reported on a survey showing that the average compensation package for commercial loan officers was up 17% in 2012 to $101,376, a result of the critical shortage of people with the required expertise.[1]

But banks must control costs. Consider the situation of senior managers at a community bank reviewing a salary survey for business loan officers. Should they offer salaries at the higher end of the range to attract the very best prospects and take other steps to retain highly competent personnel? The results of one study suggest an affirmative answer to this question.[2]

This article first considers how financial theorists view a bank's monitoring process and the role loan officers play in it. It then discusses what the empirical models say about the relationship between loan officer compensation and a bank's financial performance.

Bank Monitoring in the Theory of Finance

As defined by researchers, monitoring is the act of obtaining private information about the borrowing firm through its multiple interactions with the bank.

Indeed, it is through the bank-borrower relationship that banks obtain information about a business borrower's creditworthiness. One source of information is the borrowing firm's checking account at the lending bank. Monitoring this account should provide an early warning about a firm experiencing a sudden and sharp decline in sales, unexpectedly high expenses, or other financial problems.

A broad definition of monitoring also includes the initial screening effort. Clearly, this is where most undesirable business loans should be identified. The project to be funded should be a positive net-present-value project—that is, the present value of the expected cash flows from the project must exceed the cost—or the firm will have difficulty repaying.

Theoretical studies have suggested additional reasons why banks that invest more resources in monitoring should have better financial performance.

Information is costly to obtain, but it is often reusable, so it can be employed to monitor other borrowers.

Moreover, a bank has overlapping generations of loan officers. Since every local market is different, it is important for the more senior officers to pass their specialized knowledge of the local economy and business community on to others. Specialized knowledge by sector is also valuable, and banks focusing on certain types of businesses have an information advantage when lending to them. For both reasons, there should be a strong incentive to invest in loan officers who have superior information-production and information-processing skills.

Ideally, the result will be a bank with a strong credit culture based on monitoring and bank-borrower relationships.

There should be a strong incentive to invest in loan officers who have superior information-production and information-processing skills.

Loan officers and senior management should understand that lenders perform a better service for the bank when they reject a bad loan than when they recommend a marginal one. Loan officers compensated even in part on volume do not have an incentive to do this.

Design and Results of the Study

As discussed, monitoring is beneficial, but it is also costly. Do the benefits outweigh the costs?

Consider the Reports of Condition and Income (call reports) for all banks following the commercial lending business model as defined by the FDIC.[3] These banks have 25% or more of their total assets in commercial and industrial loans, real estate construction and development loans, and loans secured by commercial real estate properties. The FDIC finds that these banks account for over half the industry in terms of number of banks.

We restrict our sample to banks following this business model and in existence for the entire seven-year period from 1999 to 2005. This comes to 2,295 banks per year, for a large total sample of 16,065 bank-year observations. Most of the sample would be described as community banks using any reasonable definition of the term. There are no mega banks in the group, although our largest bank—headquartered in Cincinnati, Ohio—had a substantial $194 billion in total assets in 2005.

Two economic concepts are used in our study: the "monitoring proxy" and "profit efficiency" (both are defined below). We estimate an equation using multiple regression analysis, which is a standard research technique. The key point to understand is that the equation describes the average relationship between the variables shown by the 16,065 observations in the sample. The sign of the coefficients tells us whether the relationship is positive or negative.

Loan monitoring cannot be observed directly, and loan officer salaries are not shown separately on the call reports. The call reports do, however, provide information on total salaries and benefits. Thus we follow a procedure developed in two earlier studies by Ian Sharpe and his coauthors:[4] We calculate a monitoring proxy for each bank, using the ratio of salaries and benefits to total noninterest expense—the *salary ratio*.

Sharpe's essential insight is that differences in salary ratios among banks should partly reflect the quantity and quality of labor input into the bank monitoring process. Loan officer salaries are a large component of total personnel cost, and at the margin banks that compete actively for the best loan officers should have a high ratio of total salaries and benefits to total noninterest expense.

Ratio of Salaries to Total Noninterest Expense

	2000	2005	2009
Top quartile	0.5711	0.5930	0.5439
Median	0.5340	0.5558	0.4990
Bottom quartile	0.4941	0.5147	0.4404

Why do researchers use total noninterest expense rather than assets or total employees in constructing the ratio? Because expense control is important to bank performance. Other things equal, banks with higher ratios of salaries to total noninterest expense have lower total noninterest expense than other banks.

The proxy was vetted in the two Sharpe studies and it produces the expected results. One of the studies shows a statistically significant positive relation between the proxy and both interest rates on business loans and loan maturities. The other study finds a positive relation between the proxy and excess stock market returns to a borrowing firm when it is announced that a commercial bank has made a loan to that firm. As will be shown, the proxy also works in our study.

To calculate the monitoring proxy, we use statistical techniques to control for the other factors affecting salary ratios.[5] For example, we find, not surprisingly, that a bank with higher fee income relative to assets, or a higher percentage of the loan portfolio in commercial and industrial loans, has a higher salary ratio. Both these activities require more personnel and hence greater salary expense.

The monitoring proxy shows how an institution's salary ratio compares to the sample *after* we control for the other factors. A high proxy suggests that a bank invests more resources in monitoring.

The table shown above can help in determining how your bank's salary ratio, easily calculated from call report data, compares to that of other banks. Banks with ratios above 59.3% in 2005 would be in the top quartile; those below 51.5% would be in the bottom quartile.

The data in the table does not reflect the regression analysis adjustment. The raw data might show a higher ratio for

In business lending, the job of the loan officer is not to produce more loans. Rather, it is to produce good information about the borrower.

your bank than the adjusted data if you have substantial fee income, a large portfolio of commercial and industrial loans, or both. In this case, the monitoring proxy for your bank would be lower than the raw numbers indicate.

We estimate the statistical relationship between our proxy and bank financial performance, which brings us to "profit efficiency"—the efficiency of the bank in generating profits.

In a number of earlier studies, we estimated an efficient frontier for the U.S. commercial banking industry. Profit efficiency measures how close each bank is to the frontier. Although we look at financial results, not practices, a bank on the efficient frontier is, in effect, a "best practices" bank. The banks on the frontier generate the largest net income from a given balance sheet.

Academic researchers do not consider return on assets (ROA) and return on equity (ROE) to be the most scientific measures of a bank's financial performance. ROA and ROE are affected by asset composition, liability composition, bank size, fee income, local market competition, risk, and other variables. Profit efficiency analysis controls for all these factors and captures the essential aspects of financial performance. For the banks in our study, the correlation coefficient (R^2) between profit efficiency and return on assets is 49%.

Significantly, we find that our monitoring proxy is one of the most substantial variables affecting a bank's financial performance (profit efficiency) in the sample period. It has the second-largest effect after fee income.

We also divide our sample into two subsamples. The small-bank sample includes all banks with total assets below the median ($167 million) in 2005, the latest year for our sample. The large-bank sample consists of banks above the median.

The relationship between the proxy and bank performance holds only for the large-bank sample, but that sample accounts for 94.3% of total bank assets in 2005. This result is important because it makes clear that the results are *not* being driven by the large number of very small banks in smaller markets where profitability is often higher because of limited competition. That 94.3% of assets are in banks above the median size is not at all surprising. It simply reflects the small size of many banks in the industry, resulting in a low level of total assets for all the banks in the small-bank sample.

We ran additional tests to determine if our results are robust to different data and different versions of the model. Our finding is that if we use a sample of all banks in existence for any year in the sample period, rather than just those in existence for the entire period, the results are essentially the same. However, using the ratio of salaries to assets or salaries to employees does not produce as strong a monitoring proxy.

The Monitoring Proxy Predicts Loan Losses

A second closely related result is that more monitoring results in lower loan losses. While this result is not surprising, we find that our proxy predicts loan losses *up to four years ahead,* for each of the years 2006 through 2009, with high statistical significance.

Specifically, for each of the four years the proxy predicts three measures of bad loans: 1) nonperforming loans, 2) charge-offs, and 3) loan loss provisions. For each year, the monitoring proxy is significant at the 1% level. We consider this result remarkable since it is unusual to find that high a level of statistical significance consistently in every test.

Sharpe's proxy clearly does measure a bank's monitoring effort. Not surprisingly, banks that have a high investment in monitoring appear to have weathered the financial crisis better than others.

Loan Officer Turnover Hurts Banks

The results of high loan officer turnover can be dire, as any expert witness on banking practice and lender liability can tell you. Opportunists move from one bank to another. Some make careless mistakes; others are motivated to get a loan on the books regardless of its quality. There are loan officers who fail to communicate appropriately with the borrower, to properly document the loan file, to renew Uniform Commercial Code liens, to apply payments properly, or to be certain that a previous mortgage is paid off before writing a new first mortgage.

Of course, higher salaries do not prevent carelessness. But carelessness and self-dealing should certainly be less prevalent at a bank with a good, values-driven credit culture. In such a culture, with its stable atmosphere, loan officers recognize that their interests are intimately tied to the long-run value of the bank.

In business lending, the job of the loan officer is not to produce more loans. Rather, it is to produce good information about the borrower. Good loan officer compensation programs must recognize the difference.

One final point about salaries and bank performance: Studies other than this one find that high-performance banks do a better job of controlling expenses than other banks do. Although these higher-performance banks pay higher-than-average salaries, their turnover is lower and their assets per employee are higher. Hence, somewhat higher salaries paid to higher-quality lenders do not necessarily result in higher costs.

Conclusion

We find that banks with more investment in loan monitoring have better financial performance than other banks and that the effect of monitoring on overall bank performance is large.

Paying near the higher end of the ranges shown in loan officer salary surveys and taking other steps to retain competent commercial loan officers would appear from the data to be a wise strategy in building and maintaining a high-quality loan portfolio. ❖

***James E. McNulty** is professor of finance at Florida Atlantic University, Boca Raton, Florida. He can be reached at* mcnultyj@fau.edu. ***Aigbe Akhigbe** is Moyer Chair and professor of finance at the University of Akron, Akron, Ohio. He can be reached at* aigbe@uakron.edu.

Notes

1. See "Lending Skills in Demand," *Wall Street Journal,* November 26, 2012. Of the 405 banks participating in the survey, 270 have less than $500 million in assets. Survey highlights are available at www.crowehorwath.com.

2. See "Bank Monitoring, Profit Efficiency and the Commercial Lending Business Model," A. Akhigbe and J. E. McNulty, *Journal of Economics and Business,* November 2011.

3. See Quarterly Banking Profile, Federal Deposit Insurance Corporation, 2004.

4. See "Does Bank Monitoring Influence Loan Contract Terms?" A.D.F Coleman, N. Esho, and I.G. Sharpe, *Journal of Financial Services Research,* 2006; and "Does a Bank's Loan Screening and Monitoring Matter?" K.W. Lee and I.G. Sharpe, *Journal of Financial Services Research,* 2009.

5. The procedure is a fixed-effects regression analysis, which produces a separate coefficient for each of the 2,295 banks. This coefficient shows, on average for the seven-year period as a whole, how that institution's salary ratio compares to those of the other banks *after* controlling for the other factors.

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Going With the Flow (After Distributions)

Cash flow after distributions can potentially give a borrower control of the repayment analysis. This article examines how this happens and explores ways to avoid it.

BY JOHN CASSIS, CRC

ANYONE INVOLVED IN commercial lending for any length of time will notice trends in underwriting practices. Techniques evolve as we observe and learn more about the process of lending.

One of the more recent and widespread trends has been the switch from cash flow to *cash flow after distributions*. This measure has become ubiquitous in U.S. banking. It has even migrated from credit analysis into financial covenants. It is unclear what's driven the mass adoption of cash flow after distributions, but it looks like it's here to stay.

This article will examine the benefits of measuring cash flow after—instead of before—distributions. It will review how the calculation is used in analysis and its impact on loan covenants. Finally, it will take a look at some shortcomings to using this method and discuss ways to obtain the benefits while avoiding the problems. For simplicity of discussion and calculation, this article will define cash flow as EBITDA (earnings before interest, taxes, depreciation, and amortization).[1]

Two Reasons for the Change

Why cash flow after distributions? There are typically two responses. The first is that distributions are taken by the owners to pay income tax and thus are required payments by the company. The second response is that owners will pay themselves back before they'll pay the bank. Both reasons make a lot of sense. There must be additional reasons, but we'll at least address these two.

To Account for Taxes

Most businesses that are not publicly traded are structured as Subchapter S corporations (S corps) or limited liability companies (LLCs). These structures are used by the large majority of small and mid-sized businesses we analyze. Their key characteristic is that they do not directly pay income taxes; the tax is passed through to the individual owners, who are responsible for paying their share. This differs from a Subchapter C corporation (C corp), which is directly responsible for paying tax on its own profits.

When an S corp or LLC reports a net profit of $200M, for example, this doesn't account for income tax due. If we used the $200M directly in our analysis, we'd be missing a significant expense because the tax is not directly paid by the business.

What often happens is that the owners will take a distribution from the company to pay their share of the tax personally. In our example, let's say that income tax due is $40M. Distributions to the owners might then be a corresponding $40M.

The key problem is that there is absolutely no certainty regarding the size of a distribution the owner will take. It can be completely arbitrary.

Since accounting reflects a distribution as an equity-related transaction and not a deduction from revenue, it doesn't appear as an expense on the income statement. But if the corporate entity were a C corporation instead of an S corp or an LLC, that income tax would be shown as an expense on the income statement, and net income would be reported after income tax expense. We are facing a major difference in net profit and cash flow simply because of our borrower's corporate structure.

So should we account for the income tax of the pass-through entities or not? The trend in underwriting has been a decided yes, as profits generated by businesses with other structures generate a matching income tax obligation. There are other "off-income-statement" cash outlays for which analysts must remain vigilant as well. Current portion of long-term debt is not an expense, but must be accounted for either in debt service or in cash flow when using EBDA (earnings before depreciation and amortization). Also, recurring mandatory capital expenditures do not appear as an expense on the income statement, but must be deducted from cash flow when present. Our "phantom" income tax, then, would be another entry in this off-income-statement category.

Owners Paying Themselves before Paying the Bank

Whenever we see a distribution of cash from the business to the owner, it is important to ask the following: Did the borrower pay the bank first and then distribute funds to the owners to cover taxes and other personal needs? Or did the borrower pay its owners first and put the bank second?

Basic finance principles suggest that a creditor always gets paid before the equity holders. This is evidenced by the fact that yields on bank debt and bonds are lower than expected returns on common stock, suggesting that debt is safer than equity. Cash flow is believed to be available to pay obligations on company debt before the owners are paid. Indeed, if that's not the case, creditors can force the company into liquidation in order to receive their payment. In the case of bankruptcy, those creditors will have a priority interest over the shareholders.

This basic principle theoretically should apply to all businesses. However, bankers have found that sometimes, especially when times are difficult, owners of a business will strip profits from their companies and transfer them to their own pockets. This might not be as significant a concern when the owners are guarantors and are cooperative. While this is usually the case, both factors are not present 100% of the time.

For this reason, bankers will sometimes take the default approach of assuming that owners will pay themselves before they pay the bank. When this is the case, bank debt is effectively viewed as junior to shareholder equity. Thus all payments to owners are viewed as the equivalent of an expenditure that must be made before payments to the bank.

The Variable Nature of Distributions

We've seen why a business will pay distributions to owners to cover taxes. The argument for using cash flow after distributions for income taxes seems pretty logical and hard to counter. But when we start looking at cash flow after all distributions (not just after distributions for income taxes), problems begin to develop.

The key problem is that there is absolutely no certainty regarding the size of a distribution the owner will take. It can be completely arbitrary. Let's explore some scenarios that can drive the amount and timing of distributions:

- **Distributions to pay income taxes are not always taken.** The theory is that business owners will distribute at least enough to pay income taxes. However, I have seen many circumstances in which a business was very profitable and income tax was due on that profit, but the owner took no distributions. It's possible the owner had enough personal cash on hand and simply made the "executive decision" to pay the tax that way. Or maybe there was a loss carry forward that shielded the current year's income.
- **Distributions to pay this year's income taxes are not always made this year.** Many owners make quarterly payments to the IRS to cover income taxes. Others do not and wait until the company's taxable income is known. This is especially true when the business has a good year and it distributes excess cash flow as a bonus. That means income tax is not paid in the year the profit is earned, but in the following year (and sometimes it's paid over two years). If the owners take the distributions after the fiscal year ends, then the analyst might be facing a distribution figure in 2012 that actually relates more to profit from 2011. But the analyst probably won't know for sure.
- **Distributions include payout of excess cash on hand.**

Not only is it possible to pay out all of the cash flow generated in a given year, but it's also possible to exceed that. If a company is carrying cash in excess of what's needed to support operations, management may decide to make a special one-time distribution to the shareholders. This extra distribution would get counted in our calculation of cash flow after distributions. And if the total distribution exceeded the cash flow, we'd be analyzing a negative number.

- Distributions arising from asset sales and other nonrecurring events. Sometimes a business will experience an unusual or one-time windfall. One example would be proceeds from the sale of an asset that did not need replacing. Another might be when the borrower prevails in a lawsuit. As with distribution of excess cash, such distributions do not necessarily have any bearing on income taxes or the cash flow of the business.
- Distributions in other forms. "Distributions" are typically defined as payments of cash dividends or property distributions, if they are defined at all. However, another trend I've seen involves the payment of cash by the business to its owners as a shareholder receivable. This payment does not affect the distributions figure related to equity and instead causes an increase in the balance sheet asset "note receivable–shareholder." Thus, it's possible for the owner to take money out of the company without it being reflected as a distribution. If the analyst is not careful and the covenant is not properly worded, this payout would be missed.

The scenarios above show us that distributions can vary between zero and greater than 100% of cash flow. When we use straight cash flow after distributions, this can be a problem. Simply stated, our analysis now includes a component that does not follow any rules related to what's available to repay the bank. It is a wildcard, and if we don't establish guidelines that allow us to maintain consistent and meaningful treatment of cash flow, this wildcard will filter into our debt service coverage (DSC) analysis and eventually into our (possibly incorrect) decision to approve or decline a loan.

We'll think through some guidelines to help us neutralize the random nature of distributions shortly. But first, let's imagine that our borrowers knew we bankers were facing this little dilemma. Certainly, the possibility would exist for the borrower to influence the distributions wildcard and thus our entire repayment analysis. In general, bankers don't share underwriting guidelines with borrowers. However, when the guideline is so important that it can alter a bank's willingness to write a loan, it makes sense to make the borrower aware.

Giving the Borrower Control of Your Analysis

We make the borrower aware of our guidelines through loan covenants. In the case of a cash flow covenant, we let the borrower know that if defined cash flow falls below a certain level in proportion to debt service, then the anticipated risk in the transaction has changed and the bank reserves the right to reconsider the relationship.

Since bankers are trending toward cash flow after distributions as a key repayment measure, it's no surprise that this measure has made it into the loan covenants with great regularity. In many cases, "distribution" is not a defined term. As a result, the banker, customer, and customer's accountant will view "distribution" as a dividend. If the banker intends to characterize all payments from the company to the owner as distributions, the banker must specify that. Otherwise, it would be impossible to enforce this intention when a dispute arises.

So now the borrower and the borrower's accountant are aware of a key underwriting measure. While they cannot legally control or alter the "cash flow" portion of this measure, they can freely and legally control the "after distributions" portion. This is not to suggest nefarious behavior on the part of the borrower or the accountant. But the potential for manipulation is there, and if the banker does not word the covenant carefully, it is likely to happen at some point in the future. When the banker uses cash flow after total distributions, the DSC calculation and all the decisions based on it become prisoners to the random whim or calculated intention of the borrower.

Let's take a look at how the borrower could potentially employ any of the scenarios above to alter compliance with the covenant and DSC used in the banker's underwriting:

- Distributions to pay income taxes are not always taken. This one is self-evident. If the borrower has other means, such as having cash or securities, borrowing from family or a home equity line, or taking a larger distribution from another owned business not part of the covenant, it can skirt around the need to pay a distribution. In this case, the banker won't even account for income tax resulting from the company's taxable income.

> When the guideline is so important that it can alter a bank's willingness to write a loan, it makes sense to make the borrower aware.

- Distributions to pay this year's income taxes are not always made this year. Deferring a distribution to a later period is a simple thing to do. Most borrowers believe that "next year will be better," so some might figure that charging distributions arising from this year's profit against next year's income will help avoid a possible covenant default based on this year's financial results. Then when analyzing next year's cash flow, the banker mismatches it with the prior year's distribution for income tax.
- Distributions in other forms. Taking cash out of the

business in the form of a shareholder receivable is the easiest way to violate a covenant in spirit without technically violating it. Again, unless the covenant specifically equates payment of a shareholder receivable to payment of a distribution, the banker will lose the argument. The cash will have left the company, which will be "in compliance" with the covenant, even though from a practical standpoint it will not be.

Now we give special attention to the case of distributions in excess of taxes. For the borrower who is genuinely abiding by the cash-flow-after-distributions requirement, this covenant has the effect of stranding unneeded cash on the balance sheet. Let's assume we have a DSC requirement based on cash flow after distributions of 1.25x and that our borrower has remained in compliance with the covenant for three years in a row. The covenant trend analysis might look something like this:

Table 1

	2010	2011	2012
Cash flow after distributions	$500M	$500M	$500M
Debt service	$400M	$400M	$400M
Debt service coverage (DSC)	1.25x	1.25x	1.25x
Excess cash flow after debt service	$100M	$100M	$100M
Cumulative excess cash flow	$100M	$200M	$300M

So in 2010, 2011, and 2012, cash flow after distributions was barely sufficient to allow compliance with the DSC covenant. Each year, $100M of cash flow was retained in excess of debt service. By the end of 2012, there is $300M of excess cash now stranded in the business. The covenant effectively forces this cash to be forever locked on the balance sheet.

