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DO YOU NEED A BANK HOLDING COMPANY?

KEEPING DUE DILIGENCE ON THE FRONT BURNER

GROWING PAINS
5 tips for boosting core deposits

BANK WIRE

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DO YOU NEED A BANK HOLDING COMPANY?

For years, the vast majority of U.S. banks have used a bank holding company (BHC) structure. Recently, however, several prominent regional banks have elected to shed their BHCs by merging them into their subsidiary banks. This development has many community banks wondering whether the BHC model has become obsolete.

PROS AND CONS

The answer to this question: It depends (big surprise). Some banks may find that eliminating the BHC structure simplifies financial reporting, streamlines regulatory oversight and reduces administrative expenses. Others — particularly those that qualify as "small bank holding companies" — may find that the benefits of the BHC structure outweigh its costs.

It's important to keep in mind that recent legislation expanded the definition of small BHC to include those with consolidated total assets of $3 billion or less (up from $1 billion). (See "Advantages of small BHC status" on page 3.) Here are some of the possible reasons for eliminating a holding company, along with a review of the continued benefits of the BHC structure.

REASONS FOR DISCARDING YOUR BHC

Potential advantages of eliminating a BHC include the following:

Reduced regulatory oversight. Banks without a holding company are no longer supervised by the Federal Reserve (the Fed) — except for Fed member banks. This can reduce compliance costs. The Fed strives to rely on an organization's primary regulator and scales its supervisory approach depending on that organization's complexity, risk and condition. So the cost savings from reduced regulatory oversight will likely be insubstantial for smaller organizations.

Lower administrative costs. Eliminating the BHC simplifies financial reporting and reduces costs associated with maintaining separate legal entities. These costs include additional taxes, fees, and accounting expenses; dual boards; and duplicative policies and procedures.

No need to deal with the SEC. Some BHCs must report to the SEC, but banks are generally exempt from the SEC's registration and reporting requirements. However, it's important to note that, in the absence of a BHC, some securities-related reporting requirements will shift to the bank's primary regulator.

BENEFITS OF BHC STRUCTURE

Although the Dodd-Frank Act eliminated some earlier advantages of BHCs, most notably the inclusion of trust-preferred securities in Tier 1 capital, the BHC model continues to provide significant benefits for many banks, including:

Liquidity. BHCs have greater flexibility to repurchase stock. The ability of banks to create a market for their own stock is limited by state and federal law, and reducing capital usually requires prior approval.

M&A flexibility. BHCs (particularly small BHCs) have significant flexibility in structuring and financing M&A transactions. Plus, they can maintain acquired banks as separate institutions, allowing them to be integrated more deliberately with other subsidiary banks.

EVEN IF YOU CONCLUDE THE PROS OF ELIMINATING THE BHC OUTWEIGH THE CONS, EVALUATE YOUR BANK'S LONG-TERM NEEDS.

Increased permissible activities. BHCs may engage in specific business and investment activities that are off limits to banks. For example, a BHC may invest in up to 5% of any entity's voting securities without prior regulatory approval.

Purchasing problem assets. BHCs can purchase problem assets from their subsidiary banks, helping them improve their capital ratios and otherwise strengthen their financial performance.

Dividend flexibility. BHCs have more flexibility than banks in paying dividends.

Leveraging debt. Small BHCs have the ability to use debt to raise capital for their subsidiary banks. (See "Advantages of small BHC status" at right.)

LONG-TERM NEEDS

If you're considering eliminating your BHC, be sure to carefully weigh the potential cost-savings and other benefits compared with the benefits of maintaining the BHC structure. This is especially necessary if your organization has total consolidated assets of $3 billion or less. Also consider the costs and administrative burdens of merging your BHC into its subsidiary bank, including shareholder and regulatory approval, modification of contracts and policies, and advisory fees.

ADVANTAGES OF SMALL BHC STATUS

Banks whose holding companies qualify as small bank holding companies (small BHCs) under the Fed's small bank holding company policy statement enjoy significant advantages, especially when it comes to raising capital. And last year's Economic Growth, Regulatory Relief and Consumer Protection Act expanded these advantages to a greater number of banks by raising the threshold for small BHC status from $1 billion to $3 billion in total consolidated assets.

Small BHCs can incur greater amounts of debt than other BHCs. Plus, they're permitted to measure capital adequacy at the bank level only, without considering the BHC's consolidated capital. This allows the BHC to borrow money — using virtually any type of debt instrument — and "downstream" the proceeds to a subsidiary bank in the form of capital.

Greater access to debt also gives small BHCs greater flexibility in structuring and financing M&A transactions.

Even if you conclude the pros of eliminating the BHC outweigh the cons, evaluate your bank's long-term needs. If there's a possibility that a BHC structure will become advantageous down the road, it may be wise to retain it. Creating a new BHC when a need arises in the future may be difficult — if not impossible — and costly.

