

Banking Industry Group

2100 Clearwater Drive
Oak Brook, IL 60523
630-545-4500
www.wolfcpa.com



IN THIS ISSUE

When to Reappraise
Commercial Real Estate

BANKING BRIEFS

Tax Consequences of
Mortgage Debt Forgiveness



Member of the
Wolf Financial Group

community Banking

Better Ways ▲ Better Results

A NEWSLETTER FOR THE BANKING INDUSTRY

SPRING 2009

THE FINANCIAL CRISIS

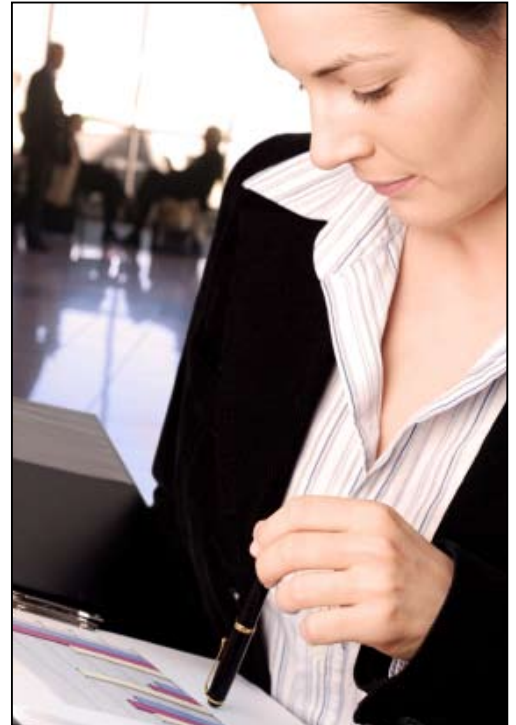
Opportunities in the Midst of the Storm

The banking industry has obviously gone through its share of turmoil over the past year. But all is not “gloom and doom” for banks, despite what the news headlines might lead you to believe. In its 2008 Small Business Banking Satisfaction Study, J.D. Power and Associates actually reports some good news for banks. Despite the economic uncertainty and tight credit environment that prevail today, the level of satisfaction among small business owners with their banking institutions has increased over the past year – from 697 (on a 1,000-point scale) in 2007 to 720 in 2008.

Respondents to the survey (owners of companies with annual sales of between \$100,000 and \$10 million) said their banks are doing a better job of providing shorter wait times and resolving their problems. Factors relating to the relationship with their account manager and their in-person branch experience are most important to small business owners, accounting for 40 percent of the overall banking experience, the study found. “This underscores how critical it is to proficiently execute simple relationship fundamentals, including welcoming customers to the branch, assigning dedicated bankers to their accounts and establishing proactive quality outreach practices,” noted Rockwell Clancy, executive director of financial services for J.D. Power. “Simply meeting with small business customers at their place of business significantly improves satisfaction.”

Taking the Offensive

Clearly, there are opportunities in the midst of today’s storm for banks, despite the challenges posed by the credit crunch and financial crisis.



The first step should be to refocus on the areas where you can truly add value to your relationships with small business customers – things like building strong relationships between them and their account managers, as noted in the J.D. Power survey, as well as serving as one of their trusted advisors, not just their “banker.” Meanwhile, if your bank is well-capitalized with good credit ratings, a strong balance sheet and the desire and capacity to lend, there may be profitable lending opportunities in today’s marketplace. Here are a few strategies that can help you take advantage of them:

Target the best customers of your troubled competitors. You can identify troubled financial institutions in your market by downloading their Uniform Bank Performance Reports (UBPRs) from the

When to Reappraise Commercial Real Estate



Declining real estate values over the past couple of years have impacted financial institutions in many ways. One effect that may be particularly troublesome for banks is the declining value of commercial real estate held as collateral to secure income property loans where the source of repayment is the property itself.