Why? Because if, in 2012, the owner tries to distribute just its net accumulated cash flow earned in 2010 and 2011 (which totals $200M), then 2012 cash flow after distributions would be reduced from $500M to $300M. The result then becomes both a covenant DSC and an underwriting DSC of 0.75x, even though the owner made no attempt to distribute the excess cash earned in 2012 (the year being analyzed). Furthermore, that distribution decision did not actually have any bearing on the company's ability to generate cash for servicing debt.

The distribution of cash in excess of the amount required to pay tax appears to be somewhat arbitrary and can be controlled by the borrower with reason or with no reason at all.

This excess cash is now susceptible to corporate theft, fraud loss, and liability due to lawsuit. If such a loss were to actually occur, then the honest borrower who was just trying to abide with the covenant would have a leg to stand on when pointing the finger at the bank as playing a role in the loss. This is not an outcome the bank intended when writing the covenant.

Furthermore, if this borrower were a real estate holding company, the stranding of excess cash flow effectively eliminates one of the owner's key incentives for investing in the real estate in the first place: to generate a return on investment. Owners who couldn't reap the benefit of their investments might become frustrated with their banking relationships. Again, this is not a result the bank would have intended.

Can the borrower request a waiver from the bank in order to distribute excess cash? Sure. But what's the point of structuring a covenant in such a way that it needs to be waived year after year? Such behavior could also render the covenant meaningless as the cause of a default should the loan ever find its way into litigation. Also, is there any banker who relishes the idea of having to go through the process of explaining and obtaining a covenant waiver every year?

A Better Way?

We've stated the need to account for income taxes not directly paid by pass-through entities. For this purpose, the use of cash flow after distributions is meaningful and proper. We've discussed the notion that, when times get tough, the expectation that the bank comes before the owner may not hold up. We've also seen problems that can occur when we don't tighten the reins on what we consider distributions that should be deducted as an expense equivalent in our repayment calculation.

Let's return to basics and recognize what we are trying to arrive at: the borrower's ability to repay. Let's assume by default that our definition of "cash flow" has already been adjusted for any nonrecurring items on the income statement and for recurring mandatory capital expenditures. What we are missing now is income tax stemming from the profitability of the business.

Let's first address what we lose in our analysis if we fail to capture distributions other than those made for taxes. The distribution of cash in excess of the amount required to pay tax appears to be somewhat arbitrary and can be controlled by the borrower with reason or with no reason at all. As a result, this wildcard aspect of distributions should not have an impact on how we view repayment ability because it doesn't have anything to do with how much revenue in excess of expenses the business generates in any given year.

When the owner truly puts payments to himself ahead of the bank, the banker will know. When there is not enough business cash flow to meet both the personal needs of the owners and the debt service obligations of the business, and when the owners put themselves first, the banker will start to experience true payment defaults. Those defaults will probably happen well before the cash-flow-after-distributions covenant is calculated as being in default. Plus, such excess distributions will be seen during other aspects of underwriting, such as preparation of a global cash flow, and should be evaluated and controlled at that time.

In the end, any cash distribution for reasons other than income taxes has a lasting effect on equity, as opposed to any effect on whether the business was capable of generating sufficient cash flow in the current year to cover related debt service. The lasting impact of such excess distributions will thus be captured when the banker analyzes cash levels, the full cash flow statement (operating, investing, and financing), net worth, and leverage ratios. Remember, distributions are largely an equity-related event.

Thus, if excess distributions truly are a risk factor in the credit decision, such as that for a highly leveraged borrower, then the covenant might best be structured as a minimum-net-worth or maximum-debt-to-worth covenant (further adjusted for any "distributions" in the form of shareholder notes receivable).

This then allows the DSC covenant to be defined purely using cash flow and debt service. Based on our prior discussion, though, since it is appropriate to account for income tax for a pass-through entity in the underwriting, then it would probably also be appropriate to allow for it in the financial covenant (the way capex often is). Now let's address how to analyze this and write it into the covenant.

Whether or not a distribution is taken to pay the income tax, it is still an expense that would be owed by the business if not for its corporate structure. This does not diminish the principle that any tax stemming from corporate profit should be supported by corporate profit. For this reason, I favor an EBIDA calculation (that is, after taxes) for debt repayment, as opposed to an EBITDA calculation (that is, before taxes).

We've established that total distributions might not serve as a reliable indicator for income tax due on business profit. Unless we want to ignore income tax altogether, we need to insert something in place of distributions. The simplest thing to do is to calculate the income tax due. The banker has several choices here. The most common approach I've seen is to pick a tax rate and apply that consistently to net income.

There are a couple of things to note with this approach. The first is that it is important for the banker to use taxable net income per the tax return. When tax returns are not available and an estimate for income tax must be used, it can be based on net income as shown on the books. But this is not optimal, as tax profit and book profit can sometimes vary greatly. Do not base the calculation on cash flow. Taxable net income for an S corporation can be found on Line 8 of IRS Schedule M-1, as shown in Figure 1.[2]

Figure 1

IRS Schedule M-1

From 1120S (2012) page 5

Schedule M-1 Reconciliation of Income (Loss) per Books With Income (Loss) per Return
Note. Schedule M-3 required instead of Schedule M-1 if total assets are $10 million or more—see instructions

1 Net income (loss) per books		5 Income recorded on books this year not included on Schedule K, lines 1 through 10 (itemize)	
2 Income included on Schedule K, lines 1, 2, 3c, 4, 5a, 6, 7, 8a, 9, and 10, not recorded on books this year (itemize)		a Tax-exempt interest $	
3 Expenses recorded on books this year not included on Schedule K, lines 1 through 12 and 14 (itemize)		6 Deductions included on Schedule K, lines 1 through 12 and 14l, not charged against book income this year (itemize):	
a Depreciation $		a Depreciation $	
b Travel and entertainment $			
		7 Add lines 5 and 6	
4 Add lines 1 through 3		8 Income (loss) (Schedule K, line 18). Line 4 less line 7	

Source: Internal Revenue Service

The next thing to consider is the tax rate. The rates applied most commonly are either 30% or 35%, which are linked historically to C corporations. Income taxes related to pass-through entities, for the most part, are taxed at the individual rates (though there are exceptions that fall outside the scope of our discussion). Those rates are typically much less than the C corporation rate, which explains why so many business owners prefer either S corp or LLC structures.

Whether or not a distribution is taken to pay the income tax, it is still an expense that would be owed by the business if not for its corporate structure.

The most correct approach is to use each individual's tax rate. But even with this approach, complications arise. You can have more than one owner and thus more than one rate. You would then split the taxable profit according to ownership percentage, apply the different rates, and sum the results. However, you also need to determine if you prefer to use the marginal tax rate, the average tax rate, a fixed rate, or a sliding rate.

Figure 2

Marginal Tax Rates For Married Taxpayers Filing Jointly

Schedule Y-1—If your filing status is **Married filing jointly** or **Qualifying widow(er)**

If your taxable income is: Over–	But not over–	The tax is:	of the amount over–
$0	$17,400	—— 10%	$0
17,400	70,700	$1,740.00 + 15%	17,400
70,700	142,700	9,735.00 + 25%	70,700
142,700	217,450	27,735.00 + 28%	142,700
217,450	388,350	48,665.00 + 33%	217,450
388,350	——	105,062.00 + 35%	388,350

Source: Internal Revenue Service

Figure 3

Standard Deduction for– · People who check any box on line 39a or 39b or who can be claimed as a dependent, see instructions. · All others: Single or Married filing separately, $5,950 Married filing jointly or Qualifying widow(er) $11,900 Head of household, $8,700	40	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)		40	
	41	Subtract line 40 from line 38		41	
	42	**Exemptions.** Multiply $3,800 by the number on line 6d		42	
	43	**Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-		43	
	44	**Tax** (see instructions). Check if any from: **a** Form(s) 8814 **b** Form 4972 **c** 962 election		44	
	45	**Alternative minimum tax** (see instructions). Attach Form 6251		45	
	46	Add lines 44 and 45		46	
	47	Foreign tax credit. Attach Form 1116 if required	47		
	48	Credit for child and dependent care expenses. Attach Form 2441	48		
	49	Education Credits from Form 8863, line 19	49		
	50	Retirement savings contributions credit. Attach Form 8880	50		
	51	Child tax credit. Attach Schedule 8812, if required	51		
	52	Residential energy credits. Attach Form 5695	52		
	53	Other credits from Form: **a** 3800 **b** 8801 **c**	53		
	54	Add lines 47 through 53. These are your **total credits**		54	
	55	Subtract line 54 from line 46. If line 54 is more than line 46, enter -0-		55	
Other Taxes	56	Self-employment tax. Attach Schedule SE		56	
	57	Unreported social security and Medicare tax from Form: **a** 4137 **b** 8919		57	
	58	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required		58	
	59a	Household employment taxes from Schedule H		59a	
	b	First-time homebuyer credit repayment. Attach Form 5405 if required		59b	
	60	Other taxes. Enter code(s) from instructions		60	
	61	Add lines 55 through 60. This is your **total tax**		61	

Source: Internal Revenue Service

Figure 2 shows the marginal tax rate, expressed as a percentage (the schedule for married taxpayers filing jointly is shown). Since profit on a business is typically commingled with other income for purposes of determining income tax, and since the level of tax-deductible expenses is often correlated to the profit earned from a business, the argument can be made that the full marginal rate is too punishing to apply to the business income. In that case, the banker would want to use the average tax rate. This is determined by dividing total tax by taxable income (that is, by dividing line 61 by line 43 shown in Figure 3). The average tax rate is my preferred approach.

For simplicity, the banker could apply a flat tax rate, such as the 30% to 35% shown above. A flat rate would be most useful in redefining a DSC covenant—a percentage allowance is used to represent income tax as opposed to actual distributions, if any. I've typically found the average tax rate to be between 20% and 30% for the majority of small business owners. However, readers should try this for themselves over the next dozen or so personal tax returns they analyze.

For larger, more profitable businesses, the owners' average tax rates vary greatly, depending on the taxable profit and the deductions. It is not always the case that the higher the cash flow, the higher the average tax rate of the individual. But for the bank that wishes to adopt this approach with an average tax rate, it might wish to at least consistently apply a tiered flat rate. One such example is assuming 15% for taxable net income up to $100M, 20% for income up to $300M, 30% for income up to $1 million, and 35% for income above that amount.

Also, don't forget that when the business shows a taxable net loss, the income tax calculation will result in a credit.

Table 2	
Using cash flow after distributions:	
Cash flow before DS	$400M
Less distributions	(300M)
CF after distributions	$100M
Debt service	$98M
DSC	**1.02x**
Using cash flow adjusted for income tax:	
Cash flow before DS	$400M
Less estimate of income tax	(44M)*
CF after est. of income tax	$356M
Debt service	$98M
DSC	**3.63X**
Cash flow with no distributions either accounted for or taken:	
Cash flow before DS	$400M
Debt service	$98M
DSC	**4.08x**
***$200M taxable net income x 22% average tax rate**	

This is appropriate because the loss effectively acts as a shield against other taxable income on the individual's tax return in many cases.

Let's illustrate how our DSC analysis would look for a business with a taxable profit of $200M, a 22% average tax rate on the owner's tax return, cash flow before debt service of $400M, and distributions of $300M (see Table 2).

If we accept that the bank is paid before the owners, we can see that cash flow after an allowance for income tax was sufficient to cover debt service more than three times over. And the result would not be subject to influence by the borrower. The distributions to the owner would have come from cash flow in excess of debt service. To be clear, the recommended method was not developed with the idea of making DSC look better, as there will be times when the opposite is true (as in the example with no distributions).

Conclusion

Bankers should place accuracy and relevance of the repayment calculation ahead of all other analytical considerations. This is the best way to ensure that deal risk is properly evaluated.

My hope in writing this article is that bankers carefully consider the consequences that cash flow after distributions has on both the borrower and internal underwriting. ❖

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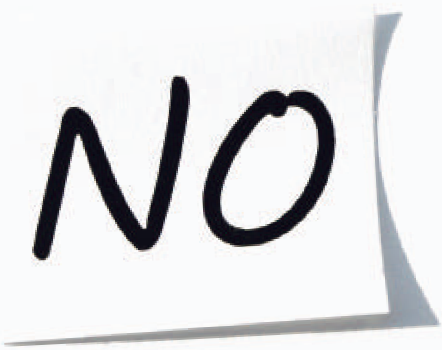
More information is available in RMA's Global Cash Flow Course. Go to www.rmahq.org. Click on Events and Training.

Notes

1. There is a still raging battle, sometimes between banks and sometimes within the same bank, as to the proper measure of "cash flow." Some favor net cash after operations (NCAO) from the Uniform Credit Analysis Cash Flow Statement, and others favor EBITDA (earnings before interest, taxes, depreciation, and amortization).

2. The complete IRS forms in Figures 1, 2, and 3 can be found on these respective Web pages: www.irs.gov/pub/irs-pdf/f1120s.pdf; www.irs.gov/pub/irs-pdf/i1040.pdf (p. 105); and www.irs.gov/pub/irs-pdf/f1040.pdf.

Count on Loan Review for the UGLY TRUTH



Executives elaborate on how the vital function of loan review has evolved—and how to make the most of its value proposition.

BY MICHAEL MARCUCCI, CRC

WELL, THE BLESSED event has finally happened. The baby is brought home and there is a celebration. Everyone is happy; even your mother-in-law is smiling. Friends and neighbors coo over the little darling. And then …Uncle Charlie walks in, takes a puff of his cigar and says, "What an ugly baby." Pandemonium ensues. How dare he say something like that! We all know the baby is beautiful! We won't be inviting *him* to parties anymore. And so it begins. Welcome to loan review: The process calls out the facts as they are, without regard to whose feelings are hurt.

Drawing on this author's personal experience from 30 years in risk management and interviews with senior loan review executives across the country, this article examines the mission of loan review, how it has evolved into a leading-edge practice relied on by critical stakeholders, and some of its fundamental challenges at mid-sized to large institutions.

Organizational Placement

The placement of the loan review function in the institution is evolving. Organizational structures and hierarchies are critical to risk and control functions because they are the institution's way of saying what's important and what's not. In this regard, the tone is set at the top of the house, with policies, resources, and compensation

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aligning with organizational structure to show the degree of focus loan review merits.

"Good risk management coverage starts at the top with a strong statement," said Maryann Lawrence, SVP, commercial credit risk review, Key Bank. Banks with plain-vanilla portfolios backed by conservative standards and consistent performance usually place loan review within the credit department, where it has a low profile. Banks that have recently come off a steep growth curve or have spent quality time with their boards explaining a regulatory order often will see the need for elevating loan review. And banks that ignore the signs warning that a greater emphasis on loan review is required to improve the credit culture often end up closed by the FDIC.[1]

> Although the practice remains quite diverse, there is a clear trend for loan review functions to align with risk management as opposed to audit.

Traditionally, at many banks, loan review has been aligned with the internal audit function. Although the practice remains quite diverse, there is a clear trend for loan review functions to align with risk management as opposed to audit. A common structure is for the senior loan review executive to report to the chief risk officer on a dotted line (administratively) and to a board governance committee, usually the risk committee, on a solid line. This structure facilitates candid feedback on credit quality, risk trends, and quality of risk management from an independent source within a committee that can focus on risk issues, versus the audit committee, which must also focus on assurance and testing functions.

This evolution away from audit and toward risk management is being driven by a number of factors:

- **Format of audit versus risk.** Audit reporting, testing, and analysis can be formulaic, which is necessary for rigorous assurance testing but inconsistent with the approach loan review must take toward its exams. While the file review component of an exam can certainly be formulaic and standardized, the other critical aspects of the exam that cover governance and management are more open-ended.
- **Emergence of chief risk officers and the establishment of board-level risk committees.** The risk committee is the venue where the key risks of the company are vetted in detail. Audit is where assurance is provided, the focus being on financial statements and operational assurance. As risk committees gain prominence, they become the place where board members can get independent views of developing trends and where views other than those of the CEO and chief lender can be discussed. In this respect, the risk committee provides a solid forum for effective challenge.
- **Evolving complexity of products, distributions, and regulations, combined with the complexity of Basel guidelines on probability of default and loss given default.** These have made specialization of resources (with management and board committees) necessary in order to properly manage the risk associated with credit in larger banks.
- **The evolving importance of the loan review function.** Loan review increasingly is being referred to as credit risk review, implying that the function has a wider scope and deeper breadth of impact within the organization.[2] Calling it credit risk review also recognizes that the function would have purview over counterparty exposure or equity investments.
- **Differences in skill sets.** These skill differences pose a problem for recruiting and career paths. There is typically very little overlap between professional auditors and professional credit risk executives. Thus, recruiting for top talent can be a problem as credit risk personnel will not see opportunities for promotion within audit.

Risk Management Lines of Defense

All the loan review executives interviewed for this article reported strong alignments in their institutions with the traditional "three lines of defense" so often articulated in regulatory guidance, trade journals, and industry practice. The first line of defense is the business unit, the second is risk management, and the third is audit. Each bank might have a slight variation to this, and smaller banks may not have sufficient resources for a clear separation of these functions or a fully built-out risk management function. Nevertheless, the model is almost universal.

No alignment of resources is perfect or even optimally aligned for an extended period of time. Inevitably, resource gaps will pose a risk challenge and overlaps will create an efficiency challenge. Most bankers said they saw no significant *gaps* in coverage, although there might be occasional *overlaps* (the latter was preferred to the former). With regard to loan review, the function has characteristics of both the second line and third line of defense, with its placement and emphasis being a function of factors that include portfolio size and complexity, the evolution of the risk culture, and recent events or losses that may have occurred.

According to Ronald Johnson, SVP and director of credit examination, Zions Bancorporation, "Loan review is the third line of defense. The second line is the credit function under the chief credit officer. Loan review places primary responsibility on the first line [the business unit] and also asks why the second line may have failed." Heidi Andrion, executive vice president, Capital One, has a similar philosophy, noting, "Loan review plays an important role in enforcing discipline."

At PNC, Debbie Amundson, assistant general auditor and SVP, echoed these comments, adding, "We have the three lines of defense and credit audit is independent, but in aggregate we are less formally segregated. The PNC culture is that everyone is responsible for risk…everyone owns it."

Other executives had similar thoughts, suggesting that the lines-of-defense strategy is clearly not an absolute across the industry, nor is it within the different product lines. With commercial lending, loan review has the opportunity via file review and other soft coverage strategies to be very close to the deal flow of individual credits and can influence risk accepted on the margin in real time. In retail, there is less influence on a real-time basis with the acquisition of new risk. Loan review's efforts are concentrated on portfolio reviews and assurance testing of risk acquisition.

Use of Data Analytics

One prevailing theme across the industry is the increase in the use of data analytics, both in preparation for an actual exam and during continuous monitoring. Data analytics usually take the form of some access to the underlying loan information from the loan accounting system. This method is preferred to relying on reports generated by the line of business, which can be manipulated or delayed in their production as sales and growth reports take precedence over risk and control reports within the business lines.

Of the bankers interviewed for this article, all but one had dedicated data analytics teams in their loan review organization. Several viewed the function as an area targeted for growth in the near future. A small number of banks now have one or two Ph.D.s within their data analytics teams to provide effective challenges to model validation teams and to act as resources to teams that may be examining the data validity or accuracy of complex probability-of-default and loss-given-default models. Whatever the structure may be, the evolving model of a rigorous data analytics team within loan review would reflect the following characteristics and dimensions:

- Data analytics are used heavily at the planning and scoping stage of the examination. The team gains access to the core loan accounting system, extracting the data elements that are necessary to develop both a risk profile and a sampling of files to be reviewed.
- Once the core data is obtained, the team slices the data to spot any developing trends or unrecognized risks. These risks may be loan exceptions, industry concentration performance, outlier debt service, or leverage ratios. More sophisticated teams may match data in a covariance mode to determine any correlations between recent growth and risks developing on the margin.
- The data analytics team should not proceed without being guided by the senior loan review manager who has overall responsibility for the examination. Under leadership having deep industry and portfolio knowledge, the data analytics team can target resources into the risk metrics and data elements that make the most sense and can further develop a time-series analysis to spot credit quality deterioration, growth in marginally risky areas, and so on. Without guidance from an experienced expert, data analytics could develop into a distraction instead of a value-added exercise. Indeed, efforts can result in "analysis paralysis" instead of meaningful information for management.
- Once the critical data elements are determined, the data analytics team should take the initiative to incorporate them into a continuous monitoring program that loan review can use between exams to monitor portfolio performance against the stated risk appetite.

File Review versus Governance

Each of the executives interviewed for this article said that file review is the crux of what loan review does, especially in commercial lending. (In retail lending, file review is usually replaced by automated reviews of decision engines.[3]) It is an important component and allows the loan review function to determine a number of factors at the deal or obligor level, including:

- Risk-rating accuracy.
- Quality of portfolio management.
- Accuracy of loss reserves.
- Covenant structure in place versus the structure approved.

But the most important attribute that the file review can reveal is the skill set and competency level of the loan officers and account managers. "File review is the basis of our work and is used to uncover risk management practices…what is really going on," said Bob Shotkus, director of credit review, Regions Bank. A thorough review of a complex borrowing relationship by an experienced credit professional not involved with the origination or management of the relationship can objectively assess how well risks were identified, analyzed, mitigated, and translated into a risk classification and risk rating. Since the risk ratings drive the allowance for loan and lease losses (ALLL), this is a critical component of validating the inputs to this heavily scrutinized item of the balance sheet.

> One prevailing theme across the industry is the increase in the use of data analytics, both in preparation for an actual exam and during continuous monitoring.

File review also figures prominently in the level of "coverage" afforded by the loan review group. Coverage refers to the percentage of the portfolio as measured in total exposure that is reviewed by loan review over a certain period. The coverage goals are set by the board or the governing committee, and from this goal the loan review executive builds a staffing plan.