KEEPING DUE DILIGENCE ON THE FRONT BURNER

Every banker knows the importance of due diligence in determining whether to make a loan. But it's easy to backslide and rely on just a few superficial financial markers that may, or may not, indicate creditworthiness. Here's a reminder of some due diligence steps to take to help you dig deeper and ensure your bank's loan portfolio is more secure.

ASSESSING RISK FROM MANY ANGLES

Start the due diligence process as an auditor would. That is, before you open a borrower's financial statements, consider documenting the risks in the borrower's industry, applicable economic conditions, sources of collateral and the borrower's business operations.

This risk assessment identifies what's most relevant and where your greatest exposure lies, what trends you expect in this year's financials, and which bank products the customer might need. Risk assessments save time because you're targeting due diligence on what matters most.

EVALUATING RELIABILITY

Now tackle the financial statements, keeping in mind your risk assessment. First evaluate the reliability of the financial information. If it's prepared by an in-house bookkeeper or accountant, consider his or her skill level and whether the statements conform to Generally Accepted Accounting Principles. If statements are CPA-prepared, consider the level of assurance: compilation, review or audit.

Comprehensive statements include a balance sheet, income statement, statement of cash flows and footnote disclosures. Make sure the balance sheet "balances" — that is, assets equal liabilities plus equity. You'd be surprised how often internally prepared financial statements are out of balance.

Statements that compare two (or more) years of financial performance are ideal. If they're not comparative,

pull out last year's statements. Then, note any major swings in assets, liabilities or capital. Better yet, enter the data into a spreadsheet and highlight changes greater than 10% *and* $10,000 (a common materiality rule of thumb accountants use for private firms). You should also highlight changes that failed to meet the trends you identified in your risk assessment. For example, you expected something to change more than 10% but it did not.

Now ask yourself whether these changes make sense based on your preliminary risk assessment. Brainstorm possible explanations *before* asking the borrower. This allows you to apply professional skepticism when you hear borrowers' explanations.

KEEPING SCORE

Use your risk assessment to create a scorecard for each borrower. It often helps to discuss your risk assessment with co-workers and to specialize in an industry niche.

One ratio that belongs on every scorecard is *profit margin (net income / sales)*. Every lender wants to know whether borrowers are making money. But a profitability analysis shouldn't stop at the top and bottom of the income statement. It's useful to look at individual line items, such as returns, rent, payroll, owners' compensation, travel and entertainment, interest and depreciation expense. This data can provide reams of information on your client's financial health.

Other useful metrics include *current ratio (current assets / current liabilities)*, which measures short-term liquidity or whether a company's current assets (including cash, receivables and inventory) are sufficient to cover its current obligations (accrued expenses, payables, current debt maturities). High liquidity provides breathing room in volatile markets.

In addition, *total asset turnover (sales / total assets)* is an efficiency metric that tells how many dollars in sales a borrower generates from each dollar invested in assets. Again, more in-depth analysis — for example, receivables aging or inventory turnover — is necessary to better understand potential weaknesses and risks.

Finally, calculating the *interest coverage ratio (earnings before interest and taxes / interest expense)* provides a snapshot of a company's ability to pay interest charges. The higher a borrower's interest coverage ratio is, the better positioned it is to weather financial storms.

When applying these metrics, compare a company to itself over time and benchmark it against competitors, if possible. If customers' explanations don't make sense, consider recommending that they hire a CPA to perform an agreed-upon-procedures engagement, targeting specific high-risk areas.

KEEPING AWARE OF RISK AND REWARD

A healthy loan portfolio carries with it a certain amount of uncertainty. But, to minimize the potential for problems down the line, that uncertainty needs to be quantified, documented and analyzed. Taking these due diligence steps can help make your loans rewarding, rather than risky. ■

GROWING PAINS

5 tips for boosting core deposits

As interest rates continue to rise, competition among banks for core deposits is heating up. This creates a challenge for community banks striving to grow their core deposits to fund lending activities. On the one hand, banks need to consider paying higher rates to attract deposits. On the other hand, increasing the cost of deposits cuts into their profit margins.

TAKE THE RIGHT STEPS

Here are five tips for attracting core deposits while keeping costs under control:

1. Avoid short-term fixes. It's important to recognize that building core deposits is a long-term strategy — there are no quick fixes. Offering above-market interest rates, for example, may attract new customers in the short term, but it's unlikely to support sustainable deposit growth. That's because customers who're attracted to higher rates are more likely to abandon you when a better rate comes along. In the long run, it's better to focus on customers who value service over interest rates.

2. Don't underestimate the importance of branches. A recent J.D. Power banking satisfaction study offers insights into the value of branches. According to the study, although 28% of retail bank customers are now digital-only, they are among the least satisfied. The most satisfied customers are "branch-dependent digital customers" — those who take advantage of online or mobile banking but also visit a branch two or more times during a three-month period.