As a result, the federal regulatory agencies are putting increased emphasis on the need for banks to reexamine the current market value of such property by reappraising the property based on new, more realistic assumptions. The value of such property directly impacts the calculation of the adequacy of a bank's allowance for loan and lease losses (ALLL) and testing for loan impairment as directed by FAS 114, another reason for regulatory concern.

Proposed New Interagency Appraisal Guidelines

In response to heightened concerns over collateral appraisals and credit quality, the federal regulatory agencies issued for comment in November proposed

Interagency Appraisal and Evaluation Guidelines that reaffirm supervisory expectations for sound real estate appraisal and evaluation practices. The guidelines help clarify risk management principles and internal controls for ensuring that banks' real estate collateral appraisals are reliable and support their real estate-related transactions.

The interagency guidelines would replace the 1994 Interagency Appraisal and Evaluation Guidelines by incorporating recent supervisory issuances and reflecting changes since then in industry practices, uniform appraisal standards and new technologies. They would apply to all of a bank's real estate lending functions, including both commercial and residential.

The proposed guidelines offer an expanded discussion of portfolio management techniques and circumstances under which an institution should update real estate collateral valuations, as well as more detail on the regulators' expectations for an independent appraisal and evaluation function. They also include more explanation of the regulators' minimum appraisal standards and revisions to the Uniform Standards of Professional Appraisal Practice (USPAP).

A Structured Process

Given these new proposed guidelines and the tremendous uncertainty of today's credit environment, banks should have a structured process in place for monitoring the value of commercial real estate held as collateral and ordering reappraisals when necessary. Examine collateral and loans in the following order of priority:

2. Marginal loans backed by questionable real estate collateral that has likely declined in value.
3. Good loans backed by marginal real estate collateral that may have declined in value.

Re-appraisals obviously cost money, so use your best judgment in determining what types of commercial real estate may need reappraising. The value of a warehouse in south Florida probably hasn't changed significantly in the past year or two, for example, but the value of a condo or apartment building there almost surely has. Also consider the size of the loan (is it material to your institution?) and the loan-to-value ratio.

How to Order Appraisals

In addition, regulators are now insisting that banks segregate the ordering of appraisals. In other words, an individual who is independent of the lending decision must order and evaluate the appraisal — someone in credit administration, for example. This person must be knowledgeable about appraisals, maintain a list of approved appraisers, and select from this list an appraiser with appropriate expertise (e.g., by type of property and market area) and knowledge.

You should note that a technical review may be required on larger credits — i.e., those that are material to your bank — that goes beyond just making sure the appraisal conforms to USPAP standards. Such a review would test key assumptions, such as gross potential rent, vacancy factor, operating expenses, cap rate, etc. ■

1. Troubled loans backed by questionable real estate collateral that has likely declined in value.

FDIC's Web site at <http://fdic.gov>. Then begin a targeted calling effort that focuses on luring these customers to your bank. In your calls, however, do not speak ill of your competitors; simply ask customers if they have unmet lending needs you might be able to help them with. Keep in mind that some banks that aren't troubled either can't, or don't want to, fund loans in the current environment — their good customers should be part of your calling efforts as well.

Also look to nurture relationships with small business owners' centers of influence, such as their accountants and attorneys. Let them know that you have money to lend and are looking for good customers to lend to. They are likely to know if their customers are experiencing problems renewing or increasing their lines of credit, and they have a vested interest in referring them to potential sources of financing.

Look for customers that need to buy fixed assets. Clues to this may be hidden in a business' financial statements. For example, if accumulated depreciation exceeds the net book value of fixed assets, those assets are likely getting old and the business may be a candidate for an equipment term loan. Similarly, if the net fixed asset base has been going down over successive years, the business is not even replacing depreciation. Of course, the business may not be replacing fixed assets because it doesn't have the capital, or can't qualify for the financing, to do so.

Also note that vendor financing, a traditional source of equipment financing for many small businesses, is largely unavailable today. This may represent another lending opportunity for your bank. And remember that Section 179 offers incentives for purchasing fixed assets and placing them into service. Congress and the new Obama administration passed an economic stimulus package that would extend the higher Section 179 expensing limit of \$250,000 per year through the end of 2009.