Coverage has the advantage of easily quantifying the activity of loan review and can be tracked over time. The drawback is that the quickest way to reach coverage goals is to concentrate on very large exposures; for large banks, this can mean concentrating on large single points of risk such as sovereign exposures. Conducting a review of the largest exposures in the portfolio certainly makes sense, but the reality is that, by virtue of being large, these exposures have already gone through multiple levels of review and approval. Most banks have policies that would require the largest exposures to have been countersigned by risk management and then further reviewed by the board. So while these reviews are interesting, highly visible, and contribute to the coverage goal, they would rarely be expected to produce a meaningful challenge to the business unit or produce any relevant findings. If there are any significant deviations from established policy or the stated risk appetite, they would more likely be found just below the threshold where higher approval authorities or risk management review are required.

Loan review attendance at critical governance meetings should be codified in policy so that invitations are not a matter of discretion.

File review is often referred to as "hard" coverage—the name implying that the reviews are tangible. In recent years, more loan review organizations have begun to place significant emphasis on governance issues associated with managing credit exposure. This type of focus is called "soft coverage" and includes the following:

- Attendance and a voice at watch-list meetings.
- Continuous review of portfolio performance.
- Deep-dive reviews of newly originated loans on a real-time basis.
- Attendance and a voice at the ALLL review meetings.
- A voice and vote in the development of credit policy changes.

A leading practice of soft coverage is found at PNC. "Credit audit admin has an ex officio role and seat on all critical committees," noted Amundson. "This includes the credit committee, where reviews of new borrowers are part of transaction testing. The chief credit officer values our insights, observations, and questions."

Loan review attendance at critical governance meetings should be codified in policy so that invitations are not a matter of discretion. Enforcing this by policy is critical; otherwise there is always the chance that loan review is not invited to the meetings for large or risky deals—which is when its input is most needed. This happened during the run-up to the recent credit crisis when firms would ask key risk executives to leave the room when unusual deals or situations were on the agenda.[4]

While each bank official interviewed agreed that the governance aspect of what loan review does is important and growing in significance, it was also recognized that the skill set required for this type of coverage was very different from that for the typical file reviewer. Capital One's Heidi Andrion said she saw the need for a rebalanced skill set and "turned the staffing model on its head," adding that "we had a combination of career credit reviewers and relatively junior people with good credentials, but limited subject-matter expertise. The function didn't have a lot of stature because of that and therefore could not provide effective challenge."

For the file reviewer, the skill set required is focused on traditional credit competencies such as cash flow analysis, collateral valuation, risk identification, loan structure to mitigate risks, and documentation skills (execution, perfection of liens, etc.). But interacting with a loan file that does not talk back or take exception to your findings is one thing. Facing off with a senior vice president and discussing portfolio metrics, processes for troubled debt restructurings, and the adequacy of the allowance or the population stability index of a credit card portfolio is a completely different thing. Loan review executives have found that this skill set requires significant coaching within the management ranks and has resulted in some turnover in staff.

Who Audits Loan Review?

We all have bosses—someone looking over our shoulders, asking for explanations, insisting on justification for actions. The test of time has shown we can "expect what we inspect." That said, who inspects loan review? And are there diminished returns to the value proposition when we have "checkers checking checkers"?

Practices among those interviewed varied. Below are some of their approaches to auditing loan review:

- A dedicated internal quality assurance team can enforce high standards and drive all reviews toward materially consistent conclusions. Peer reviews can also accomplish this, but they can result in performance coalescing around the mean. Both options are relatively low-cost and can occur on a continuous basis. On the downside, internal reviews are not independent.
- Internal audit can serve as independent validation of loan review processes when the two organizations are separate. The auditors conducting the examination of loan review must possess competency in both audit and credit risk, but the intersection of these two skill sets is rare. Several loan review managers commented that this type of review, while looking good on paper, rarely adds value to the practice and typically doesn't raise loan review's value proposition.
- Outside stakeholders such as third-party firms or regulators can also provide effective reviews. Independence is much clearer and the competency level is usually very high. Outside providers also expose loan

review to best industry practices, raising the performance bar. The downside of this strategy is the expense of the ongoing fees plus the startup cost measured in the time it takes for reviewers unfamiliar with the bank's portfolio to come up to speed. This hidden cost manifests itself in a productivity loss, often felt in the credit department as underwriters invest time in preparing files for review and answering examiners' questions.
- Relying on bank regulators to provide objective feedback is risky, as the feedback may take the form of a management required action (MRA) or consent letter!

Most loan review departments have some combination of the options above. They usually rely on peer reviews for certain audits and augment that with a dedicated quality review function, then wrap an outside review around the department—sometimes on a two- to three-year cycle. Much smaller banks can outsource the function to one of the very qualified outside loan review firms. The board audit committee can validate the vendor's performance and also perform a robust review of the firm when the contract is renewed.

Staffing Models, Career Paths, and Skill Sets

Loan review staffing models are primarily driven by coverage goals set by the board. Coverage averages around 50% of the portfolio, although values can be as low as 25% and as high as 60%, depending on the portfolio mix and the methodology. Staff productivity can easily be translated into a plan for achieving coverage goals, depending on experience and the complexity of loans. A secondary consideration is the level of sophistication of the supporting resources, primarily the data analytics teams that improve efficiency and effectiveness with prep time and reporting.

Mike Jackson, credit risk review manager, BB&T, said, "Our model is a hybrid. We have a methodology to determine typical production of the average number of reviews that can be completed each month in order to meet our target goal of about 40%. In consumer, we target about 20%. But we also perform continuous monitoring, which involves a sampling of large commercial underwritings each month."

At Regions Bank, Shotkus said, "For commercial [for example, specialty lending, C&I, real estate, ABL, etc.] we cover 40% to 60% via hard coverage plus another 10% with soft coverage. For consumer, that is a processes-driven review where coverage of transactions is small (around 1%), although coverage isn't part of the report. In business and community banking, we view that much like consumer in that the review is process oriented, with yearly coverage of 5% to 7% as the target. We also have continuous reviews where we sample new/renewed loans, check risk-rating changes, look at servicing, and so on. For continuous reviews, we do a quarterly business unit review report combining our work with asset trends [and] risk management assessments and produce a four- to five-page document providing our assessments to the business unit and senior management."

The skill sets and experience needed to attain these goals have evolved over the past few years. They are driven by an increasing appetite for knowledgeable managers who can translate large volumes of data into information that can inform management judgments. They are also driven by experienced credit professionals who can review loans and portfolios and then offer meaningful observations and recommendations. Managers typically have 20 to 30 years of experience with diverse product lines and have served in sales, underwriting, and credit administration. File examiners usually have five to seven years of experience, have come up through the ranks, and view loan review as a two- to three-year rotational assignment that would lead to a more senior position in the line or credit.

During the review, a loan officer has a detailed understanding of the customer and is familiar with the file, having managed the account for years. Any missing docs or incomplete financial statements can be quickly obtained. In addition, loan officers have time on their side. A seasoned loan officer can often wear down an inexperienced loan review examiner, knowing full well that the exam has a time limit and other files are waiting.

To counter this, the loan review examiner must have an equal or better understanding of credit risk. A key method for providing skill set parity is to augment job experience with formal industry certification. The Credit Risk Certification offered by RMA is one of the best ways for credit professionals to demonstrate industry-recognized competence.

The Future

What is the greatest challenge for loan review? Three comments resonate.

BB&T's Jackson said he saw it as "convincing the bank that models are not the be-all and end-all." The increasing complexity and size of the loan portfolios owing to industry consolidation make this comment especially relevant. Less experienced loan officers—those who never used pen and pencil to do a cash flow analysis or who never had a borrower with a 1% probability-of-default file for bankruptcy (after first clearing all the inventory out of the warehouse)—have a tendency to rely on complex models without first consulting common sense or fundamental credit analysis. Loan review looks at complex deals with an independent eye and can also set aside complex algorithms in favor of reviewing the primary

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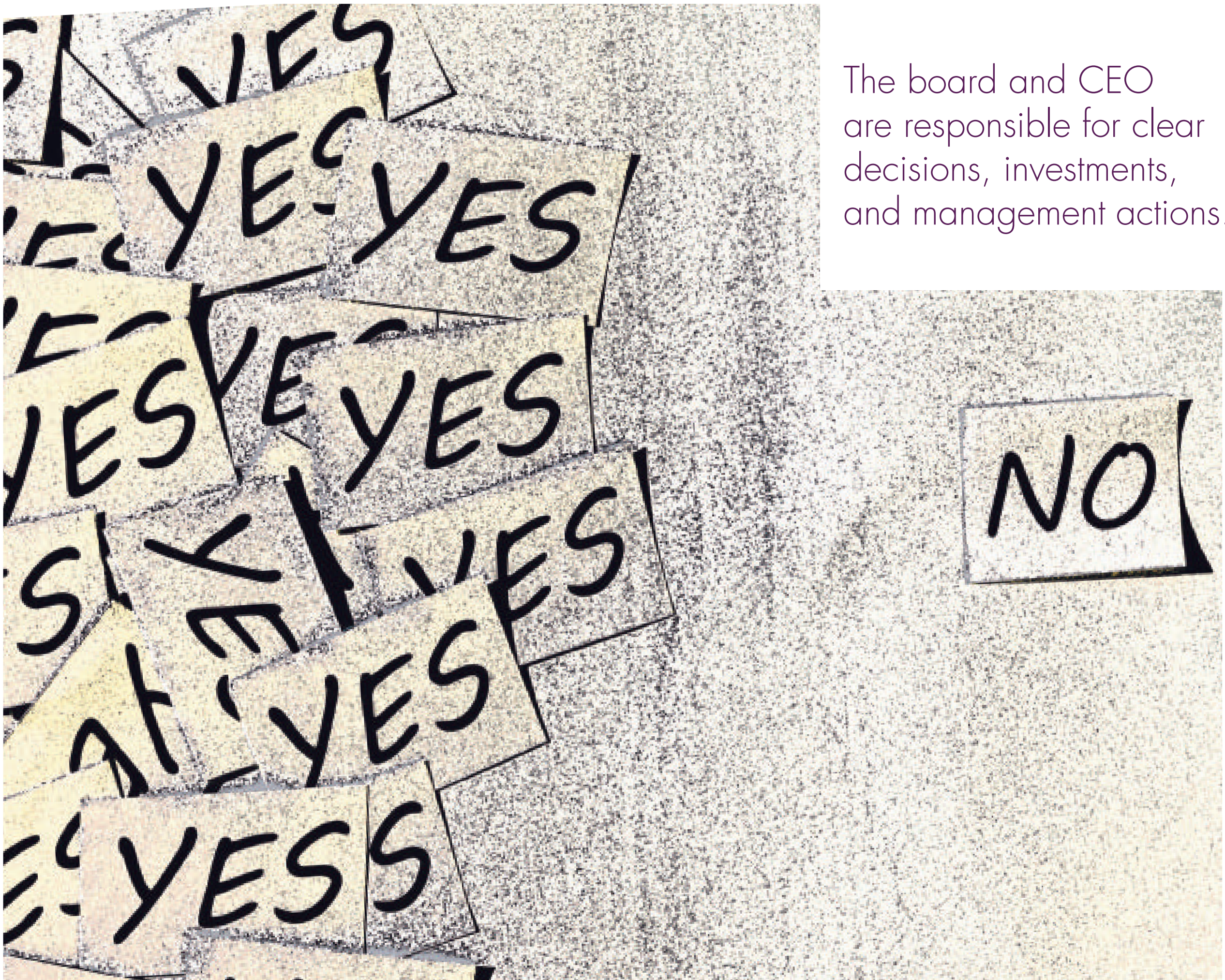

The board and CEO are responsible for clear decisions, investments, and management actions.

Top 10 Characteristics of a Successful Loan Review Function

1. Tone from the top	The board and CEO are responsible for clear decisions, investments, and management actions that emphasize and respect the need for loan review to provide effective challenges. Nothing happens without a firm commitment, codified in policy and supported by resources and compensation.
2. Independence	The organizational structure must demonstrate loan review's independence from the credit function. There should be a solid line to the full board or a board committee.
3. Skill parity	A loan review exam can be compared to asymmetrical warfare.[5] To counter the loan officer's deep knowledge about the relationship of the portfolio, loan review's skill set must be bolstered by ongoing training, assignment rotations, industry certifications, and internal peer reviews. These take time and require significant resource investments by the bank.
4. Governance	Loan review managers should attend critical governance committee meetings as ex officio members and be assigned to "own" discrete portfolios within the bank, monitoring their performance with business-unit-generated reports and loan review metrics.
5. Off-season coverage	Only mediocre loan review managers limit their contact with business unit counterparts exclusively to the examination. Stay in contact between exams to monitor performance, but also to keep apprised of personnel changes, portfolio acquisitions, changes in risk appetites, and new product introductions. These significant events, or even audit results from other areas, may change the risk profile such that an examination may be moved up, delayed, or changed in scope.
6. Evidence of influence	After exams, file work, perhaps a few downgrades, and many reports, can loan review point to tangible improvements in the lending culture? If the answer is yes, it has added value. Otherwise, a strategy disconnect is preventing this critical line of defense from contributing to the franchise. As Larry Gordon, SVP and director of credit review, Huntington Bancshares, said, "The function is not there just to ding people…it exists to highlight opportunities to achieve a strong credit culture, which should also be consistent with management's intent."
7. Career path	Where do examiners go after loan review? If loan review is able to attract top performers and also place them in senior-level credit or line positions later, that indicates a solid career path and it will support a refreshed pipeline of employees.
8. External focus	Banking is highly cyclical, and lending patterns and standards move with a high degree of correlation. Local market dynamics add additional pressure. Keeping an eye on these trends by monitoring any of the publicly available databases[6] is a best practice that keeps the loan review executive apprised of industry trends. It also allows the loan review manager to augment board reporting with a view of the marketplace.
9. Forward thinking	Looking around the corner is a critical challenge. The board doesn't need loan review to inform it of a potential problem after a loss has been declared. Loan review needs to articulate an independent, dispassionate view of developing risks that is animated by experience and driven by data.
10. Risk appetite link	Banks make money by being fairly compensated for the risks they take. They mitigate and control those risks and avoid those that are outside the bounds of the bank's stated risk appetite. Loan review must filter its views and opinions through this risk appetite prism.

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source of repayment and the realistic value of collateral.

Also, a seasoned loan review examiner can educate a technically savvy but less experienced lender about the outcome of similar deals that have been reviewed in the past. The examiner can also tell the lender that the credit committee will not look favorably on a loan officer who tries to explain away a bad loan by saying, "But the model said it was okay."

Andrion said the greatest challenge for loan review is "establishing itself as a function that the business takes very seriously, ensuring that the lessons of the past have been learned." This is a great perspective as regulators look to loan review to call the loans as they see them in light of the ups and downs of economic cycles over many years. This perspective requires decades of experience, which is the primary reason that loan review departments are typically staffed with seasoned credit professionals. Loan review effectively serves as the institutional repository of the true performance of new programs introduced by sales and marketing over the years.

Mike Buzzell, SVP and deputy chief loan examiner, Wells Fargo, said the greatest challenge is "having the foresight to anticipate developing trends before they occur, rather than sitting right in the middle of them; in this regard, the number-one weapon is experience."

Loan review managers can apply the lessons of the past to help management navigate the more hazardous aspects of lending. Loan review also can temper the sometimes optimistic forecasts of department managers who may be relying on aggressive portfolio loan growth or assumptions (for single points of risk) to mask latent problems in the loan portfolio.

Conclusion

Twenty-five years ago, loan review examiners and managers were not exactly on the cutting edge of credit risk management. Loan review was sometimes staffed with long-tenured employees who could not meet their sales goals and had to be put somewhere. Their next career step was a timeshare in Vero Beach and a check from the company pension fund (when those existed). Exams were perfunctory, and effective challenges or criticisms were rare. Things have changed.

Nobody wants to hear that their baby is ugly—and nobody wants to say it. But to provide effective challenge and be a viable line of defense, this is exactly what loan review must do. In addition to deep experience, sound technical skills, and a command of internal and external data, loan review managers must possess keen communication and diplomatic skills.

File review will always provide the red meat for loan review's observations, but files are reviewed within the context of the actual exam. In our fast-moving, risky, and rapidly consolidating industry, loan review must maintain contact with its assigned business units and use portfolio analytics to continuously monitor trends. Viewing the bank's portfolio in the context of a competitive marketplace, today's loan review executive must provide a dispassionate view of the key risks relative to the stated risk appetite. The organizational dimensions and placement of loan review can occur across a wide spectrum of possibilities driven by risk appetite, culture, incentives, and institutional history with credit risk.

Larry Gordon at Huntington Bancshares summed it up well. "The greatest value a credit review department adds in this environment is to drive a strong credit culture through transparent assessments that create ongoing coaching opportunities," he said. "Further, it is not uncommon for the business segments to view credit review as a superior hunting ground for talent where they can actively recruit credit review officers with line experience to propagate the desired culture." ❖

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More information is available in RMA's Loan Review Department Managers Forum. Go to www.rmahq.org. Click on Events and Training.

Notes

1. An excellent source of information on bank failures is the FDIC's Inspector General website (www.fdicig.gov). The MLRs frequently cite "poor credit administration" as the reason for failures, often noting that the loan review function was ineffective in providing feedback to the board or an effective challenge to management. For example, in the Columbia River Bank review (Report IDR-10-002, September 1, 2012), "insufficient loan reviews, an inappropriate ALLL methodology…and inadequate real estate appraisal practices all contributed" to the bank's failure. The report further noted that the penetration of loan review portfolio coverage at Columbia River was only 9%.

2. The names *credit risk review* and *loan review* are used interchangeably in this article. Most of the organizations interviewed for this article call the process *credit risk review.*

3. File review in retail lending takes the form of capturing the key data elements that drive loan decisions and independently running them against the model rules approved by the business unit. Any discrepancies are then analyzed and form the basis of findings or recommendations. For secured loans, independent evaluations of collateral values are necessary to fully evaluate the lending process.

4. This scenario occurred at Lehman Brothers. Even though the firm employed a well-qualified risk officer who had a Ph.D. in economics, "she was often asked to leave the room when issues concerning risk came up at executive committee meetings" (quote taken from *Too Big to Fail* by Andrew Ross Sorkin, Penguin Books).

5. This is a military term used to describe combatants whose resources, strategies, or tactics differ significantly.

6. An excellent source of data is the FDIC's website for bank and industry analysis. The Statistics on Depository Institutions provide a wealth of standardized information built from call reports (www.fdic.gov/bank). The Federal Reserve banks also offer useful statistics, particularly the Federal Reserve Bank of Boston (www.bostonfed.org/economic/data.htm).

THE COACH APPROACH

Reinvigorate Your Resource Managers

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BY ERIN HUBBARD

IN THE DECEMBER-JANUARY 2013 issue, we met Megan, a 10-year veteran banker from National Bank. Even though Megan was working harder than ever before, she had begun to fall short of her sales goals.

After an exhaustive and futile struggle to restore her pipeline and strengthen her relationships with the lawyers and accountants most closely affiliated with her prospects—in other words, her center of influence—Megan determined that being a relationship manager was not enough for her clients anymore. The traditional methodology of cold calling, blitzing, and waiting for the phone to ring was not working. Her current client relationships were eroding and her job wasn't much fun.

Through research and objective examination of her strategies, Megan knew she had to become more than a "banker." She had to reinvent herself as a *resource manager*—a true trusted adviser.[1]

Megan is not a lone wolf at National Bank. It was the proper coaching, guidance, and tactical support of her manager, Steve, that helped transform her into the resource manager she is today. As regional business banking manager, Steve leads 10 bankers, including Megan. He, too, recognized the wayward turn sales numbers had taken over the last three years. Impressed with Megan's success, he began to guide his nine other sales associates toward adopting this new and client-focused sales strategy.

Though initially sales numbers were improving, Steve recognized that progress still fell short of forecasted results. During Wednesday morning sales meetings, when his team discussed the previous week's calls and reviewed upcoming deals, everyone seemed optimistic about their potential leads. Yet when he followed up, Steve discovered the forecasts rarely mirrored reality. Effectively wielding the extraordinary power of his sales force hinged on accurately forecasting deals most likely to close, Steve concluded. Accurate forecasts would allow the team to focus more intently on deals with a high likelihood of closing and ignore those likely to go away.

Lack of forecast accuracy is not an issue unique to Steve's organization. In the 2012 Sales Performance Optimization Study conducted by CSO Insights, more than 50% of respondents reported that they needed to improve their forecasting capabilities.

A case study in CSO Insights' *Sales Management 2.0 eBook, Volume 2* featured the global insurance firm Aon Corporation. In that analysis, Joe Demmler, vice president of global marketing and regional director of sales and marketing, noted that consistent improvements to pipeline accuracy and forecasting were significant to a successful sales transformation. "Aon is very focused on forecast accuracy—that is, what will close, for how much, by when," said Demmler. "Our objective was to exceed an accuracy rate of 80%, and that has been accomplished."

As reps spend more time on high-quality deals, the chances of high-performing opportunities being lost to the competition or ending in a no-decision are reduced. The importance of accurate forecasting was confirmed for Steve when, one day, he found Megan visibly frustrated, shaking her head at the phone and scowling at her inbox. Her resource manager strategy had hit a wall. By increasing her number of sales opportunities, Megan had also increased the amount of deals that would not close, no matter how doggedly she pursued them. Creating more opportunity essentially meant watching more deals go by the wayside. Steve desperately needed more accurate forecasting to coach Megan through this challenging time.