Interestingly, the satisfaction gap between branch-dependent customers and more "digital-centric" customers was most pronounced among Millennials and Generation Xers. This is a bit surprising, since it's commonly thought that younger customers eschew branches. It's still the case that the majority of customers, including younger generations, prefer to open accounts at a branch — with personalized guidance — because they find it confusing to do online.

3. Focus on service. According to J.D. Power, weaker performance in the areas of communication and advice, new account openings, and products and fees caused lower satisfaction levels among digital-only customers. To attract and retain engaged customers and grow core deposits, banks need to improve communications and provide quality, personalized advice and other services consistently. And it's key to make these strides across both digital and branch channels.

4. Specialize. Community banks that specialize in particular industries or types of banking are often able to attract customers who value specialized services over interest rates. The right niche — whether it's health care, professional services firms, hospitality, agriculture or some other industry — depends on the bank's history and the needs of the community.

5. Consider reciprocal deposits. A provision of the Economic Growth, Regulatory Relief and Consumer Protection Act of 2018 creates an opportunity for community banks to boost deposits by taking advantage of reciprocal deposits. These are deposits a bank receives through a deposit placement network in exchange for placing matching deposits at other banks in the network. One advantage of these networks is that they enable banks to attract large-dollar, stable, local depositors by offering them insured deposits beyond the $250,000 FDIC threshold. (Insurance coverage is increased by spreading deposits among several network banks.)

The act made it easier for banks to take advantage of reciprocal deposits by providing that these deposits (up to the lesser of 20% of total liabilities or $5 billion) won't be considered "brokered deposits" if specific requirements are met. Brokered deposits are subject to a variety of rules and restrictions that make them more costly than traditional core deposits.

DEVELOP A STRATEGY

These days, it's easy for customers to switch banks to obtain a higher interest rate. The key to attracting and retaining stable core deposits is to have a strategy for providing value (apart from interest) that makes customers want to stick around. ■

BANK WIRE

FinCEN CREATES EXCEPTION TO BENEFICIAL OWNERSHIP RULE

As part of its efforts to combat money laundering and other fraudulent activity, the Financial Crimes Enforcement Network (FinCEN) issued its Beneficial Ownership Rule, effective for new accounts opened on or after May 11, 2018. The rule requires banks, as part of their customer identification programs, to verify the identity of the beneficial owners of certain legal entities. Beneficial owners include individuals who, directly or indirectly, own 25% or more of an entity, as well as any individual who has "significant responsibility to control, manage or direct the legal entity."

In a September 7, 2018, ruling, FinCEN created an exception to the beneficial ownership rule for legal entities that open new accounts on or after the effective date as a result of:

- Rolling over a certificate of deposit,
- Renewing, modifying or extending a loan, commercial line of credit or credit card account that doesn't require underwriting review and approval, or
- Renewing a safe deposit box rental.

The exception applies only to rollovers, renewals, modifications or extensions of the above product types that take place on or after May 11, 2018. It doesn't apply to the initial opening of such accounts. ■

BANKS CONSIDERING USE OF ALTERNATIVE CREDIT DATA

Some lenders are considering the use of alternative data to expand access to credit for people with thin credit histories or negative items on their credit reports. By developing innovative techniques for analyzing a borrower's ability to repay, lenders can expand their pools of potential borrowers beyond those identified by traditional techniques.

Alternative data refers to information that may be used to evaluate creditworthiness but is not traditionally part of a credit report. Examples include rent payments, mobile phone payments, cable TV payments and bank account information. This may also include education, occupation and even social media activities.

It may take some time before alternative data techniques catch on among community banks. In 2017, the Consumer Financial Protection Bureau (CFPB) released a "Request for Information" seeking information about alternative data and the modeling techniques used to analyze them. You can find the document, which discusses the benefits and risks associated with alternative data, at consumerfinance.gov. (To reach the link, type "regarding alternative" in the search box.) ■

SUPERVISORY GUIDANCE ISN'T THE LAW

In a recent joint statement, the federal banking agencies clarified that supervisory guidance "does not have the force and effect of law." Among other things, the agencies intend to limit the use of numerical thresholds or other "bright lines" in describing expectations, and examiners won't criticize banks for "violations" of supervisory guidance. ■

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P&G Associates ("P&G") has been meeting the specific risk management needs of community banks of all sizes since 1991. As a high quality and affordable alternative to national firms, P&G provides internal audit, regulatory compliance, BSA/AML, information technology and enterprise risk management review services and software. P&G is exclusively dedicated to the banking industry, providing clients with dedicated, focused and hand-held services reflective of a wide range of skills, experience and industry expertise. As a Firm, we have also been proactive in assisting our clients with the designing, implementation and testing of the internal control environment to assist management with the attestation requirement under the Sarbanes-Oxley Act.

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