Look for customers with maturing balloon payments. Many businesses bought real estate between 2003-2005 with three- and five-year balloon payments that are maturing but cannot refinance them with their current banks. Similarly, some businesses want to refinance now to avoid ARM adjustments, or simply to take advantage of the current low rates. Both of these scenarios may present opportunities for you to meet the needs of businesses whose current banks can't. Look for opportunities to re-price loans. As counter-intuitive as this may sound, the current environment may offer opportunities to cull your portfolio and re-price loans that have been marginally profitable or unprofitable in the past.

Playing Defense

Just as important as taking advantage of new opportunities is protecting the good customers that you currently have. This is especially true if your bank is not

in a financially strong position right now. The first thing you should do is consolidate your troubled loans into the hands of workout specialists who have the time and expertise to deal with them most effectively. This will free up your business development officers to spend more time protecting their turf and calling on potential new customers. If your ability to lend money is limited, be sure to allocate the funds that you do have for loans to your best possible customers and strongest, most profitable relationships.

Of course, with deposits in such high demand, many banks are not even considering making loans to companies without a corresponding deposit relationship. For these banks, the priorities have shifted to credit quality, securing deposits, and loan growth — in that order. ■

To discuss these and other opportunities in more detail, contact Tim Johnson, partner, Wolf & Company LLP at 630-545-4594.

Regulators Clarify Banks' Roles and Responsibilities

Late last year, federal regulatory agencies issued a joint statement emphasizing the "prudent role that bank lending practices play in promoting the nation's economic welfare." The agencies encouraged banks to work together with regulators to ensure that the needs of creditworthy borrowers are met, specifically by:

- Providing credit in a manner consistent with prudent lending practices, and continuing to ensure that they consider new lending opportunities on the basis of realistic asset valuations and a balanced assessment of borrowers' repayment capacities.
- Maintaining a strong capital position by ensuring the adequacy of their capital base and focusing on effective and efficient capital planning and longer-term capital maintenance.
- Engaging in appropriate loss mitigation strategies and foreclosure prevention by working with existing mortgage borrowers to avoid preventable foreclosures, as well as mitigate other potential mortgage-related losses.
- Reassessing the incentive implications of their compensation policies to ensure that they are aligned with the long-term prudential interests of the institution.

Banking Industry Group

2100 Clearwater Drive, Oak Brook, IL 60523
630-545-4500 www.wolfcpa.com



A Wolf Financial Group Member



BANKING BRIEFS

Tax Consequences of Mortgage Debt Forgiveness

As a result of the mortgage meltdown and the ongoing rise in foreclosures, many individuals today are dealing with mortgage restructuring and mortgage debt forgiveness.

The tax treatment of income that results from what's known as a Discharge of Indebtedness (DOI), however, can be confusing. The Internal Revenue Code (Sec. 61(a) (12)) subjects any gross income that results from a DOI to taxation.

The good news is that the federal government has stepped in to help the thousands of families getting hit with huge tax bills after losing their house due to foreclosure.

The Mortgage Forgiveness Debt Relief Act of 2007 allows taxpayers to exclude income from the discharge of debt on their principal residence. There is no dollar limit if the principal balance of the loan was less than \$2 million (or \$1 million if married filing separately) at the time the loan was forgiven.

Debt reduced through mortgage restructuring, as well as mortgage debt forgiven in connection with a foreclosure, qualifies for this relief.

This provision originally applied to debt forgiven in 2007, 2008 and 2009, but was extended through 2012 by the Emergency Economic Stabilization Act of 2008.

However, it is important to note that this change only applies to homes used as a principal residence. Debt forgiven on second homes, rental property or business property does not qualify for this tax-relief provision.

Individuals should receive Form 1099-C Cancellation of Debt from their lender showing the amount of debt forgiven or cancelled. The IRS urges borrowers to check this form carefully, paying particular attention to the amount of debt forgiven (Box 2) and the value listed for their home (Box 7). ■