For Steve, more accurate forecasting meant more time spent gathering information—an impossible task, given that it already took him long enough to prepare and analyze existing spreadsheets and reports. His best option, then, was to encourage frequent use of the bank's customer relationship management (CRM) system for better data aggregation. Through frequent inter-department collaboration, his bank adopted a more formal, companywide CRM user-adoption strategy with the goal of more accurate sales forecasting. With a better data bank, Steve would be able to quickly access information to help him rate the quality of all potential deals—a powerful tool for boosting the efficiency of his team's sales efforts.

As reps spend more time on high-quality deals, the chances of high-performing opportunities being lost to the competition or ending in a no-decision are reduced.

Seeing Megan discouraged was also confirmation that strategy and philosophy alone wouldn't be enough. Without an organized, thoughtful manager-to-sales-associate coaching plan—in addition to more accurate forecasting—Steve knew Megan would completely lose confidence in her role as a resource manager. Steve recognized that he had to improve his coaching performance if he were to assist his colleagues in achieving their potential.

Like Steve, many sales managers are unaware of their deficits and, at times, don't even know where to start. Jim Dickie, managing partner with CSO Insights, concurs. "One of the challenges," he said, "is that people are promoted to a sales manager role because they are good at selling. However, the role of the sales manager is not to sell; they are no longer a contributor, but rather a mentor and coach. That is a challenge because that may not be where their strengths lie."

Michael Joyce, first vice president of business banking, First Merchants Corporation, offers four items that have assisted him in his role as sales manager:

1. The same routines and disciplines that make a successful salesperson will not bring success as a manager. But being disciplined and having a routine will.
2. Stick to your routine, but also ask for feedback from your salespeople so you can make appropriate changes. This will help get buy-in for the sales management process.

Listen to the feedback and take it to heart.
3. Trust the data. Look forward and not backward. Learn to understand the data. Replicate your wins, but also look for new opportunities.
4. Listen, learn from your mistakes, look for new ideas, and stay open.

Steve was beginning to stay open. He was more approachable because he actively sought feedback from his team and took it to heart. He began to understand the rampant frustrations and confusion the associates were facing. He discovered that his coveted Wednesday "sales meetings" were more a version of "liar's poker," in which sales associates exaggerated the quality of deals and their likelihood to close, and that those meetings never really produced anything of value.

The new meeting regimen proved to be a great opportunity for Steve to understand where each team member stands in terms of progress from a gap-to-goal perspective.

Restructuring meetings to rectify the concerns voiced by his sales associates, Steve concluded, would serve as the backbone for a more efficient sales force. For advice on conducting productive meetings, Steve read an article by Jill Konrath[2] that outlined the traits of unsuccessful meetings:
1. They have no clear purpose or agenda.
2. They add nothing new or valuable to the life of the salesperson.
3. They lack an action plan or takeaway at the end.

Including accurate, timely sales data to foster more productive sales tactics greatly enhanced the value and significance of the time the RMs spent in meetings. With those points in mind, Steve created a new meeting regimen geared toward gaining and maintaining the necessary momentum for improved sales performance.

Strategic Pipelines

Steve started by implementing strategic pipelines—45-minute weekly meetings with direct reports to discuss team progress-to-plan. Steve now discusses team gap-to-goal from both an activity and outcome perspective. Rather than creating separate spreadsheets, he now accesses his pipeline data from the CRM system. This approach "encourages" his team to use the system daily and creates one version of the truth to increase forecasting accuracy.

In this meeting, Steve also talks about "wins" the team has had and the "learns" from the week. These wins and learns cause the team to prepare for the meeting more strategically. This simple addition to the meeting agenda has generated a new level of collaboration between reps.

Steve also has implemented a sales tactics and training element to each meeting. One example is the "hot prospect" lottery, where one randomly chosen banker talks about a top-prospect opportunity that has yet to hit the pipeline. Other meeting participants listen to the five-minute overview of the opportunity and then have five minutes to comment and ask questions. This has led everyone to have at least one "hot" prospect they are working. Steve has also found that this simple discussion strategy has helped bankers close more business in a shortened sales cycle.

To conclude each strategic pipeline meeting, Steve gives an assignment he calls "the tip of the week." This is a short behavior that each banker must execute. It might be a question to ask on calls, a value-added article to send, or something that focuses the banker outward. To facilitate accountability between meetings, Steve starts the next pipeline strategy meeting with a review of the tip and what the bankers learned in executing it.

Skill Builders

The next meeting Steve introduced was "skill builders." Held midmonth, this 60-minute meeting dovetails nicely with a shortened pipeline strategy meeting, either commencing or concluding it. There are skill drills, partner visits, discussions of sales books—lots of ideas that foster greater engagement to ensure that bankers leave the meeting with much more knowledge than when it started.

Steve's final step toward restructuring meetings at his office was to reschedule them, choosing time slots that freed up the days and times of the week most conducive to contacting clients. As Megan realized, Monday mornings were the best time to plan for the week ahead. Consequently, Steve decided to hold his meetings Monday at 8 a.m. Why hold a sales meeting Wednesday morning when that is one of the best days for making sales calls? While this new schedule may not create more hours in the workday, it certainly allows his bankers to plan calls more effectively.

After some time, things started to change at National Bank. Steve's team actually became a team, and pipelines were becoming more robust. Additional coaching was needed, however, to more effectively enable his RMs to follow the resource manager philosophy.

Coaching and Joint Calls

The new meeting regimen proved to be a great opportunity for Steve to understand where each team member stands in terms of progress from a gap-to-goal perspective. However, he still couldn't identify specific performance improvement opportunities for each banker without creating an observation-based plan.

The fulcrum of the resource manager philosophy—to conduct conversations geared toward the needs of the customer, rather than cold calling—required sales associates to be at ease with sincere, genial, and client-centered discourse. He had to see his RMs in action to determine the quality of their conversations. Thus, he began to execute the following observational techniques:

1. **Joint calls:** Steve began to regularly join bankers on business development calls. In tandem with the resource manager, Steve planned, executed, and observed calls.
2. **Observations:** The observations took place in the office, with the client present, while Steve watched the resource manager and listened for specific skill strengths and improvement opportunities. While observing calls, it occurred to him to watch his team in the same way while they were on the telephone. Although it made his RMs nervous to have him listening in, it helped them identify what worked in their attempt to get the face-to-face appointments they needed to continue the conversation process.

Tom Doherty, managing director of business banking at The PrivateBank, accentuates this point, noting:

> "It is imperative that sales managers are out in the field to see how prospects react to your resource managers. Joint calls are a great way to do this; going over a pre-call plan to ensure the RM is well prepared for the call also helps. Your RMs must establish what the goal of the call is, and going through a pre-call plan with them will ensure this is done. We schedule joint calls once per quarter with our managers. We go over a pre-call plan, attend the call, and then debrief afterwards. The debrief must include a lot of questions from the sales manager to the RM. Coach on the strengths and challenges, and also go over the pre-call plan after the call to see if the RM stuck to it and if the call went as expected."

Through his observations, Steve was not only able to identify areas of improvement; he also found best practices he could share with his team. With Doherty's advice in mind, Steve was more careful with his debrief. He made sure to "ask and then tell." To avoid judgment and focus on behaviors, he posed questions such as "What could you have done better on that voice mail?" or "What would you do next time to collaborate with the gatekeeper?"

After perfecting the strategy, Steve formulated a post-call, post-observational coaching process that facilitated more proactive debriefing sessions.

The Post-Observational Coaching Process

Steve used the following five-step process to focus on coaching a single skill versus overwhelming his RMs with trying to improve many skills at one time.

1. **Isolate:** Target a skill that, when taken to the next level, will help improve the resource manager's performance.
2. **Discriminate:** Understand the difference between good and less-than-ideal behaviors.
3. **Observe:** See the skill on a call or on the phone.
4. **Communicate:** Rather than advising them through a monologue, sit with each resource manager and ask great coaching questions so that the RMs talk 80% of the time.
5. **Follow up:** Always create an action plan—something simple that coaches and RMs can go along with.

With this five-step coaching process, Steve's sales force gained a better understanding of how to create conversations that lead to great opportunities, first for the client and then for the bank's bottom line.

In addition to newly formatted team meetings and coaching strategies, Steve recognized how important it is to strategize one-on-one with each associate every week. He calls these meetings "touch bases"—short, 15-minute conversations targeting specific sales outcomes and activities for the past and upcoming weeks. Steve also used these as an opportunity to follow up on issues discussed at the pipeline strategy or skill builders sessions in review of action items from previous joint calls or coaching sessions.

At first, team members were skeptical of these touch bases; they viewed them as a grading session and micro management. But since Steve did not focus on tick marks as much as outcomes and best practices, individuals actually began to look forward to them.

> "It is imperative that sales managers are out in the field to see how prospects react to your resource managers."

"Top performers will learn to look forward to these check-ins and won't view them as a 'big brother check-in,'" noted Doherty. "The manager has to reinforce this, though; the check-ins should be there to assist the resource managers."

Through the process of working with Megan to create a resource manager philosophy, Steve learned that creating RMs had little to do with sales training. It was all about creating a culture of coaching and accountability—not just for his team members, but for him as well. Through teamwork, collaboration, and objective reflection—facilitated by accurate pipeline data—Steve and his National Bank colleagues became a team, improved their client relationships, and affected the bottom line.

Next time, learn how Steve's team continues to transform the culture at National Bank by harnessing technology to optimize the results of the resource manager process. ❖

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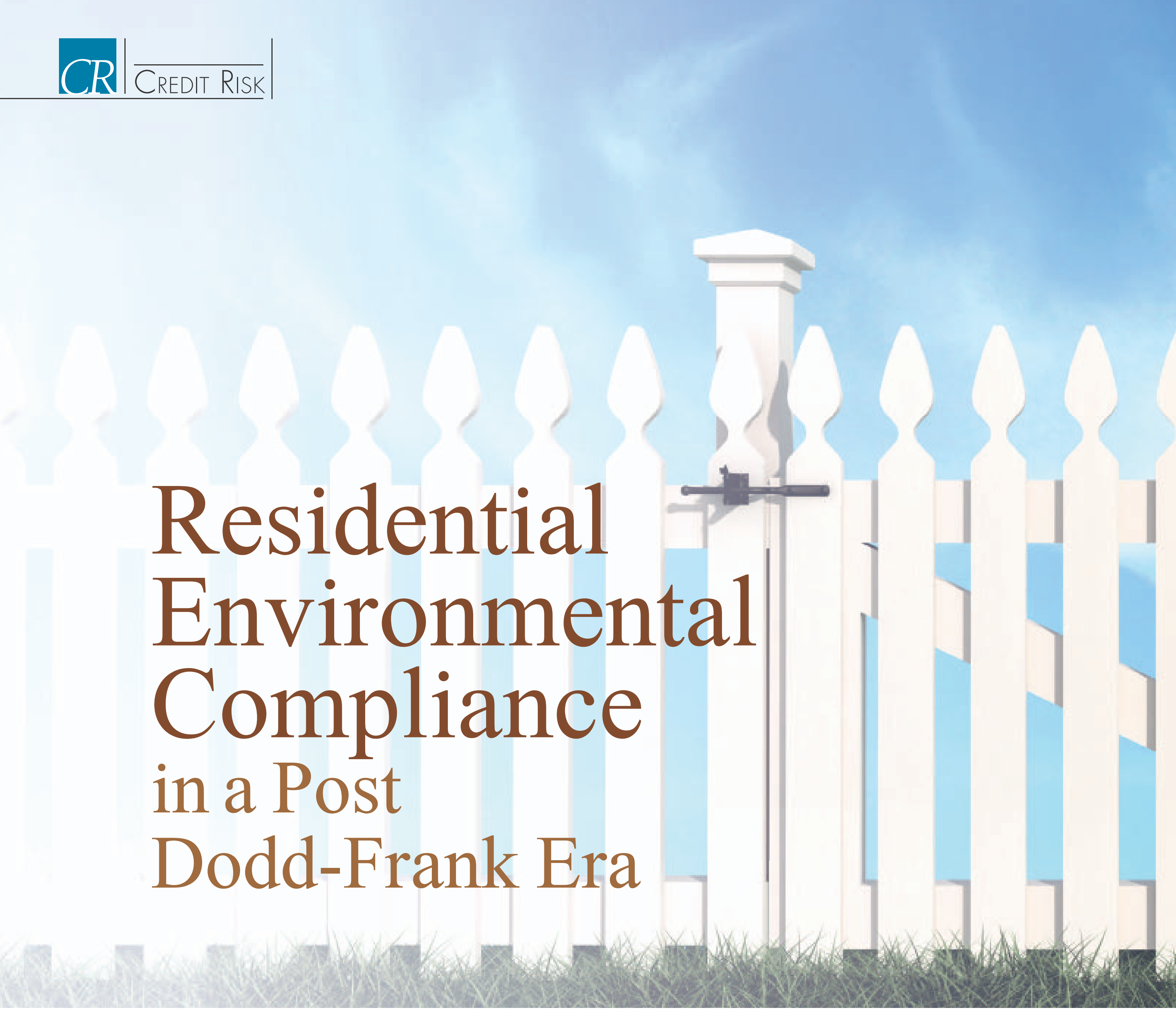
Notes

1. To learn how Megan changed her role to that of trusted adviser, see "It's Time to Become a Resource Manager," by Jack Hubbard, *The RMA Journal*, December 2012–January 2013.
2. Konrath is the author of several bestselling books, including *SNAP Selling*.



Residential Environmental Compliance in a Post Dodd-Frank Era

Technology has reduced the cost of residential environmental compliance, but the need for due diligence has never been greater. Now is a good time for lenders to revisit how they address residential property contamination issues in their lending practices.

BY JACK HUNTRESS AND JAMES D. HABERLEN

IN A POST Dodd-Frank era, the order of the day is consumer protection, disclosure, and transparency. New requirements are being introduced, and existing ones that may have been ignored are now being enforced. Chief among the agencies releasing and enforcing these regulations is the Consumer Financial Protection Bureau. In addition, Fannie Mae and Freddie Mac have ramped up scrutiny of the mortgages sold to them, resulting in increased loan ineligibility and repurchase risk for lenders.

For those working in residential lending, it is important to consider the new regulations in the context of traditional due diligence requirements, including credit checks, flood checks, and appraisals. For instance, since 1994, Fannie Mae has acknowledged the importance of reporting environmental contamination on a property during the appraisal process. Similarly, Freddie Mac and HUD request information about potential contamination on or near the subject property, also to be reported during the appraisal process. Unfortunately,

HEMERA/THINKSTOCK

these requirements are not being enforced, which has led to unnecessary consumer health issues and lending risk.

For a number of important reasons, however, lenders may not be able to ignore these environmental requirements any longer. This article evaluates why change is likely. Specific attention is given to each of the following issues, with emphasis on their roles in supporting a shift to a stricter environmental practice:

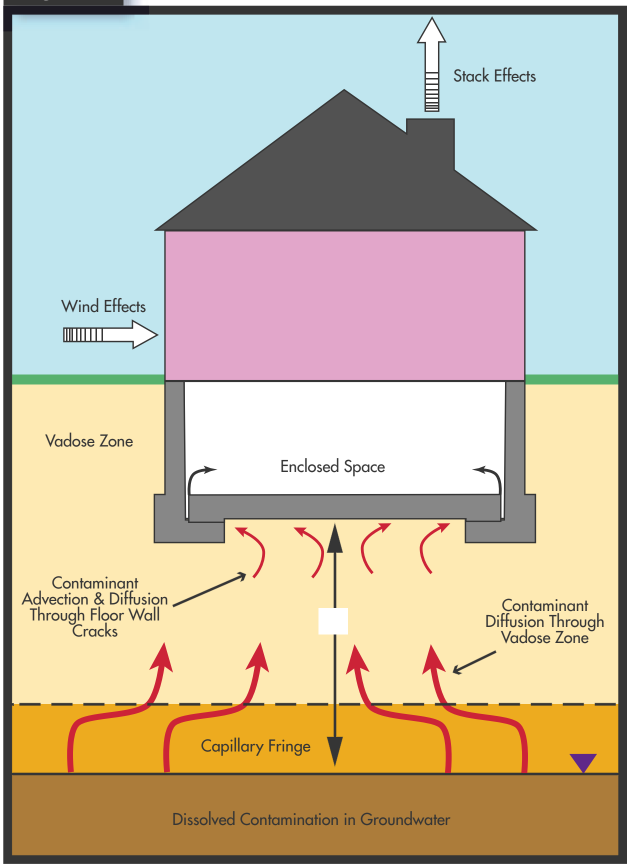
- Growing public concern and regulatory scrutiny over vapor intrusion.
- Environmental requirements of Fannie Mae, Freddie Mac, and HUD.
- Tougher consumer protection and informed consent in the post Dodd-Frank era.
- Tightening of residential mortgage standards by Fannie Mae and Freddie Mac.
- Technological advances that now enable cost-effective solutions for complying with existing requirements.

Vapor Intrusion: The "Game Changer"

Lenders fortunate enough to have avoided environmental issues with residential property mortgages will now find vapor intrusion (VI) a powerful new driver for environmental screenings. VI occurs when volatile chemicals migrate from contaminated groundwater or soil into an overlying building. Figure 1 illustrates this risk in a conceptual model.

VI is fast becoming a "game changer" owing to the growing awareness of vapor-related risk, the potential health effects, and new federal and state guidance on managing VI risk—all of which point to a strong rationale for performing

Figure 1



Source: The Brownfields and Land Revitalization Technology Support Center (http://www.brownfieldstsc.org)

environmental screening as part of residential loan transactions. One reason why VI is of particular concern in residential properties is that, once a pathway is established into a building and vapors enter a home, occupants are unable to avoid exposure. Thus, VI is different from soil or groundwater contamination. In the case of the latter contaminations, people can limit their exposure by changing their behavior (for example, by avoiding tap water and not letting children play in backyards).

Although VI has been known as a risk since the 1990s, only in the past few years has science advanced enough for us to better understand the risks and the mitigation techniques. The U.S. Environmental Protection Agency (EPA) is also in the final stages of issuing updated VI guidance, and 33 states have already developed specific guidance to assess the potential for VI, largely following the EPA's lead.

Additionally, the American Society for Testing and Materials (ASTM), by updating both the standard for assessing vapor encroachment onto a property (E2600) and Phase I Environmental Site Assessments (E1527), is creating a market where vapor migration screening will become standard due diligence practice for commercial property, including multifamily (five or more units) residential properties.

Given the trend toward vapor migration screening

Lenders fortunate enough to have avoided environmental issues with residential property mortgages will now find vapor intrusion a powerful new driver for environmental screenings.

for commercial and multifamily properties, as well as the growing body of evidence on potential health risks, there is a compelling case for screening residential properties (single-family and multifamily up to four units) for VI risk, particularly for the following reasons:

- People typically spend more time in their homes than at their workplaces.
- Children are likely to be more sensitive than adults to the effects of contaminated air; the more time they spend in their homes, the more they are exposed.
- Most people live and spend more time in first-floor and basement settings (where VI risk is greatest) of residential properties than they do in commercial structures.
- Residential buildings usually do not have the airflow refreshing that commercial buildings are typically required to provide.

For residential properties, all these factors create an increased risk profile for exposure limits in situations where contaminated soil or groundwater may migrate to indoor air.

Following the pathways for exposure to contaminated soil and groundwater (such as water supply) has long been a logical way to find and mitigate contaminated properties, but the VI pathway, after being overlooked for years, is a recent addition to today's environmental risk audits of commercial real estate. Numerous plumes thought to be benign because residents drew on municipal water have reemerged as issues because of toxic vapors entering homes.

Pompton Lakes, New Jersey, offers just one of many VI cases around the country. It illustrates the issue of consumer protection and disclosure for homes sitting atop carcinogenic plumes of PCE and TCE, mostly caused by dry cleaning solvents. What is particularly noteworthy about the Pompton Lakes plume, which originated from a former industrial facility, is that information about the contamination was publicly available, yet was not disclosed to buyers and owners until after they learned of their exposure. Figure 2 depicts the Pompton Lakes flume that affected more than 400 homes. If detected early, VI risk can be mitigated rather easily and cost effectively.[1] Further, the principal mitigation technology is not unlike that for managing radon risk by a network of qualified contractors using reliable equipment.

As awareness of VI risk continues to grow and more is known about the health effects, the number of vapor cases continues to grow. New instances of VI are being discovered all the time, and previously overlooked sites are being reopened by state regulatory agencies. A broad summary of all known VI cases to date can be found in Appendix A of the Land Contamination and Residential Properties Summit Report.[2]

Fannie Mae, Freddie Mac, and HUD Requirements

Unlike multifamily and commercial properties, single-family residential transactions rarely involve any environmental due diligence. This is somewhat surprising, given the multiple requirements calling for the reporting of land contamination information in residential property transactions.

Largely embedded in the appraisal process, environmental due diligence requirements have been on the books since as early as 1994, but the ability to fulfill these reporting requirements within reasonable time and cost constraints has only recently been developed. Prudent lenders are watching this changing landscape closely, especially those selling into the secondary market, as greater enforcement of these requirements could lead to loan ineligibility or even repurchase risk.

