March/April 2011

Bank Notes

A timely information and idea statement

Loan Pricing Risks Elevated

Compliance officers and chief credit officers need to be focused on internal controls surrounding the pricing of consumer loans. The most obvious need for this focus is the Fair and Accurate Credit Transactions Act (FACTA) change that came into effect on Jan. 1, 2011. However, an equal need for attention comes from the regulatory scrutiny on loan pricing discrimination. This article will address both issues and provide you with information to ask critical questions to stave off regulator action.

Implementation of final rules for risk-based pricing issued

FACTA was signed into law on Dec. 4, 2003. It amended the Fair Credit Reporting Act (FCRA) by making it easier for consumers to fight identity theft, improving the accuracy of credit reports and enhancing consumers' control over credit solicitations. Section 311 of FACTA added a new section to the FCRA, section 615(h), to address risk-based pricing. Section 615(h) required the Federal Reserve Board of Governors and the Federal Trade Commission to jointly issue rules implementing the risk-based pricing provisions. The proposed rules were issued on May 19, 2008 with comment period ending Aug. 18, 2008. The final rules were published in the Federal Register on Jan. 15, 2010, and are codified as part of Regulation V, at 12 CFR 222. The rules were effective Jan. 1, 2011 and can be found on the Federal Reserve website.

Risk-based pricing refers to the practice of offering different pricing plans for credit offered to consumers based on the risk of nonpayment by that consumer. The consumer's credit score, obtained from a credit report, is usually the driving factor in assessing this risk. In general, creditors using a risk-based pricing model offer more favorable terms, including lower interest rates and fees, to consumers with higher credit scores, and less favorable terms, often higher interest rates and fees, to consumers with lower credit scores. Under the new rules, these practices require the delivery of a notice.

Simply, the notice is required to be issued by a financial institution that:

- Uses a consumer report in connection with an application of credit to a consumer
- Based on that report, grants or extends credit on *material terms* that are *materially less* favorable than the most *favorable* terms available to a substantial number of consumers by that institution

For this article, we have stated the requirements too simply. After all, this is a compliance regulation, so there are plenty of exceptions, commentaries and clarifications. Your compliance officer should be on top of this and if not, an outside compliance specialist can help you, and your compliance officer navigate through the requirements.

Fair lending examinations focused on fair pricing

Coupled with the above requirements for disclosure, we are seeing a significant uptick in examination issues related to fair pricing. In short, the agencies are focused on the pricing of consumer loans when executing their fair lending examination procedures.

To be sure, no new requirements are causing the focus on fair pricing discrimination. The Federal Financial Institutions Examination Council's (FFIEC) examination procedures have always had fair pricing as a potential focal point for an exam. In fact, the procedures have long held that examiners should be concerned with five primary risk factors for pricing discrimination. Specifically, those factors are:

- P1 - Relationship between loan pricing and compensation of loan officers or brokers
- P2 - Lenders having broad discretion in pricing or transaction fees

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Incentive-Based Compensation Arrangements – Dodd-Frank Section 956

The Dodd-Frank Wall Street Reform and Consumer Protection Act, which was signed into law on July 21, 2010, requires federal agencies to jointly prescribe regulations or guidelines with respect to incentive-based compensation practices at "Covered Financial Institutions" (financial institutions with over $1B in total assets). Specifically, section 956 of the Dodd-Frank Act requires that the agencies prohibit incentive-based payment arrangements at a covered financial institution that they determine encourage inappropriate risks that could lead to a material financial loss.

Under the act, a covered financial institution must disclose the structure of its incentive-based compensation arrangements to its appropriate federal regulator sufficient to determine whether the structure provides "excessive compensation, fees or benefits" or "could lead to material financial loss" to the institution. The Dodd-Frank Act does not demand that a covered financial institution report the actual compensation of particular individuals as part of this requirement.

On Feb. 4, 2011 the FDIC adopted proposed rules implementing Section 956 of the Dodd-Frank Act. Until this time, the agencies had only presented the "Interagency Guidance on Sound Compensation Policies" in June of 2010, which was actually intended as "principles based guidelines," without having the force and effect of law. While the new proposal is rule-based, those rules are really not any more specific than the general guidelines. While prohibiting incentive-based pay plans that could lead to a material financial loss, the proposed rules provide no guidance as to what constitutes the materiality of loss. The proposal's stated goal is to achieve a better "balance" between the incentive to take risks in order to drive bank performance and whatever incentive exists to avoid too much risk.

Establishing the appropriate levels of risk on both sides of this equation is a relative concept. The proposed rules provide no criteria or structure which would enable regulators to identify the "right" or "wrong" level of variable compensation and its calibration to risk factors. Bankers will need to find a way to quantify the risk inherent in their business models and compare it to the dollar value of the incentive awards in their compensation plans.

The new proposal pertains to financial institutions with $1 billion or more in consolidated assets (Covered Financial Institutions), while for those under $1 billion, the new proposal would require no changes. The new rules prohibit any incentive-based compensation arrangement that encourages executive officers, employees, directors or principal shareholders (Covered Persons) to expose the institution to inappropriate risks by providing the Covered Persons with excessive compensation. Any incentive-based compensation arrangements for Covered Persons that encourage inappropriate risk-taking by the Covered Financial Institution that could lead to a material financial loss are also prohibited.