On the first page of the Uniform Residential Appraisal

Figure 2

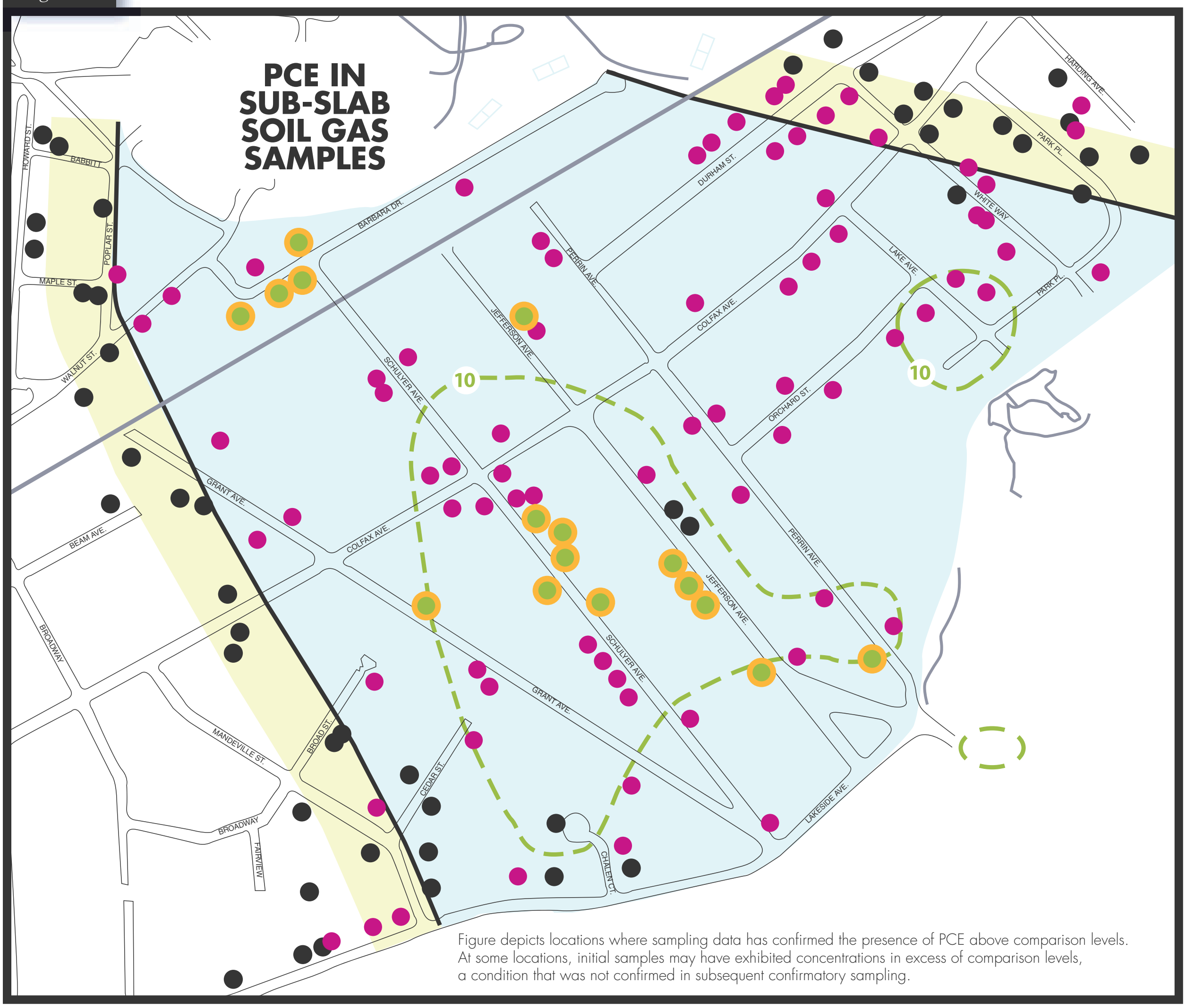


Figure depicts locations where sampling data has confirmed the presence of PCE above comparison levels. At some locations, initial samples may have exhibited concentrations in excess of comparison levels, a condition that was not confirmed in subsequent confirmatory sampling.

Source: Pompton Lakes Works (http://www.pomptonlakesworks.com)

Legend

- PCE in Sub-Slab Soil Gas ≥ 16 pg/m² (includes non-detections)
- PCE in Sub-Slab Soil Gas ≥ 16 pg/m²
- PCE in Sub-Slab Soil Gas ≥ 1,000 pg/m²
- PCE in Shallow Groundwater ≤ 10 pg/L

Figure 3

Environmental Risk Disclosure on the URAR

S I T E									
Utilities	Public	Other (describe)		Public	Other (describe)	Off-Site Improvements – Type		Public	Private
Electricity	☐	☐	Water	☐	☐	Street		☐	☐
Gas	☐	☐	Sanitary/Sewer	☐	☐	Alley		☐	☐
FEMA Special Flood Hazard Area ☐ Yes ☐ No			FEMA Flood Zone		FEMA Map#		FEMA Map Date		
Are the utilities and off-site improvements typical in the market area? ☐ Yes ☐ No If no, describe									
Are there any adverse site conditions or external factors (easements, environmental conditions, land uses, etc)? ☐ Yes ☐ No If yes, describe									

Source: Fannie Mae (https://www.fanniemae.com/content/guide_form/1004.pdf)

Report (URAR), shown in Figure 3, the appraiser is asked to provide environmental information on a number of property- and area-related topics. The three mortgage agencies call for disclosure of this information in the Freddie Mac Single-Family Guide, the Fannie Mae Single-Family Selling Guide, and the HUD Valuation Analysis for Single-Family Dwellings and HUD FHA HOC Reference Guide.

The answer to the question on the form is typically one of the following responses: unknown, none apparent, or even, in some cases, N/A, even though the vast majority of this information is already publicly available on the Internet. The widespread lack of environmental information on these forms is simply not valid. Although only a small portion of homes are affected by any type of environmental condition, a recent study by Environmental Data Resources on 1,000 residential addresses nationwide revealed that 85% of properties had high-liability spill records within a half-mile radius. The benefits of assessing environmental contamination up front are many—but one of the most important is that, with accurate information in hand, buyers are able to make better decisions.

More information on how land contamination records play a role in the way property loans are transacted—and what it means for the lenders extending credit—is available from each of the following sources:[3]

- Uniform Standards of Professional Appraisal Practice (USPAP).
- Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA).
- HUD Multifamily Standards.
- 24 CFR 200.926 (Appendix K).
- FDIC Guidelines for an Environmental Risk Program.
- Consumer Financial Protection Bureau (CFPB) Bulletin.
- OCC Environmental Risk Policy RE 213.
- International Valuation Guidance Note No. 7.

What has changed dramatically over the past 18 years is the ability to access this information and report on what is known about a property's potential for contamination. The Internet, mapping capabilities, and publicly accessible information have all played a significant role in this change, making information about a property's environmental profile easier to obtain than ever.

Consumer Protection and Informed Consent

In a post Dodd-Frank era, where information is just a few mouse clicks away, environmental due diligence during the mortgage-lending process remains a policy of "don't ask, don't tell," even though clear guidelines and regulations have existed since the early 1990s.

In mortgage lending, compliance, safety and soundness in lending operations, and consumer goodwill are all at stake when environmental risk goes undetected. With additional property intelligence to mitigate collateral risk, lenders can make more-informed lending decisions.

Although these requirements are largely associated with the appraisal process, it's not necessary that the information affect the value of the property. In cases where there is known contamination at or proximate to a property, the Uniform Standards of Professional Appraisal Practice (USPAP) recommend providing a true and accurate statement describing why the environmental contamination does not affect the value. The benefit to consumers is that the information is reported in a place that would be disclosed to them as part of the mortgage origination process.

Tightening Residential Mortgage Standards

In the residential mortgage community, the risk of liability stemming from undetected or unmitigated environmental dangers has not yet been fully embraced in an operational sense. It's handled on an exceptions basis, usually ending with the lender declining the loan application because of property ineligibility.

Given regulatory pressures to increase consumer protection, the use of environmental data early in the lending process is one way to mitigate the dangers by identifying any potential risk earlier in the process and mitigating the hazard as appropriate. Further, because of the marketplace shift to more residential properties being purchased by small investors, there is a new level of liability concern as these loans and properties have not traditionally been handled with the same rigor as standard commercial lending for multifamily residential properties, even though they are, in fact, "commercial operations."

Additionally, the topic of environmental justice and the potential scrutiny of the Consumer Financial Protection Bureau[4] are further drivers for environmental screening becoming part of the residential lending process. Currently, the CFPB, by way of the Dodd-Frank Act, has a mandate to issue rules governing real estate settlement-related functions that specifically include appraisals. Proactive risk mitigation is one of the hallmarks regulators look for when evaluating a financial institution's health, so efforts to tighten property-specific policies could help put a lender in good standing with regulators.

Technology Advancements

It's impossible to ignore the role of technology in property risk management. Advances in technology have made environmental assessments on all types of properties, including residential, easier than ever before. Admittedly, in the early 1990s, the costs and turnaround times of performing environmental reporting limited the use of environmental data in underwriting to only the largest commercial property transactions. Information on sites had to be gathered, mapped, and delivered, all of which cost hundreds of dollars and took days to complete.

In today's world, the Internet, cloud computing, e-mail, broadband, and high-speed wireless, along with many advances in database and mapping technologies, are providing a far different definition of what's possible and are changing the landscape for time and cost structures. For example, flood screening and detailed credit reporting can now be performed in less than a second at a cost of just dollars per transaction. Similarly, it's possible to conduct a quick environmental screening with the same parameters. As stated above, the definition of what constitutes reasonably ascertainable and "known" information has changed. Informed lenders are staying on top of these changes and revising their policies as the definition of "best practices" advances along with technology. These improvements ultimately will lead to better compliance with existing requirements.

An example of these requirements is the following statement from the Freddie Mac *Single-Family Seller/Servicer Guide,* Volume I, Section 44.15(i):

"The appraiser must consider any known contaminated sites or hazardous substances that affect the property or the neighborhood in which the property is located. The appraiser must also note the presence of contaminated sites or hazardous substances in the appraisal report, make appropriate adjustments to reflect any impact on market value, and comment on the effect they have on the marketability of the subject property:

Proximity of the property and/or its neighborhood to a contaminated site [and]

Proximity of the property to ground water contamination, chemical or petroleum spills, or other hazardous substances that are expected to impact the area for more than a year."

Specific Concerns for Residential Lenders

The concerns facing the residential lending community today fall into one of three broad areas: consumer health, value diminution, and lender liability/risk. By looking at each of these, it's possible to explore the cause-and-effect dynamic hidden beneath the surface of status quo practices.

Consumer Health

Each year thousands of people have health-related issues connected to contaminated soil, air, or drinking water. The effects of this contamination can range from respiratory illness and external rashes to a variety of cancers from known carcinogens. Contaminants such as benzene (found in gasoline) or perchloroethylene (used in dry cleaning operations) are pervasive nationwide, along with hundreds of other contaminants used in manufacturing and business operations.

People may be exposed to health hazards when they breath vapor intrusion in a home or steam in a shower; ingest contaminants directly (through drinking water) or indirectly (from eating vegetables); or have contact with contaminants on the skin or in a shower.

As mentioned above, contaminated soil and drinking water have long been considered risks to human health, but VI is a consumer health issue that has, to date, largely been overlooked. The simple but necessary act of breathing threatens constant exposure once a pathway has been established within a building.

Appliances, toys, vehicles, food, beauty aids, and other products are all subject to appropriate disclosure so that the consumer is well aware of the risk posed. Further, millions of dollars are spent annually investigating the risks and enforcing action against those who do not disclose as required. Homes are no different, especially those sold and backed by federally insured mortgages. Existing rules call for the identification of environmental hazards, and these hazards are expected to be mitigated before the borrower and lender enter into a mortgage agreement.

Best practices for performing risk screenings are evolving over time as awareness of environmental risk expands and technology allows for easier access to property risk information during loan transactions. For a better understanding, one needs look no further than the way in which flood risk has evolved over the past decade. Today, the growing awareness of VI risk, particularly in residential and multifamily properties, has elevated the importance of property due diligence and provides ample rationale for performing environmental risk screenings and disclosure.

Further, in February 2013, the EPA, HUD, and the White House Council on Environmental Quality announced a new initiative that encourages federal agencies to take preemptive actions that will help reduce the number of American homes with health and safety hazards.[5] This action is a referendum on homes that cause health issues and, in turn, hold back the economy through lost days and increased medical costs. HUD Secretary Shaun Donovan announced the action, saying, "It is clear that unhealthy and unsafe housing has an impact on the health of millions of people in the United States, which is why we must do everything we can to ensure that individuals and families have a healthy place to call home."

Value Diminution

The appraisal community recognizes the drastic diminution in value that can occur when a property is environmentally contaminated or has a negative environmental stigma associated with it. When a property cannot be financed owing to an unmitigated environmental issue, the number of would-be buyers falls dramatically. When a case makes headlines (as Pompton Lakes did), the value diminution is even more intense. The reduced demand for damaged properties has a direct influence on market value.

In weak market conditions like those experienced since 2009, environmental impacts tend to be exacerbated. When property prices are depressed, the impact that an issue can have (expressed as a percentage of total value) is that much greater than during a period of higher property prices.

Lender Liability and Risk

There are numerous ways in which lenders are exposed to the risk of property contamination in residential lending practices. Although not all of them have historically been major concerns for lenders, they deserve renewed attention in today's era of increased disclosure and transparency. The potential risks of residential property contamination to a lender include the following:

- **Loan ineligibility or repurchase risk.** Lending practices are halted or hindered because the secondary market prohibits the sale of the loan or forces repurchase due to contamination.
- **Direct liability.** Issues arise from contaminated properties that the bank takes title to or sells (as part of REO dealings).[6] The bank is, in fact, the gatekeeper, and consumers do rely on the bank to protect them.
- **Reputational risk.** Lenders are drawn into situations where homeowners are faced with contaminated soil, drinking water, or VI. Although the lender may not be directly liable for the exposure, it can certainly suffer reputational risk because of its inability or unwillingness to resolve the issue. Imagine the challenge if any one bank had been the primary lender to borrowers residing in the contaminated Pompton Lakes neighborhood.
- **Repayment risk.** Simply put, a borrower (or a family member) experiencing health issues can be at risk of nonpayment of the loan when confronted month after month with the hard choice of paying the mortgage on the contaminated family home or paying the doctors trying to nurse the borrower back to health.

Conclusion

The risky practice of overlooking land contamination information as part of residential lending could well be on the cusp of change. In light of new enforcement initiatives and requirements, it's a good time for lenders to revisit how they address residential property contamination issues in their lending practices. Numerous environmental requirements in the appraisal process have existed for nearly two decades, but now new drivers on the VI and consumer-protection fronts are providing more pressure for enforcement. Further, technology advances have eliminated the once prohibitive cost and time constraints for performing such screenings up front.

The world of information disclosure is constantly evolving. What was impossible a decade ago is now a click away. Environmental land contamination information is both readily available and readily ascertainable in today's digital world. This effectively changes the definition of what is known at the time of a property transaction. It also has the potential to lower the public's exposure to public health risks and aligns with the EPA and HUD's reenergized focus on healthy homes.

Residential mortgage lenders would be well served to get ahead of this change and consider how they and their business partners can include environmental screening in their lending policies, improve their risk management practices, and reduce public exposure to contaminated soil, groundwater, and vapor. ❖

The authors are with Environmental Data Resources, where ***Jack Huntress*** *is managing director, residential services, and* ***James D. Haberlen*** *is vice president, strategic client program. They can be reached at* jhuntress@edrnet.com *and* jhaberlen@edrnet.com.

Notes

1. See "EPA Technical Documents and Tools Prepared to Support Guidance Development," U.S. Environmental Protection Agency. Available at http://www.epa.gov/oswer/vaporintrusion/guidance.html/.
2. See "Latest News for Environmental Consultants," Environmental Data Resources, Inc. Available at http://www.edrnet.com/community/blogs/environmental-consultants/latest-news-for-environmental-consultants/2012/08.
3. These sources are detailed in the Land Contamination and Residential Properties Summit Report. See http://www.edrnet.com/community/blogs/environmental-consultants/latest-news-for-environmental-consultants/2012/08.
4. See "Protecting Consumers from Irresponsible Mortgage Lending," Consumer Financial Protection Bureau, 2013. Available at http://www.consumerfinance.gov/.
5. For more on this new initiative, Advancing Healthy Housing: A Strategy for Action, see the press release "Federal Agencies Working to Make Homes Healthier," February 4, 2013. Available at http://yosemite.epa.gov/opa/admpress.nsf/0/3e6188a2d58e2c0f85257b08004e66de.
6. See "Bank Sues Contaminating Dry Cleaner's Owner," Oakpark.com, June 8, 2010. Available at http://www.oakpark.com/News/Articles/6-8-2010/Bank-sues-contaminating-dry-cleaner's-owner/.

Internal Controls and Best Practices for Appraisal Departments

Since the credit crisis began in 2008, the regulators have made appraisal departments a major focus of bank examinations. How effective is your bank's program?

By Robert S. Ely and George R. Mann

Although many banks have internal appraisal departments, there is no "gold standard" with which to compare them. Is the department operating effectively and efficiently? Is it understaffed or overstaffed? How well does it serve its internal customers? How does it compare to industry best practices? And what *are* the industry best practices?

Addressing these issues can provide a multitude of benefits. Most important, having the appraisal department adopt industry best practices enhances its support of the lending and workout groups—a benefit that pays off in both up and down markets. Also, it's better for the bank to implement policies and procedures at its own discretion rather than be ordered to by internal audit or bank examiners. Here are some guidelines that banks can follow in reviewing their appraisal functions.

Bank Examiner Perspective

In November 1995, the OCC published *Commercial Real Estate and Construction Lending: Comptroller's Handbook*, a document containing 92 questions relating to internal controls. The instructions state: "The following questionnaire is provided as a tool to assist examiners in assessing the

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The document *Interagency Appraisal and Evaluation Guidelines*, issued in December 2010, offers banks a guide to establishing an effective appraisal program:

"An institution's board of directors or its designated committee is responsible for adopting and reviewing policies and procedures that establish an effective real estate appraisal and evaluation program. The program should:

- Provide for the independence of the persons ordering, performing, and reviewing appraisals or evaluations.
- Establish selection criteria and procedures to evaluate and monitor the ongoing performance of appraisers and persons who perform evaluations.
- Ensure that appraisals comply with the agencies' appraisal regulations and are consistent with supervisory guidance.
- Ensure that appraisals and evaluations contain sufficient information to support the credit decision.
- Maintain criteria for the content and appropriate use of evaluations consistent with safe and sound banking practices.
- Provide for the receipt and review of the appraisal or evaluation report in a timely manner to facilitate the credit decision.
- Develop criteria to assess whether an existing appraisal or evaluation may be used to support a subsequent transaction.
- Implement internal controls that promote compliance with these program standards, including those related to monitoring third party arrangements.
- Establish criteria for monitoring collateral values.
- Establish criteria for obtaining appraisals or evaluations for transactions that are not otherwise covered by the appraisal requirements of the Agencies' appraisal regulations."

bank's internal controls, policies, practices, and procedures in regard to commercial real estate and construction lending." Seventeen of these questions apply to appraisals and evaluations.

Although your bank may not be examined by the OCC, it would be useful to obtain this document and note the items examiners will be looking for in your appraisal department before your next examination. The 10 bullet points in the December 2010 *Interagency Appraisal and Evaluation Guidelines* are certainly items that will be examined (see box).

Internal Stakeholders

Internal stakeholders include lending units, workout and special assets groups, loan review, credit administration, and risk management. A positive—and hopefully value-added—relationship between the appraisal department and all internal stakeholders will benefit the bank.

Achieving total satisfaction is difficult, however, because stakeholders have diverse and sometimes conflicting goals for the appraisal department. It is not unusual for loan officers to contend that other banks are getting their appraisals done more quickly and more cheaply. Lending units often argue that values are too low, while special assets may claim the values are too high. Loan officers think appraisal reviews take too long, while the appraisal department manager seeking to add staff must make a well-supported case for it to senior management.

Recently, the authors reviewed a bank appraisal department, and the stakeholders posed the following questions:

1. Why do our internal reviewers sometimes direct the outside appraisers to change their work product rather than accept their product and then, through the review process, make value adjustments? Is our practice in this respect appropriate, common, or unusual?
2. Why do we differ frequently on participation deals, rejecting or extensively modifying the agent bank's appraisal? How is it we know better what to do than some of the biggest appraisal firms in the country?
3. Some perceive our turnaround times and service level agreement (SLA) delivery times to be slow, excessive, and/or uncompetitive. Are they?
4. Are our appraisal fees higher than our competitors'? Are we being forced into steep discounting to stay competitive?

How do you know if the appraisal department or stakeholder is right? Or what is actually happening at other banks? What are the industry standards? A detailed review of the appraisal department should answer those questions and many more. Here are the steps to take when reviewing an appraisal department.

Procedures for managing and scoring vendors and their credentials, if not contained in individual policies, are important for evaluating the quality of the appraisal pool used by the department.

Step 1: Scope of Work

As with any project, determining the scope of work is an important initial step. A sample scope might be as follows:

1. Determine compliance with applicable laws, rulings, and regulations, specifically Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).
2. Evaluate the adequacy of policies, practices, procedures, and internal controls for analyzing the value of real estate collateral.
3. Learn if bank employees are operating in accordance with the established guidelines.
4. Review a sampling of appraisals and evaluations for quality and reasonableness.
5. Recommend options and solutions when policies, practices, procedures, objectives, or internal controls are deficient or when violations of laws, rulings, or regulations have been noted.

Step 2: Information Gathering

Essential Information

Memorandums of understanding addressing the real estate appraisal program, as well as findings of previous examinations and audits, provide insights into department operations and any issues. Appraisal and evaluation policies and procedures, including those for internal appraisal departments, are key to understanding how the program compares with best practices and if it is adhering to internal policy.

Procedures for managing and scoring vendors and their credentials, if not contained in individual policies, are important for evaluating the quality of the appraisal pool used by the department.

A review of the operational technology platforms helps reveal the effectiveness of systems used to deliver services to internal customers, including request submissions, request for proposal (RFP) processes, data and report delivery systems, communications, and archival systems.

Finally, appraisal reports should be scrutinized for:

- Large-dollar credits.
- Loans secured by complex or specialized properties.
- Nonresidential real estate construction loans.
- Loans in geographic areas with unfavorable market conditions.
- Out-of-area real estate.
- Loan participations and Shared National Credits.
- Workouts; OREO/SAD.
- Other loans as determined by senior management.

Other Pertinent Information

- Employee resumes and state licenses (if available), as well as organizational chart(s) applicable to the real estate appraisal department.
- The list of approved fee appraisers and their application files, including a list of fee appraisers removed from the approved list.
- The list of agents that order and/or review real estate appraisals for the bank and copies of any agreements or contracts for such services.
- Appraisal-related correspondence, including the department's RFP, engagement letter, and appraisal review forms.
- A sampling of internal evaluation reports, if the appraisal was performed internally.
- A sampling of internal review reports performed by each reviewer (internal and external), including reviews where a reconsideration of value was required.
- The list of approved internal evaluators and their qualifications.
- Internal management reports on loans with appraisal policy exceptions.
- Internal management reports used to monitor the progress and effectiveness of the appraisal process and copies of appraisal tracking logs.

Additionally, data and reporting for appraisal assignments pertaining to the following factors:

- Average turn times (internal and external).

Table 1

Chief Appraiser Interview	
1.	How do you qualify new fee appraisers who want to be added to the bank's approved list?
2.	When was the last time a fee appraiser was taken off the approved list? Why?
3.	How do you track appraisal quality?
4.	Who sends out the RFPs and engages appraisers?
5.	How do you handle employee education and training?
6.	Does the bank pay for any professional designations?
7.	Does your department charge the lending units for reviews? If so, how?

Table 2

Staff Review Appraiser Interview	
1.	What information is required from loan officers for appraisal requests?
2.	What type of interaction is allowed between the loan officer and fee appraiser?
3.	Do you release appraisal reports to loan officers *before* your review is complete?
4.	How long do you have to complete a review?
5.	How are complaints from loan officers and/or borrowers handled?
6.	For what reasons have you rejected an appraisal report?
7.	How often are reports rejected?
8.	How old does an appraisal have to be before you won't review it?
9.	How do you handle going concern or apartment appraisals with regard to FF&E?

A well-functioning and efficient appraisal program is the cornerstone of a bank's collateral evaluation function.

Table 3

Peer Survey Information

Bank Size	\$20–\$30B	< \$5B	< \$5B	< \$5B	< \$5B	\$10–\$15B	\$10–\$15B	\$50–\$75B
No. of Technical Reviews	140; Resid. –530	240	20	200–250	125	215; Resid –500	100	200
No. of Compliance Checklists	60; Resid. –660	N/A	130	200	150	240	N/A	240
Technical Review Turn Time	1 Week: Resid. –2 Bus. Days	5-7 Business Days	1 Week	1 Week	1 Week	6 Bus. Days	1 Week	1 Week
Compliance Checklist Turn Time	No set time; Resid. –2 Bus. Days	N/A	1 Week	3–5 Bus. Days	1 Week	3 Bus. Days	N/A	1 Bus. Day
Appraisal Turn Time	40 Cal. Days	21–28 Cal. Days	21 Cal. Days	25 Cal. Days	28 Cal. Days	30 Cal. Days	4–6 Weeks	35 Cal. Days
Average Appraisal Fee	\$2700; Resid. –\$840	\$3200–\$3500	\$3000	\$4000	\$3600	\$3400	\$3500 - \$5500	\$2850
Perform Internal Evaluations	No	No	Yes	No	Yes	Occasionally	No	No
Charge LOBs for Evaluations	N/A	N/A	Soon	N/A	Yes	No	N/A	N/A
Fee for Evaluations	N/A	N/A	TBD	N/A	\$500	N/A	N/A	N/A
Residential Appraisal Turn Time	7 Cal. Days	5–7 Cal. Days	7 Cal. Days	5–7 Cal. Days	N/A	5–6 Cal. Days	N/A	N/A

- Average fees by lending group.
- Percentage of appraisal report types ordered (restricted use, summary, self-contained).
- Number of rejected reports or any reports where a reconsideration of value was necessary.
- Appraiser concentrations.
- Appraiser scoring.

Any specific documentation, reports, reviews, or analyses senior management believes are necessary for the project.

Step 3: Interviews and Peer Survey

Interviews are an excellent way to determine if policies and procedures are actually being followed. Policies may appear appropriate, but if staff is not complying with them the bank may be taking on unknown risks. Interview results can also reveal ways to improve policies and procedures.

Parties that should be interviewed include appraisal department employees and stakeholders.

Tables 1 and 2 provide a sampling of questions for staff review appraisers and the appraisal department manager.

Another source of valuable information is peer banks. Table 3 shows the type of information that can be obtained from appraisal departments at peer banks. This information is helpful in showing stakeholders and senior management how the bank's SLAs compare with other banks.

Step 4: Results of Review

Write a memorandum stating your findings regarding:

- The quality of department management and employees.
- The adequacy of written policies relating to real estate appraisal and evaluation.
- The efficiency and effectiveness of the appraisal order and review process.
- The manner in which bank offices are operating in conformance with established policy.
- The overall quality and reasonableness of the appraisals ordered by the bank.
- The quality of internal appraisal reviews.
- The quality and reasonableness of internal evaluations.
- Market areas or property types of concern.
- Areas of noncompliance with FIRREA and bank policy.
- Suggested options or solutions to areas of noncompliance or items that could use improvement.
- Other items to be addressed specified by senior management.
- Other items of significance.

Conclusion

A well-functioning and efficient appraisal program is the cornerstone of a bank's collateral evaluation function. The bank's appraisal department must be in step with best practices, provide good internal customer service, and perform due diligence with a high level of competence.

This is important not only to credit quality and risk management, but also to the bank's ability to service its loan customers in a timely and professional manner. The elements discussed in this article provide a framework for evaluating your appraisal program's effectiveness—a determination that could help your bank avoid losses. ❖

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Dev Strischek talks to Billy M. Atkinson, chair of the Financial Accounting Foundation's new Private Company Council. This is the latest in a series of interviews with accounting industry leaders conducted by Strischek over the past two years.

Billy M. Atkinson

New FAF Entity Is Developing GAAP for Private Companies

Strischek: As chair of the Private Company Council of the Financial Accounting Foundation (FAF), you must have amassed considerable experience in the accounting profession. Would you share some of the highlights of your life and career?

Atkinson: I've had 39 years of experience in public accounting in the Houston and the Texas market, where I was an audit and risk management partner in the PricewaterhouseCoopers Private Company Services practice. Our office size grew from 25 to 1,300 before I retired in 2011. It grew largely because of the emergence of the private company market.

I was appointed to a six-year term on the Texas State Board of Public Accountancy in 1999 by Governor George W. Bush and served as its presiding officer from 2003 to 2005, in the post-Enron era. I chaired the major case and technical standards enforcement committees, among others, and served on the board rules and executive committees. I subsequently served as chairman of the National Association of State Boards of Accountancy (NASBA) from

Dev Strischek's series of interviews with accounting industry leaders for *The RMA Journal* also includes:

- *AICPA Proposes New Financial Reporting Framework for Small and Midsize Companies: An Interview with Robert Durak, AICPA's Director of Private Company Financial Reporting,* April 2013
- *FAF Council to Address Accounting Complexity for Privately Held Firms: An Interview with Terri Polley, President and CEO, Financial Accounting Foundation,* February 2013
- *Working to Improve and Converge U.S. and International Accounting Standards: An Interview with Leslie F. Seidman, Chairman of the FASB,* June 2011
- *Preparing to Represent CPA Interests on a Global Scale: An interview with Barry C. Melancon, President and CEO of the American Institute of CPAs,* June 2011

2009 to 2010. I'd been a member of the NASBA board since 2004 and chaired several of its committees, including the education and audit committees. I also served as a member of the American Institute of Certified Public Accountants Governing Council from 2003 to 2006 and held various leadership positions in the Texas Society of CPAs. Prior to that, I chaired the Houston Society of CPAs.

By serving in these organizations, in addition to my practice, it reinforced [the idea of] public reliance on the transparency, honesty, and ethics of accounting and financial reporting under generally accepted accounting principles (GAAP). It also reinforced the duty private companies have to varied stakeholders, with whom I had considerable interaction.

This past year I began serving as board chair of a private candy manufacturing company that is family-owned. So, my perspective is fairly broad.

Strischek: Most bankers recognize accounting organizations such as the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA), but could you describe the role of NASBA and how it interacts with the FASB and the AICPA?

Atkinson: NASBA's mission is to enhance the effectiveness of the 50 state boards of accountancy, as well as those of the five U.S. territories. In support of this mission, NASBA does four things. It provides them with programs and services. It identifies, researches, and analyzes major current and emerging issues affecting state boards of accountancy and regulation. It strengthens and maintains communications with member boards to facilitate the exchange of ideas and viewpoints. And it develops and fosters relationships with organizations that impact the regulation of public accounting.

This includes interaction with the AICPA, the Securities and Exchange Commission, the Public Company Accounting Oversight Board (PCAOB), and other entities on behalf of its member boards. You must remember that the practice of public accounting as well as obtaining and retaining a CPA license are regulated by the states. Essentially, the CPA exam process is owned by the state boards and represented by NASBA. It is governed by an agreement between NASBA, the AICPA, and ProMetric. ProMetric is a provider of technology-enabled testing and assessment solutions.

Strischek: You also served on the blue ribbon panel sponsored by FAF, AICPA, and NASBA that ultimately recommended a separate, independent body to review existing and future GAAP and recommend to FASB changes to GAAP that would accommodate the 26 million private firms in the U.S. However, FAF did not establish a formal, separate board for private company GAAP. Instead, it formed the Private Company Council (PCC) to recommend GAAP revisions to FASB. As the first PCC chair, how are you ensuring the PCC's ability to represent private company interests in the development of more private-company-friendly GAAP inside the FASB-FAF organization?

Atkinson: The short answer is that I am not ensuring it. The FAF and FASB organizations are doing so. The PCC is a primary vehicle in an FAF trustee strategy to address the issue of private company financial reporting.

U.S. GAAP has been referred to by many as a "gold standard" in identifying, developing, and monitoring accounting standards as used in this country and, in some cases, others. Such a description results from the careful, diligent due process of accounting standards-setting that has evolved over the years.

Given the confidence of the public in the FASB's diligent process, I see no reason why such accounting standards development for private companies should not be directly linked to it. But it should be done in an effective manner. We can moderate the culture and process to ensure appropriate private-company-centric considerations. That is just a product of effective leadership within the organization and its strategy. Why would we want to risk the creation of a separate process? I can't imagine financial statement users supporting such a change.

My observation and experience with the FAF-FASB organization so far have confirmed that it is committed to better serving the needs of stakeholders. In particular, it is committed to serving users of private company financial statements. Such experience goes back to my role at NASBA, the blue ribbon panel process, and current PCC activities to date. I believe the FAF-FASB organization has proven this through actions in the PCC design and activation. For example, the FAF board of trustees has created the Private Company Review Committee, which will hold the PCC and FASB accountable for ensuring adequate consideration of private company issues in the standards-setting process. I have direct interaction with the chair of that FAF committee and he attends our meetings.

Additionally, our project on the Private Company Decision Making Framework requires "buy in" from both the PCC and the FASB. The PCC has already formally agreed

> By serving in these organizations, in addition to my practice, it reinforced [the idea of] public reliance on the transparency, honesty, and ethics of accounting and financial reporting under generally accepted accounting principles.

with the FASB on the drafted framework. That will be the cornerstone for private company standards-setting. We'll be using the framework, and our collective PCC member experience, to consider potential exceptions or modifications to existing U.S. GAAP on a "look back" basis. Some of that may end up benefiting both private and public company stakeholders. As another focus of our existence, we will be advising the FASB on appropriate private company considerations for items under active consideration on the FASB's technical agenda.

The PCC itself is composed of 10 members with diverse private company backgrounds and perspectives. They bring a deep understanding of the complex issues facing the FASB as it seeks to serve the best interests of all those who use, prepare, and audit private company financial statements. They also have a strong appreciation for the importance of independent standards-setting and an unwavering commitment toward greater clarity and well-informed decision making in private company financial accounting and reporting.

Strischek: The PCC has identified several topics for its review. They include consolidating variable-interest entities when applied to related-party arrangements (formerly FIN 46(R)), accounting for plain-vanilla interest rate swaps (formerly FAS 133), recognizing intangible assets acquired in business combinations (formerly FAS 141 and FAS 142), and accounting for uncertain tax positions (formerly FIN 48). What factors compelled the PCC to pick these topics over all the other possibilities?

Atkinson: These topics were identified by private company stakeholders. During the PCC's first meeting in December, FASB staff members presented the PCC with issues that concerned constituents. The constituents had provided input to the Blue Ribbon Panel on Standard Setting for Private Companies in 2010. There was also input from participants in private company round tables held in 2010 and 2011. Stakeholders raised these issues to the FAF and the FASB leading up to the creation of the PCC.

In the first PCC meeting, the FASB staff presented commonly cited issues. The PCC deliberated the areas that required the PCC's immediate attention and what the PCC could effectively and efficiently resolve.

The PCC then directed the FASB staff to develop agenda research memoranda on those items. At the February meeting, we discussed and deliberated on the items and added three projects to the agenda.

All three issues that were added to the PCC agenda in the February meeting will be equally addressed by the PCC. One was consolidating variable-interest entities in related-party arrangements. Another was accounting for plain-vanilla interest rate swaps. And the third was recognizing and measuring various identifiable intangible assets acquired in business combinations, including goodwill amortization.

These issues are often top of mind for users, preparers, and auditors of private company financial statements. In looking carefully at the uncertain tax positions [Fin 48] issue, we determined that we could see no current relevance or excess-cost-versus-benefits issues for privates other than the difficulties within the implementation process. Sure, it was, in some cases, hard. But we were not hearing or seeing continued noise relative to private companies. So we tabled the topic pending the collection of contemporary feedback. This was a PCC decision.

As the PCC, FASB, and stakeholders continue to identify issues of concern from stakeholders, the PCC will discuss, deliberate, and may direct the FASB staff to develop agenda research memoranda for consideration. Again, I emphasize input from stakeholders.

Strischek: Do you have a second and/or third set of topics the PCC is likely to review? If so, what are the issues that have put them into play for future PCC meetings?

Atkinson: Based on the stakeholder feedback and discussions at the February meeting, the PCC directed the FASB staff to develop agenda research memoranda on two new additional topics: stock-based compensation and development-stage enterprises.

We will address these topics further when the FASB staff presents research on them at the May PCC meeting. Several other topics have been discussed, some focused and others quite broad in scope. The PCC has made no decisions on such other topics yet.

The PCC will also continue to advise the FASB board on the appropriate treatment for private companies for items under active consideration on the FASB's technical agenda. For example, in the February meeting, we discussed FASB's project on definition of a nonpublic entity and provided input to the FASB on other projects. They included going concern, revenue recognition, and the Emerging Issues Task Force's project on recognition of new accounting basis [pushdown] in certain circumstances. This will continue.

Strischek: You mentioned in another interview that FASB and the PCC "share a common underlying theory that an economic transaction should dictate the accounting, and not the capital structure of a company." How do you think this shared theory will impact the degree of differentiation between the big GAAP for public companies and the evolution of a little GAAP for privately held firms?

Atkinson: In my prior interview, I did not state that the PCC and the FASB share a common underlying theory that an economic transaction should dictate the accounting. I said the reason there was going to be continued difficulty in maneuvering differences between public and private companies was this: Some believe in an underlying theory that an economic transaction should dictate the accounting, and not the capital structure of a company.

It is really too early to ascertain the impact of this view that is out there. However, the motive of the PCC is to address relevance, cost-benefit, unnecessary complexity, and user needs within GAAP. As you know, we will propose modifications or exceptions to current or developing GAAP, as may be needed, to accommodate stakeholders of private companies. This is consistent with the recommendations of the blue ribbon panel.

Strischek: The AICPA recently proposed an alternative accounting framework for private firms, and NASBA's board actually passed a resolution in January 2013 urging the AICPA to either table or withdraw the proposal to give the PCC the opportunity "to develop standards uniquely applicable to private companies that can be authoritative and part of GAAP." Would you compare and contrast the AICPA proposal with the private company GAAP to be developed by the PCC?

Atkinson: The AICPA is working on a framework intended for companies that are not required to prepare financial statements using U.S. generally accepted accounting principles. The AICPA's non-GAAP framework would be suitable only for those private companies whose financial statement users do *not* require GAAP.

The Private Company Council is looking at potential adjustments to U.S. GAAP, which is set by the FASB. The PCC is intended to consider ways to improve U.S. GAAP for private companies whose financial statement users do require GAAP. So the PCC really is not focused on the AICPA's Financial Reporting Framework for Small and Medium-Sized Entities [FRF-SMEs].

However, I would presume users of private companies' financial statements to be quite interested in the subject, whether or not another diverse basis of financial reporting is needed for dissemination or how it would be promulgated independently and reliably.

Strischek: In May 2008, the AICPA authorized the International Financial Reporting Standards (IFRS) SME accounting as GAAP, but most bankers have not seen SME accounting from their borrowers. What do you believe to be the reasons for the lack of SME adoption to date?

Atkinson: Without IFRS formally adopted as GAAP in the U.S., there is no reason to consider adoption of IFRS for SMEs.

Strischek: Do you expect the mission of the PCC to change over time? Are there many more existing generally accepted accounting principles that need to be "privatized"? In other words, are there any that need to be revised to accommodate private firms? And is it possible that the PCC might run out of GAAPs to privatize?

Atkinson: The PCC has already made significant progress in its effort to improve financial reporting for private companies by adding three projects to the agenda. It is moving forward to re-expose the proposal on the private company decision-making framework and seeking new research on stock-based compensation and development-stage enterprises.

We wanted to hit the ground running by addressing some of the critical and top-of-mind issues facing users, preparers, and auditors of private companies' financial statements. One component of success will be our ability to progress in assessing and tackling the issues that were initially identified, while continuing to address other issues concerning private company stakeholders.

The PCC will also be busy advising the FASB on the appropriate treatment for private companies for FASB's active projects.

Among others, one of the keys to our continuing success will be obtaining meaningful feedback on all issues from private company stakeholders. We expect private company financial statement users, auditors, and preparers to lend us their input and help us identify key accounting and financial reporting issues that affect them. If this user input process were to yield no issues, I guess we might not be as busy.

Strischek: Many banks lend to not-for-profit (NFP) organizations—for example, schools, churches, and charities. Will the PCC be evaluating NFP accounting, too? If not PCC, then what part of FAF will? What can we bankers do to encourage the FAF to raise NFP accounting's position on FAF's priority list?

Atkinson: The FASB's Not-for-Profit Advisory Committee (NAC) serves as a standing resource for the FASB in obtaining input from the not-for-profit sector. That covers existing guidance, current and proposed technical agenda projects, and longer-term issues affecting those organizations. The NAC, and not the PCC, addresses critical issues and is a key vehicle for hearing perspectives from the not-for-profit sector.

The NAC is monitoring the work of the PCC and advising the FASB board and staff on potential piggybacking opportunities. The FASB could take similar action on behalf of some or all not-for-profit organizations. Of the initial projects of the PCC, they are especially keeping an eye on the interest rate swaps and intangibles projects.

The NAC also successfully advocated for a project to refine the current not-for-profit financial reporting model. The point was to improve its overall usefulness to the users of NFP financial statements. Often, unlike with many private companies, they go well beyond lenders. That project is now on the FASB's active agenda. The FASB staff will continue to reach out to members of the lending community during that project.

Strischek: Finally, bankers are heavy users of financial statements and substantial lenders to privately held firms, so we have a vested interest in any effort that simplifies and improves the financial accounting of our borrowers. What can we bankers do to support the PCC in its efforts?

Atkinson: It is very important that the PCC makes decisions based on contemporary viewpoints of users that truly represent the users' needs, as well as those of preparers and auditors.

In order to improve U.S. GAAP applicable to private entities and to consider the costs and benefits of proposed improvements, the PCC, FASB, and its staff need to hear directly from private company stakeholders—especially from the *primary* users of private companies' financial statements, such as banks.

The PCC welcomes formal or informal comment letters, feedback, and input from the lending community and other users on proposed agenda topics, as well as current projects—especially when proposals are out for public comment. ❖

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The No-Doc Is Out, Suitability Is In

Lenders are being required to determine beforehand that borrowers have the ability to repay.

BY FRANCIS X. RILEY

SUITABILITY IS A relatively recent regulatory mandate that requires banks and nonbank creditors and loan originators to consider the appropriateness of the financial products they offer and to assess a consumer's ability to repay before making a loan.

The suitability requirements for certain loans and credit programs were implemented in response to the financial crisis of 2007-09 and in an effort to rid the financial industry of certain products such as the stated income loan.[1] A portion of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which provides for sweeping financial reforms, and the previously existing Credit Card Accountability Responsibility and Disclosure Act (CARD Act) require creditors to assess the consumer's reasonable ability to repay by applying certain objective considerations. Creditors that fail to do so may face regulatory investigation and enforcement actions by the Consumer Financial Protection Bureau and civil actions by affected consumers.

Background

Historically, the relationship between creditors and borrowers, even in a residential mortgage loan, was viewed as an arm's-length transaction in which both sides seek to protect and advance their own interests. The relationship was traditionally not a fiduciary one: The creditor was not required to guard the interests of the borrower over all others, including itself. Similarly, creditors previously had no legal duty to validate and ensure a consumer's ability to repay a loan or obligation.

Prior to Dodd-Frank's enactment, the only suitability standards in the mortgage industry arose from statutes such as the Home Ownership Equity Protection Act (HOEPA), which amended the Truth in Lending Act (TILA) for certain high-cost or Section 32 loans. HOEPA included a requirement that, for those types of loans, the creditor had to consider the borrower's ability to repay. Further, any refinance transactions within one year were to be "in the borrower's interest."