The rules require that the board or a committee approve all incentive plans for Covered Persons, and that policies and procedures are in place to help ensure compliance with these rules. Banks also will be required to provide an annual report to their regulators explaining the strategy and design of all variable compensation plans for Covered Persons and why they don't incent inappropriate risk-taking. Banks over $50 billion in assets (Larger Covered Financial Institutions) must also submit a description of incentive arrangements in place for those who, by virtue of their role, can expose the organization to potential substantial losses. Additionally, half or more of their compensation must be delivered in a form that is delivered at least three years after it is earned. The proposal also defines credit unions with assets over $1 billion as "Larger Covered Institutions."

The proposed rulemaking will not be published in the *Federal Register* until all of the federal agencies have reviewed and approved it. A 45-day comment period will then commence. All comments will be considered by the federal agencies, and then they will publish the final rule. The proposal anticipates that the final rule (whatever it may contain) will become effective six months after publication in the *Federal Register*. Banks will be expected to submit their informational reports within 90 days of the end of their fiscal year, following each Covered Financial Institution's fiscal year, after that six month effective date.

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Distressed Bank Acquisition Strategies

As a result of the economic turmoil over the last few years, many financial institutions have become distressed and may be targets for strategic acquisitions. In the current climate, healthy banks are increasingly considering acquiring distressed banks for a potential low cost source of growth, new market penetration opportunities, an increased legal lending limit, enhanced liquidity and generally increasing institution value. It is currently a favorable climate for institutions looking to achieve such goals with the help of an FDIC-assisted transaction.

RSM McGladrey and Resolution Asset Management (RAM), a subsidiary of Cantor Fitzgerald, recently hosted a webinar to introduce and analyze new opportunities for acquiring distressed banks. The webinar presented how the FDIC disposes of assets acquired from failed institutions, as well as how healthy banks can acquire failed financial institutions under a loss-share agreement with the FDIC.

Since the beginning of 2007, the FDIC has closed 332 financial institutions with an asset value of $647.4 billion (as of Feb. 4).

The FDIC has acquired approximately $89.5 billion in assets that require disposition. Of those assets, approximately one-third have been sold through structured-sale transactions where the FDIC retains an ownership interest, auctions or securitizations. One securitization transaction has been completed, and the FDIC is in the process of bringing a commercial securitization to market.

There are certain parameters that are required in order for loans to be included in a securitized transaction. The loans have to be performing, cannot be more than 60 days delinquent and have a maturity date of one month after closing of the securitization transaction. The loans also must meet specific loan-to-value requirements at origination and/or modification. For example, a loan cannot exceed 120 percent loan-to-value. There are certain classes of assets that do not fit in the securitization model, such as loans secured by gas stations, churches or auto repair facilities.

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- P3 - Use of a risk-based pricing system that is not empirically based and statistically sound
- P4 - Substantial disparities among price quoted or charged to applicants differing by prohibited basis characteristics
- P5 - Consumer complaints alleging discrimination in loan pricing

From our perspective, P5 is the biggest risk for community based financial institutions. We are dealing with several examination issues currently where the lender lacked controls on how prices were set. Additionally, a few institutions are dealing with issues where their loan officers chose to override established controls due to circumstances or happenstance. The key to your institution's fair pricing compliance will be the ability to demonstrate a consistent routine in the pricing decision. Whether that routine is through a risk-based pricing grid or a flat one-price-fits-all pricing structure is dependent on your strategies. However, regardless of the strategy you employ, it will be scrutinized.

How it is scrutinized is what is catching the community based financial institutions off-guard. The agencies are starting to rely more heavily on a mathematical approach to fair lending reviews. They often employ regression analysis to assess whether an institutions' pricing on consumer loans is statistically different for minority vs. non-minority applications.

For consumer loans, we find this is tricky for several reasons. First, the examiners employ a controversial technique to identify the minority applications called "surname surrogates." Using a list of common Asian or Hispanic surnames, they can approximate the minority applications for their testing. This technique is problematic at best, but the agencies seem to be comfortable with it. Second, the regression is often based on what your lenders say they use in pricing, and lacks the complex variables that consumer loans can present. This results in an over simplified model. And third, most community based financial institutions do not have the experience or personnel that can defend a model.

Clearly, this uptick in focus on pricing is rising out of the subprime mortgage lending crisis. And the analysis is much easier on mortgage products than other loan types because mortgage lending has more homogeneous characteristics in addition to the fact that Home Mortgage Disclosure Act data provides race and gender variables. Our advice to clients is to be prepared for a potential pricing review of consumer loans. In addition, be prepared to have it looked at mathematically.

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21 Southeast Third Street, Suite 500
Evansville, IN 47708

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For additional copies or change of address, contact Harding, Shymanski & Company, P.S.C.
For more information, contact Christy Sayle, CFSA, CICA, at (800) 880-7800, email csayle@hsccpa.com, or Priscilla Capes, CPA, CFE, AAP, at (502) 584-4142, email pcapes@hsccpa.com. Visit our Web site at www.hsccpa.com

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