Dodd-Frank and the CFPB's Suitability Requirements

Dodd-Frank dramatically changed the long-standing relationship between bank and nonbank lenders and most consumers, in effect creating a fiduciary relationship between lenders and their borrowers. Specifically, Section 1411(a)(2) of Dodd-Frank states that "no creditor may make a residential mortgage loan unless…the consumer has a reasonable ability to repay the loan…."

Recently, the Consumer Financial Protection Bureau (CFPB) announced a final rule implementing Dodd-Frank's statutory requirements regarding a consumer's ability to repay. This final rule is scheduled to become effective January 10, 2014. It describes a certain amount of due diligence required on the part of creditors that make ability-to-repay determinations, although the rule does not mandate that they follow a specific underwriting model.

Specifically, creditors must generally consider eight underwriting factors:

1. Current or reasonable expected income or assets.
2. Current employment status (applicable when the creditor relies on income from the consumer's employment).
3. The monthly payment on the covered transaction.
4. The monthly payment on any simultaneous loan.
5. The monthly payment for mortgage-related obligations (taxes, insurance, etc.).
6. Current debt obligations, alimony, and child support.
7. The monthly debt-to-income ratio and residual income.
8. Credit history.

With respect to adjustable-rate mortgages, the mandated analysis of the monthly payments requires a creditor to calculate the ability to repay based on a fully amortizing payment schedule, which takes into account any adjustments or increases during the life of the loan. The creditor is required to verify a consumer's ability to repay the loan as it is set not only at closing, but also in the future and after the expiration of any introductory or interest-only period.

> While affirmative claims have a three-year statute of limitations, it is important to note that there is no statute of limitations on a borrower's ability to seek a recoupment or set-off in foreclosure.

The commentary to the rule provides examples and details on how to calculate payments under other loan types, including balloon, interest-only, and negative amortization loans, and provides direction on how debt-to-income ratios should be determined. It also indicates that creditors may retain flexible procedures to allow consideration of other debt obligations in light of the particular circumstances of each case, including the fact that other obligations may be paid off soon after a transaction has been closed.

In addition, a creditor must verify the information on which it bases its ability-to-repay determination by using written "third-party records" that are reasonably reliable. These records primarily refer to "a document or other record prepared or reviewed by an appropriate person other than the consumer, the creditor, or the mortgage broker, or agent of the creditor or mortgage broker." A creditor is not required to "obtain additional records to verify the existence or amount of obligations shown on a consumer's credit report or listed on the consumer's application," unless it has reason to believe that the information is inaccurate or subject to dispute.

Generally, income or asset verification should be made by examining, among other things, W-2s, tax returns, payroll receipts, financial institution records, credit reports, or other third-party documentation. These regulations and rules serve to effectively eliminate stated income or "no doc" loans that were previously available to consumers.

The final rule also requires creditors to maintain records that demonstrate their compliance with this rule for three years following consummation of the transaction.[2] This requirement coincides with the rule's three-year statute of limitations on a borrower's potential affirmative suit for an alleged violation.[3] While affirmative claims have a three-year statute of limitations, it is important to note that there is no statute of limitations on a borrower's ability to seek a recoupment or set-off in foreclosure, and a creditor may want to consider retaining compliance records beyond the three-year period.

Exemptions

The requirements set forth in Section 1411(a) of Dodd-Frank do not apply to reverse mortgages, business-purpose loans, or temporary or bridge loans with terms of 12 months or less.

Creditors who want to reduce the potential exposure from the ability-to-repay requirements may choose to make only "qualified mortgages" (QMs). Creditors making QMs will be given a safe harbor and an additional line of defense for any claims in which they failed to assess, or were negligent in assessing, a consumer's ability to repay. In theory, a creditor may defend a claim on the grounds that it issued a QM, thereby invalidating any need to determine whether the creditor made a reasonable determination of the consumer's ability to repay.

It remains to be seen how this safe harbor will be applied in practice and the types of defenses that a borrower may raise to get around the creditor's QM invocation. In addition, whether the QM actually provides a safe harbor or rebuttable presumption will also depend on whether the transaction is considered a "higher-priced loan." Generally, in order to qualify for the protections provided to QMs, the loan must contain the following terms and conditions:

- The loan term may not exceed 30 years and must provide for regular period payments that are substantially equal (except for an interest rate in an adjustable-rate mortgage, which may not result in negative amortization, principal-payment deferral, or a balloon payment).

- The total debt-to-income ratio based on the guidelines provided by the CFPB cannot exceed 43%.
- The total points and fees cannot exceed the following thresholds:
  - For loan amounts greater than or equal to $100,000, the cap is 3% of the total loan amount.
  - For loan amounts greater than $60,000 but less than $100,000, the cap is $3,000.
  - For loans greater than $20,000 but less than $60,000, the cap is 5% of the total loan amount.
  - For loans greater than $12,500 but less than $20,000, the cap is $1,000.
  - For loans less than $12,500, the cap is 8% of the total loan amount.
- The creditor must analyze and evaluate the consumer's income, debts, and other obligations in accordance with prescribed guidelines in the new Appendix Q.
- The monthly payment that must be considered is one that would be at the "maximum interest rate" that may apply in the first five years after the date on which the first regular payment is due.[4]
- The final rule also provides for alternative bases to qualify for the QM protections, including those loans eligible to be purchased or guaranteed by Fannie Mae or Freddie Mac, or eligible to be insured or guaranteed by HUD, the VA, the Department of Agriculture, or the Rural Housing Service under their underwriting guidelines. These loans will only need to meet certain limited requirements—that is, no more than a 30-year term, regular amortizing payments, and adherence to the points and fees thresholds—and will not need to meet the remaining conditions for a QM, such as the debt-to-income requirements.

The rule also provides creditors with an exemption when refinancing a consumer's "nonstandard mortgage" to a "standard mortgage." Nonstandard mortgages include interest-only loans, negative amortization loans, and adjustable-rate mortgages with an introductory fixed rate for a period of one year or longer. Standard mortgages must provide for regular payments, an interest rate that is fixed for the first five years, and a loan term that does not exceed 40 years. In addition, the total points and fees must comply with the thresholds described above, and the proceeds must be used to pay off the outstanding balance of the nonstandard mortgage.

The CARD Act

The requirement for determining a consumer's ability to repay is not just applicable to residential mortgages. Through the CARD Act, which became law in 2009, Congress has required creditors to assess a borrower's ability to make the necessary payments prior to opening a new credit card account. Specifically, it states that a creditor "may not open any credit card account for any consumer under an open-end consumer credit plan, or increase any credit limit applicable to such account, unless the card issuer considers the ability of the consumer to make the required payments under the terms of such account."

While the types of considerations for a consumer's ability to repay are not specifically set forth, it seems likely that the CFPB, which took over the administration and enforcement of the CARD Act, will use some of the ability-to-repay requirements set forth above in determining a creditor's compliance with the CARD Act's ability-to-repay requirement.

Unfair, Deceptive, or Abusive Acts or Practices

In addition to the specific suitability requirements already described, the CFPB also has the additional and still amorphous broad authority to protect consumers from unfair, deceptive, or abusive acts or practices (UDAAP). Congress expressly stated that the purpose of the ability-to-repay determination is "to assure that consumers are offered and receive residential mortgage loans on terms that reasonably reflect their ability to repay the loans and that are understandable and *not unfair, deceptive, or abusive*" (emphasis added).[5] Thus, it is important to understand how these terms are currently defined or understood.

The requirement for determining a consumer's ability to repay is not just applicable to residential mortgages.

To declare a practice as "unfair" (and therefore unlawful), the CFPB must have a reasonable basis to conclude that the act or practice causes or is likely to cause "substantial injury to consumers, which is not reasonably avoidable by consumers; *and* such substantial injury is not outweighed by countervailing benefits to consumers or competition."[6] To declare a practice as "abusive" (and therefore unlawful), the CFPB must find that it materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service; or takes unreasonable advantage of 1) a lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service; 2) the inability of the consumer to protect his or her own interests in selecting or using a consumer financial product or service; *or* 3) the reasonable reliance by the consumer on a covered person to act in the interests of the consumer.[7]

As a general matter, the term "deceptive" has been described as a representation, omission, act, or practice that misleads or is likely to mislead the consumer, is material, and leads to an interpretation by the consumer that is reasonable under the circumstances.[8]

While the ability-to-repay rule provides some detail on how creditors should proceed, much remains uncertain, including how the QM safe harbor or rebuttable presumption will operate in practice.

It is also important to note that it is not just a creditor's own actions that can cause UDAAP liability, but also those of its third-party vendors. The CFPB has consistently treated third-party providers, especially those who interact or interface with consumers, like the creditor itself for purposes of UDAAP liability.[9]

While the CFPB has provided its final rule and guidance on the ability-to-repay requirements, it is important to keep the general UDAAP provisions in mind when constructing any regulatory compliance procedures, as these principles appear to be the foundation for many of the CFPB's enforcement actions.

Conclusion

While the ability-to-repay rule provides some detail on how creditors should proceed, much remains uncertain, including how the QM safe harbor or rebuttable presumption will operate in practice. In addition, a federal appeals court's recent finding that President Obama's recess appoints to the National Labor Relations Board were unconstitutional could have implications for the CFPB and its director, Richard Cordray, who was a recess appointment named at the same time as the NLRB members.

If Cordray's appointment is challenged and deemed to be unconstitutional, the final rule setting forth the ability-to-repay and QM requirements may be invalidated and the arguably stricter rule from Dodd-Frank would replace it. Creditors will need to monitor the situation closely in order to determine the implications of any further developments. ❖

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Notes

1. Stated income loans were designed to facilitate lending to those consumers who had difficulty documenting their incomes, such as those working on commission, the self-employed, or those on a purely commission-based salary. As such, many stated income loans did not require any type of income verification or documentation.
2. Section 25(c)(3).
3. TILA Section 130(e).
4. These requirements may also be important for determining whether a loan is a "qualified residential mortgage," or QRM. Dodd-Frank also requires certain creditors to retain no less than 5% of the credit risk of any residential mortgage that is securitized. The purpose of this requirement was to mandate that creditors making loans characterized as "risky" keep some "skin in the game" and share in some of the losses that may result after the loan is sold on the secondary market. However, loans that meet the QRM requirements will not be subject to the 5% risk-retention requirement. The QM rule and its requirements are particularly important because Dodd-Frank mandates that the QRM definition can be no broader than the definition for QM.
5. 15 U.S.C.A. § 1639b(a)(2).
6. Section 1036.
7. Section 1031.
8. CFPB Bulletin 2012-06.
9. CFPB Bulletin 2012-03.

Out of the Shadows?

How Banks and Regulators Can Better Serve the Underbanked

The underbanked are attracting the attention of a small number of forward-looking banks, which view these underserved households as a new business opportunity and a way to demonstrate social responsibility.

iStockphoto/Thinkstock

A bank is a place that will lend you money if you can prove that you don't need it.

—*Bob Hope*


HELP

By Rick Buczynski and Robert Kennedy

Evidence is growing that an increasing number of American households are joining the ranks of the underbanked, shifting away from traditional banking and relying more on alternative financial services (AFS).

The "underbanked" are the 24 million households that use a traditional bank for checking or other services, but that also use one or more AFS products from a lightly regulated nonbank. Adding this number to the millions who lack any form of deposit account—the "unbanked"—reveals a potentially disturbing shift away from fully banked households to underbanked and unbanked households over the 2009-11 period (Table 1). This development has implications for policy makers and bankers alike, presenting business opportunities as well as challenges.

Cyclical factors related to the Great Recession explain much of this shift. Unemployment soared, household incomes were compromised, and, perhaps most critically, net worth eroded. This negative wealth effect is especially worrisome for lower-income families that typically seek out AFS (Figure 1).

A recent FDIC survey suggests that other structural factors need to be taken into account—in particular, household demographics (Table 2).

Minorities, foreign-born noncitizens, the unemployed, low-income families, and the young lead the list of the underbanked and unbanked. Many other key findings reported by the FDIC are jaw-dropping:

- Almost 10 million households (8.2% of total households) are unbanked. Roughly 17 million adults live in unbanked households.
- Underbanked households increased by 2.5 million during 2009-11; unbanked households increased by 821,000 in the same period.
- 20.1% of households are underbanked, representing 24 million households with 51 million adults.
- 29.3% of households do not have a savings account and nearly one out of 10 do not have a checking account.
- One-quarter of households have accessed an AFS product in the past year, and almost one in 10 have used two or more types of AFS products.

Table 1

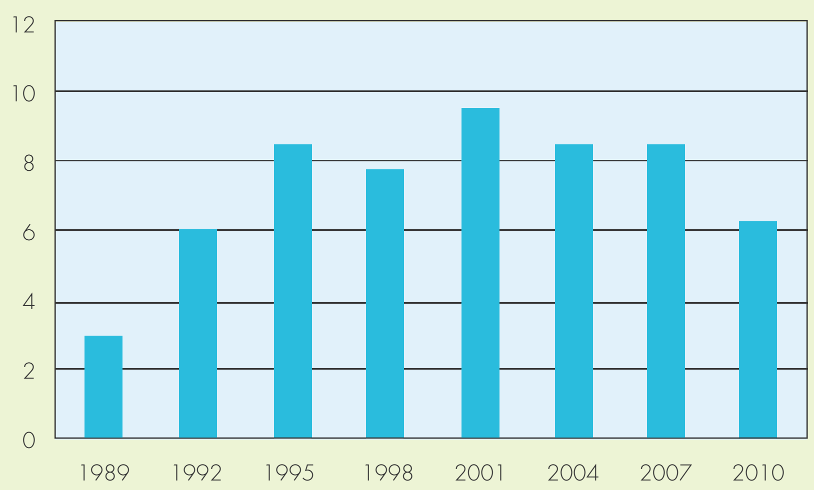
Banking Status of U.S. Households[1]

Status	2009 Millions	2009 Percent	2011 Millions	2011 Percent	Change 2009-11 Millions	Change 2009-11 Percent
Unbanked	9.1	7.6	9.9	8.2	0.8	8.9
Underbanked	21.7	18.2	24.2	20.1	2.5	11.5
Fully banked	84.9	71.4	82.8	68.8	-2.1	-2.5
Unknown	3.3	2.8	3.5	2.9	0.2	6.1
Total	119.0	100.0	120.4	100.0	1.4	1.2

Source: FDIC

Figure 1

Median Family Net Worth of the Lowest Quintile of Income Earners[2]
(Thousands of 2010 Dollars)



Source: Federal Reserve Board's Division of Research and Statistics

Serving the Underbanked: Increased Competition from Unregulated Nonbanks

Traditionally regulated commercial banks have had an increasingly difficult time serving the underbanked, including many checking account customers. Lightly regulated nonbanks such as payday lenders, check cashers, title lenders, pawn shops, and rent-to-own retailers have benefited as traditional banks have become wary of low-income customers since the financial crisis.

Nonetheless, AFS customers often are crushed by a vicious, snowballing avalanche of rising fees and interest charges that also damage their credit reputations. This debt burden is nefariously calculated in the business models of the most notorious of the lot: payday lenders, auto-title lenders, and pawn shops. The model is often a serious debt trap for the underbanked. Moreover, AFS firms stealthily shift the risk burden of the underbanked on to regulated banks, which eat the overdraft losses of abandoned checking accounts.

Ironically, heightened regulatory scrutiny of commercial banks and the many new rules designed to protect consumers from banks' predatory practices have helped drive strong growth in nonbank activity and AFS. Increased regulation of overdrafts and credit/debit cards by Congress and the Federal Reserve has led banks to innovate far less. Higher costs associated with increased regulatory pressures and generally compressed net interest margins[3] have not helped. The regulatory bill for commercial banks to serve underbanked demographics has turned into a boom for AFS providers.

Table 3 lists the main industry players in the AFS game. Many of these nonbanks advertise heavily, offering convenience and "easy" money. However, these firms are notorious for charging high fees and interest rates and for employing business practices long shunned by regulated mainstream banks. Several reports authored by IBISWorld[4] and a joint study compiled by the Consumer Federation of America and the Center for Responsible Lending[5] summarize the key products and issues:

- **Check-cashing and payday loan services.** A dominant player in the AFS space, this group generates two-thirds of its revenue from loan services. In 2011, the FDIC found that 5.5 million underbanked households—those with traditional bank checking accounts or other services—used nonbank check-cashing firms, while 1.9 million underbanked households used payday lenders. The industries' "fast cash" tune has resonated with the swelling number of underbanked individuals. According to recent studies,[6,7] payday loans have annual percentage rates that range between 225% to 300%; only 14% of borrowers can afford to repay an average monthly payday loan; and payday loans do not mitigate overdraft risk. In fact, for 27% of borrowers, payday loans actually led to checking account overdrafts. Abusive practices have drawn the ire of federal and state governments, and regulatory measures are being ramped up. The majority of states require AFS firms to file for an operating license and to adhere to strict laws regarding the principal amount of loans and loan interest rates.
- **Pawn shops.** This serious AFS player thrives on the economic hardships of the underbanked and revels in the TV show *Pawn Stars*. The pawn shop industry provides short-term loans, taking tangible personal property as collateral. In 2011, the FDIC found that 2.5 million of underbanked households used pawn shops. When borrowers repay the loan, their personal property is returned. If the borrower "defaults," the shop owns the "collateral." Approximately 40% of this industry's revenue is garnered through pawn-secured loan interest and fees. This figure probably underestimates the true revenue stream since shops can sell goods abandoned by their "clients." Regulated by the states and municipalities where they are located, pawn shops generally need a state license. States typically regulate service charges, interest rates, and maximum allowable loan amounts.
- **Prepaid credit and debit card providers.** This group, the fastest growing in the AFS industry, has had 40% annual growth over the past five years. Unlike payday lenders and pawn shops, the prepaid-card-provider industry is much more concentrated, dominated by major players like Green Dot Corporation (20% market share) and NetSpend (11% share). Prestigious American Express has joined the fray, issuing prepaid reloadable cards at Wal-Mart and Target. Recently, American Express announced that some of its prepaid cards will be insured by the FDIC, an interesting twist to this rapidly evolving market. Young individuals, even those who don't fit the typical underbanked profile, are regular users of this convenient product for online purchases. Consumers with poor credit histories also are finding this payment system increasingly attractive. Although this product typically entails high user fees and up-front cash, there is no need for credit-risk verification, nor are there delays or

Table 2

Banking Status of Select Demographic Groups (2011)

Demographic Group	Unbanked	Underbanked	Fully banked
All households	8.2%	20.1%	68.8%
African-Americans	21.4%	33.9%	41.6%
Hispanics	20.1%	28.6%	48.7%
Foreign-born noncitizens	22.2%	28.9%	45.8%
Households experiencing unemployment	22.5%	28.0%	47.5%
Lower-income households (below $15,000)	28.2%	21.6%	47.6%
Unmarried female head of household	19.1%	29.5%	48.4%
Households with holders under age 24	17.4%	31.0%	49.7%

Source: FDIC

Table 3

Main Players in the AFS Game

AFS Industry Group	Revenue 2012 ($bn)	Number of Firms	Degree of Regulation
Check-cashing and payday loan services	10.1	16,642	Medium/ increasing
Pawn shops	6.2	5,294	Heavy/ increasing
Prepaid credit and debit card providers	3.1	116	Heavy/ increasing
Home furniture rent-to-own stores	1.7	1,576	Light/steady
Consumer electronics and appliance rentals	4.0	2,101	Heavy/steady
Car-title lenders	3.6	7,730	Light/increasing

Sources: IBISWorld Inc., Consumer Federation of America and Center for Responsible Lending

declinations. After years of benign neglect by the federal regulators, the Consumer Financial Protection Bureau announced in May 2012 that it will study prepaid debit cards and consider regulations to protect consumers from high and often hidden fees.

- Rent-to-own stores. The bulk of operators are in two broad categories: home furniture rent-to-own stores and consumer electronics/appliance rentals. Many firms operate in this space, but two dominant enterprises—Rent-A-Center and Aaron's—together command more than 50% of the market. Rent-to-own stores cater to poorer households and the under-30 population. Furniture rent-to-own stores face little government intrusion and have not been addressed by the Dodd-Frank Act or the Consumer Financial Protection Bureau (CFPB). However, the consumer electronic/appliance industry faces far more regulation, as 47 states require contractual and advertising disclosures as well as consumer protection.
- Car-title lenders. Critics claim this business line literally drives borrowers to financial ruin. As the moniker makes clear, car-title loans are secured by a borrower's vehicle title that is owned outright. Nearly 8,000 firms work in this industry, where the underbanked and unbanked are ripe pickings. A study by the Center for Responsible Lending suggests that an average car-title borrower renews his loan eight times, paying $2,142 in interest for a scant $951 in credit. One in six borrowers is estimated to have suffered repossession of her vehicle. Regulation of this industry is light and spotty, depending primarily on state laws and enforcement. Given all the negative press, this industry, like payday lenders, will likely face hard-line regulator resistance down the road.

Interestingly, emerging nonbank players in the highly profitable prepaid-card business have sought to complement their retail businesses with financial services designed to facilitate point-of-sale transactions, effectively choking off the position of the regulated banks in the processing of these transactions and accounts. In this way, these retailers ensure that sales generate fee income from transactions, while reducing the processing fees paid to the banking industry.

For example, PayPal, operating without a U.S. bank charter, provides a wide range of "banking" services, offering deposit accounts insured by the FDIC, loans, and international payment services. As discussed above, large retailers like Target and Wal-Mart offer their own decoupled "debit card," providing the stores with direct access to the customer's checking account in return for a discounted price on purchases. It's likely that the prepaid-card business will morph into a secured-credit-card model for these nonbanks, with an individual's "savings account" serving as collateral. This debit card-to-loan evolution would further undermine traditional banks' value proposition to the underbanked.

The AFS industry appears to be moving out of the shadows. Although shadier operators are attempting to sidestep the law by moving online, and in some cases offshore, it will be difficult for them to stay one step ahead of government supervision. Credit card companies will continue to team up with big-name retailers, both brick-and-mortar and online (think Amazon and PayPal). Banks need an action plan to take advantage of this rapidly evolving marketplace.

The Role of the CFPB

The CFPB is more of an enforcement agency compared to the traditional federal bank regulators, which focus on institutional and systemic safety and soundness. Nonetheless, the CFPB will conduct examinations of banks with assets in excess of $10 billion, not unlike the examination program of the traditional federal bank regulators. To fulfill its mandate, the CFPB needs to ensure that nonbanks—including old-fashioned ones like payday lenders and mortgage brokers, and new ones such as Wal-Mart and PayPal—play by the same rules as traditional banks. The CFPB will apply its standards consistently across banks and nonbanks.

The banking industry needs to insist on consistent treatment and a level playing field. The consistent regulatory treatment should include on-site examinations for nonbanks, since they are currently required for regulated banks. Only with on-site examinations will the CFPB be able to determine that the nonbanks have the appropriate compliance culture and compliance management program. Consumers then would be assured of equal protection regardless of the entity's charter, including consistent error resolution processes. Banks and nonbanks would bear similar cost structures for regulatory compliance.

Business Opportunities for Commercial Banks

Realistically, banks need to compete with nonbanks in "smart" segments of the underbanked space. Banks should focus primarily on customers who already maintain banking relationships. In contrast are the payday-hungry borrowers, who rely on AFS facilities mostly for convenience in small-dollar transactions. These are typically bank checking-account customers who drift into the nonbank loan-shark universe when they have credit troubles. Banks must be careful to design a product that helps those customers take care of occasional financial problems without encouraging overuse of credit.

The most difficult market will be the unbanked—those who have never had a banking relationship or who have a spotty employment or student record. This group presents many underwriting and regulatory challenges to a commercial bank, especially in terms of the stringent "know your customer" expectations of a BSA/AML compliance program. Consequently, designing products for the unbanked market will not be easy.

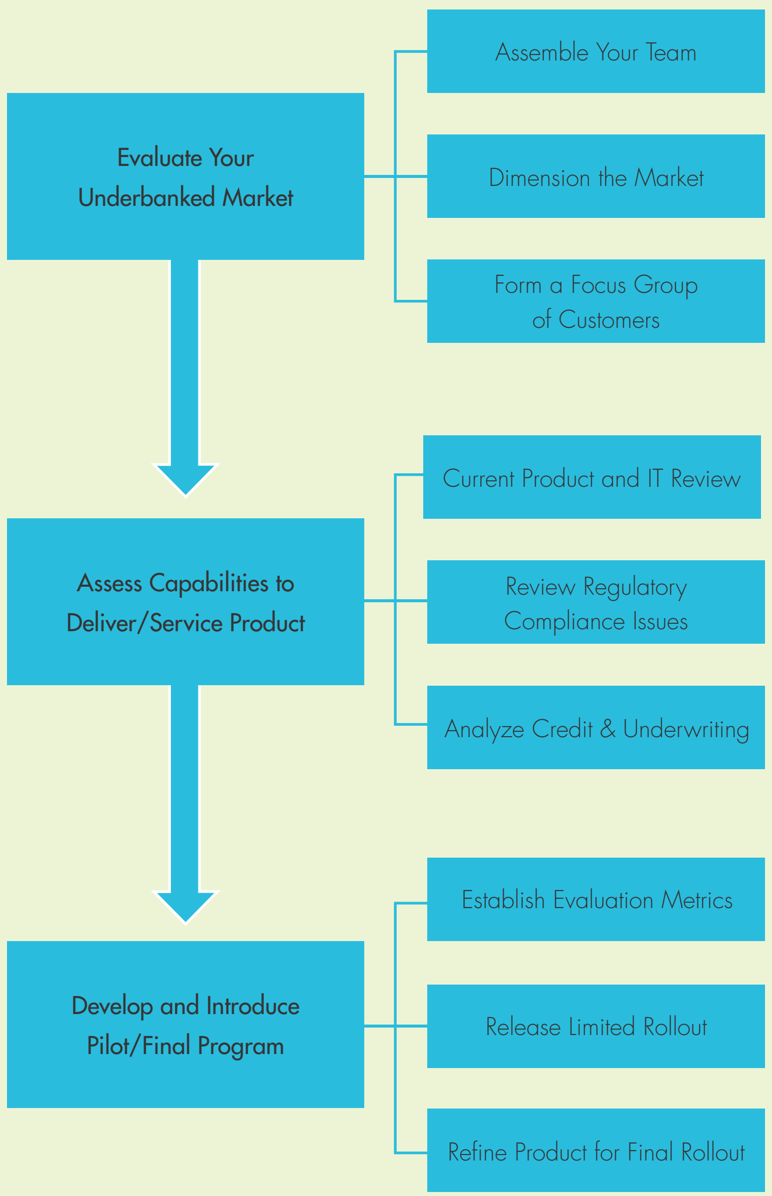
Meanwhile, banks need to develop new products to compete for consumer business, particularly in the areas of transaction processing and payments. With the likes of Wal-Mart, Target, PayPal, and major credit card companies nibbling away at this market, banks need to develop payment mechanisms with enough bite to keep them at the center of the transaction as the processor for either the consumer or the merchant—ideally, both.

Banks' undeniable advantages can be leveraged to compete with nonbank challengers:

- The vast majority of the underbanked have bank checking accounts, but they are often used as "parking lots" for funds secured via nonbanking alternative sources.
- Banks have transaction-processing capacity and network access, all at extraordinarily low costs compared with nonbanks.

Figure 2

A Business Plan for Reaching Underbanked Clients



- Despite bad press on cyber attacks, banks and their customers have suffered few losses. Unlike nonbanks, they have a solid record of regulatory compliance, particularly on dispute resolution.
- Banks retain strong relationships with merchants of all sizes.
- Banks have significant customer transaction data that can be used to develop competitive deposit account and loan products to profitably serve customers.

Before designing a business plan to serve the underbanked, banks should consider these insights from the FDIC survey:

- Understanding the characteristics of different segments of the unbanked and underbanked populations might increase the efficacy of economic inclusion strategies. The FDIC survey shows that within the broad groups of unbanked and underbanked households, there are distinct demographic segments requiring different banking services to meet their varying financial challenges.
- Having a bank account does not guarantee long-term participation in the banking system.
- Households with banking experience appear to have more positive perceptions of maintaining a bank account and rely less on AFS.
- Financial institutions might need to demonstrate the value of a bank account to AFS users who perceive nonbank financial services as more convenient, faster, less expensive, or with lower barriers to qualification.

Figure 2 provides a simple blueprint for developing an effective product to assist customers at risk from alternative lenders.

Banks should also consider these simple suggestions:

- Assemble a team of bank professionals from various departments to evaluate your underbanked market. Include business development/marketing, credit, IT, and compliance. Each will need to use the bank's customer data to identify customers who maintain low checking account balances, incur overdrafts, and use payday lenders. Establishing a focus group of existing customers drawn from the target market should be part of this exercise and will help define the salable features for a new product.
- Assess your bank's capabilities to deliver and service the product. Include a review of existing bank services and infrastructure, as well as regulatory compliance issues, principally in how they relate to credit policies and underwriting.
- Be patient before fully launching the product. A pilot program will enable you to embrace client feedback and evaluate established metrics.

Banks have significant customer transaction data that can be used to develop competitive deposit account and loan products to profitably serve customers.

Conclusion: A Win-Win-Win Situation

For commercial banks of all sizes, the underbanked represent a lending opportunity to compete with lightly regulated nonbanks. Bank customers living paycheck to paycheck and young people just starting out will benefit. By becoming bank customers, these groups will be able to build a much needed credit history. They'll also avoid the pitfalls of doing business with lightly regulated nonbanks, whose business model keeps these customers mired in debt.

Meanwhile, the banks will be able to grow market share with a segment that appears to be eroding, while also satisfying regulatory requirements and new CFPB mandates.

And let's not forget the underbanked businesses,[8] the "other underbanked." Small businesses often mimic the consumer behavior of their owners, but have unique needs that should also offer possibilities for product development. ❖

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Notes

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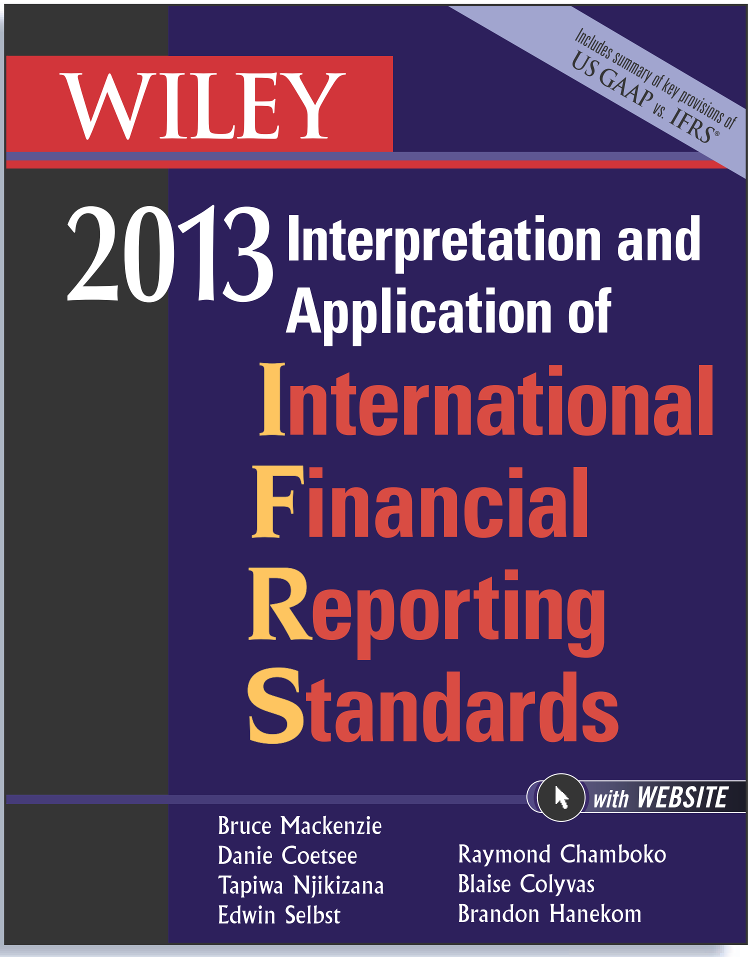

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2013 Interpretation and Application of International Financial Reporting Standards

By Bruce Mackenzie, Danie Coetsee, Tapiwa Njikizana, Raymond Chamboko, Blaise Colyvas, Brandon Hanekom, and Edwin Selbst

Reviewed by Dev Strischek

The comedian Jackie Mason used to ask his audiences, "Did you ever hear of a kid playing accountant, even if he wanted to be one?"

Well, Jackie obviously didn't grow up around this group of accountants who are behind *2013 Interpretation and Application of International Financial Reporting Standards*. With this reference book, the authors have clearly demonstrated their desire to be members of the accounting profession.

Their book updates what's going on with International Financial Reporting Standards (IFRS) and offers a comparison to U.S. generally accepted accounting principles (GAAP). Just as some of us enjoy *The Economist* because of the British viewpoint of American and world news, the same is evident in this review of accounting by a group of international accountants. So what are they reviewing?

Table of Contents for *2013 Interpretation and Application of IFRS*

Ch.	Title
1.	Introduction to International Financial Reporting Standards
2.	Conceptual Framework
3.	Presentation of Financial Statements
4.	Statement of Financial Position
5.	Statements of Profit or Loss and Other Comprehensive Income, and Changes in Equity
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24.	Financial Instruments
25.	Fair Value
26.	Income Taxes
27.	Earnings Per Share
28.	Operating Segments
29.	Related-Party Disclosures
30.	Accounting and Reporting by Retirement Benefit Plans
31.	Agriculture
32.	Extractive Industries
33.	Accounting for Insurance Contracts
34.	Interim Financial Reporting
35.	Inflation and Hyperinflation
36.	First-Time Adoption of International Financial Reporting Standards

The preface tells us that this reference work:

> "…Provides detailed, analytical explanations and illustrations of all current accounting principles promulgated by the IASB [International Accounting Standards Board] that are applicable to the 2013 financial reporting period of reporting entities. The focus of the book is to provide sufficient guidelines for entities that prepare their 2013 financial statements…. These materials have been synthesized into a user-oriented topical format…. The primary objective of this book is to assist the practitioner, user, or preparer in navigating the myriad practical problems faced in applying IFRS."

Much of the world has adopted IFRS, so the U.S. accounting-standards setter, FASB, has been working with the IASB to lessen differences between IFRS and GAAP. American bankers are likely to encounter IFRS as they lend to foreign borrowers or to domestic borrowers owned by foreign entities. So if you are one of those bankers, this reference text will help you understand how IFRS financials differ from GAAP.

The lengthy table of contents describes the subjects covered in this 1,057-page text (indexed at the end, thankfully).

Written by a world-class team of authors who are active in IFRS consulting and training—and who work with multinational listed companies, public-sector entities, and small and medium-sized enterprises—this reference book really is an indispensable guide to IFRS compliance. On top of all that, the publisher provides full details on how to download the entire book as a free ePDF, so you'll be able to do quick searches on your computer wherever you are.

Ellen DeGeneres reminisced once about accounting: "People always ask me, 'Were you funny as a child?' Well, no, I was an accountant." There is certainly nothing funny about this book's authors or its content. But if you don't get a chuckle out of this book, there's always Jackie Mason or Ellen DeGeneres to be held accountable for a laugh or two. ❖

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Debtor Can Use Evidence of Prior Negotiations to Overcome Terms of Loan Agreement

In a decision portending problems for lenders, at least in instances where loan documents are controlled by California law, the California Supreme Court has expanded the possible exceptions to the Parol Evidence Rule.

Although the court said the rule is intended to protect "the integrity of written contracts by making their terms the exclusive evidence of the parties' agreement," it ruled that a party may challenge a written agreement and present oral testimony that the written version is not consistent with the negotiations leading up to its execution.

For lending institutions, this means that the typical integration clause barring such oral testimony has lost much of its vitality:

> ***Typical Integration Clause***
>
> This agreement and the other loan documents (i) are valid, binding and enforceable against the borrower and the bank in accordance with their respective provisions and no conditions exist as to their legal effectiveness; (ii) constitute the entire agreement between the parties with respect to the subject matter hereof and thereof; and (iii) are the final expression of the intentions of the borrower and the bank. No promises, either expressed or implied, exist between the borrower and the bank, unless contained herein or therein. This agreement, together with the other loan documents, supersedes all negotiations, representations, warranties, commitments, term sheets, discussions, negotiations, offers or contracts (of any kind or nature, whether oral or written) prior to or contemporaneous with the execution hereof with respect to any matter, directly or indirectly related to the terms of this agreement and the other loan documents. This agreement and the other loan documents are the result of negotiations among the bank, the borrower and the other parties thereto, and have been reviewed (or have had the opportunity to be reviewed) by counsel to all such parties, and are the products of all parties. Accordingly, this agreement and the other loan documents shall not be construed more strictly against the bank merely because of the bank's involvement in their preparation.

In the California case *Riversland Cold Storage Inc. v. Fresno-Madera Production Credit Association,*[1] Lance and Pamela Workman were delinquent in their loan payments to Fresno-Madera Production Credit Association (FMPCA). A debt restructure agreement was executed March 26, 2007, confirming their indebtedness of $776,380. FMPCA agreed to take no enforcement action until July 1, 2007, if the Workmans made some specified payments. At that time the Workmans secured their indebtedness with liens in favor of FMPCA on eight parcels of real estate.

The Workmans did not make the stipulated payments. On March 21, 2008, FMPCA recorded a notice of default and thereafter began foreclosure proceedings. The Workmans paid the loan and the foreclosure was dismissed.

Later, the Workmans sued FMPCA, seeking money damages for fraud and negligent misrepresentation. Included were claims for rescission and reformation of the restructuring agreement.

The Workmans contended that officers of FMPCA met with them two weeks before the restructuring agreement was signed and said the loan would be extended for two years in exchange for collateral in the form of two ranch properties. But, as drafted, the restructure agreement was for only three months of forbearance and called for eight parcels as collateral. The Workmans said they did not read the agreement but simply signed it when directed to do so.

FMPCA defended on the basis of the Parol Evidence Rule, which only has an exception for fraud. The exception was limited by California decisions requiring some independent fact or representation, some fraud in the procurement of the document, or some breach of confidence about its use, not simply statements at variance with the written instrument. The issue in the Workman case was whether to continue the limitations on the fraud exception. The court declined to do so. As a result, the door has been opened a bit wider to accommodate borrowers' efforts to assert that the documents they signed were not the documents they bargained for.

It has been suggested that, in commercial loan transactions, the lender should require the borrower to retain counsel and that both the borrower and its counsel execute a certificate stating that they 1) have reviewed and discussed all the terms of the loan documents or restructuring agreement, 2) are not aware of any conflict between the terms of the documents and the borrower's understanding of the transaction, and 3) have had an opportunity to discuss the transaction with the lender or its counsel.

Recent decisions in New York have adopted a very different approach to introducing oral testimony designed to vary the terms of a written instrument. In *Nassau Beekman LLC v. Ann/Nassau Realty LLC*[2] *and New York Commercial Bank v. Sato Construction Co. Inc.*[3] New York courts refused to permit written agreements to be modified by oral testimony. ❖

The issue in the Workman case was whether to continue the limitations on the fraud exception. The court declined to do so.

BY MICHAEL L. WEISSMAN

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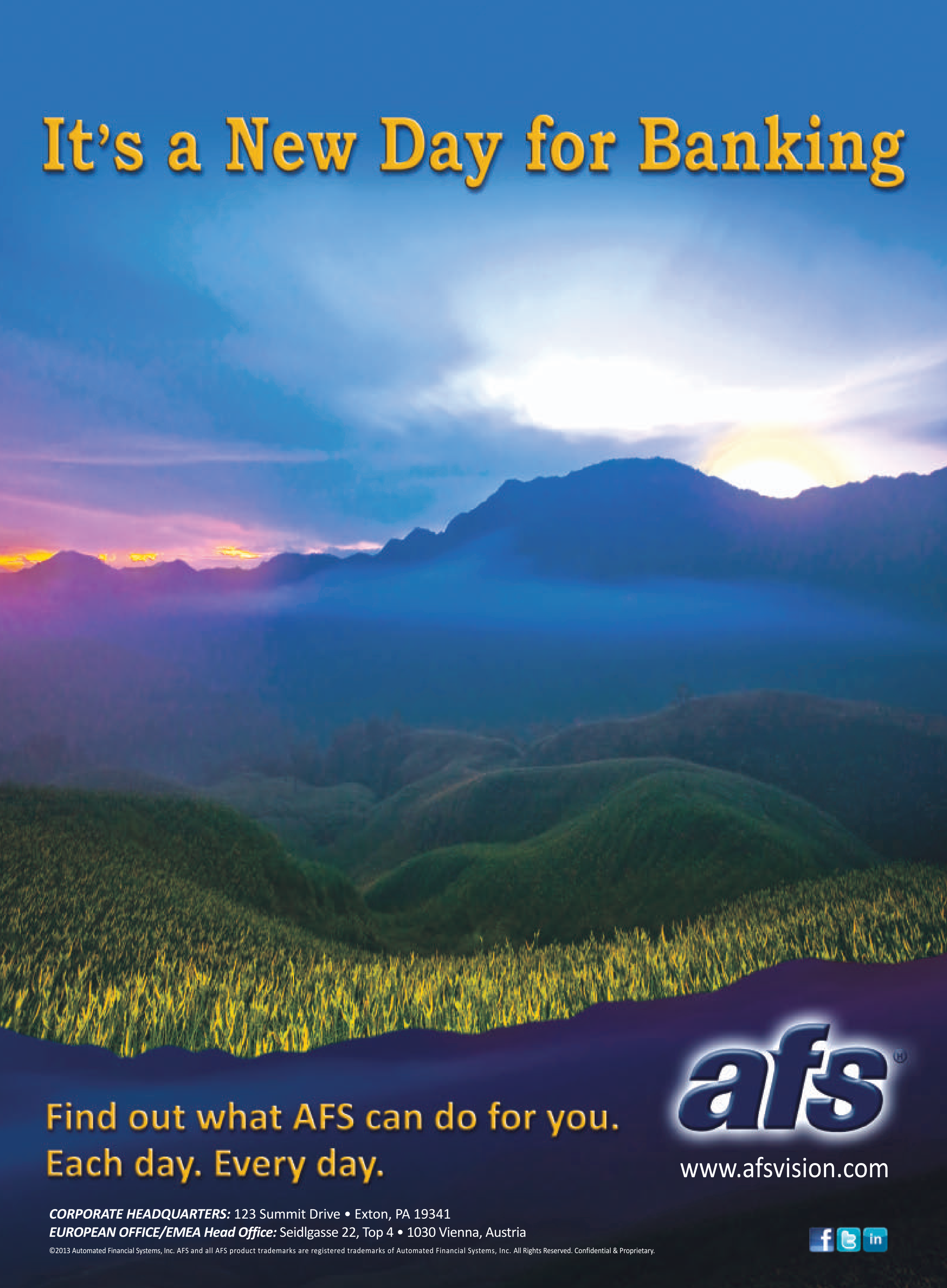
Notes
1. 291 P.3d 316 (Cal. 2013).
2. 2013 WL 362816 (N.Y. App. Div. January 31, 2013).
3. 2012 2064961 (2012).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