the riley report's February Newsletter

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the riley report February 2009

21st Century Common Sense Banking
For CEOs, Boards and Executive Officers

Welcome to the February Newsletter - Ideas or Strategies to Improve Your Bank's Performance

- **Commentary - The Economic Recovery Will Depend on Developing Products Every Bank Can Use**
- **Hundreds of Community Banks are Now Offering High Interest Checking Accounts - Are These Guys Nuts, or What?**
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The Economic Recovery Will Depend on Developing Programs that Every Bank Can Use

There is no single solution to the current banking crisis and Treasury Secretary Timothy Geithner's presentation on February 11, 2009 certainly underscored the need to use multiple approaches. One thing is certain, though, without **all** of the nation's banks involved, the recovery will be slowed. The most visible program is to push modifications, including write downs through the mortgage servicers. MSNBC's article, Here's Why It's So Hard to Modify a Mortgage, reprinted at right, outlines the pitfalls and challenges in modifying MBS mortgages.

I have a more simple solution: encourage all banks to generate and retain in their portfolios - 30 year fixed rate mortgages. That sounds like heresy for those of us who grew up through the inflation racked 1970's and vowed never again succumb to long term fixed rate assets being funded by short term liabilities. I've been a firm believer that the average mortgage, regardless of the term, pays off or refinances every 7 years. Notwithstanding this, my proposal adds the caveat that, if the mortgage remains on the bank's books at the end of 7 or 10 years and has been satisfactorily paid as agreed, the federal government would buy the loan at par.

The advantages are numerous: banks make sound loans at market rates to homeowners in their markets, the secondary market becomes an option for banks, not the primary tool for handling 30 year mortgages and there are no taxpayer dollars involved.

This proposal should be part of the national discussion. I encourage you to share this approach with your colleagues and if you agree with the concept, let the Adminstration and Congress hear your voices.

Mark C. Riley

FIRSINC and the riley report

In late 2008, after 35 years in community banking, including my recruitment to lead, as Director, President and CEO, the turnaround of two community banks, and serving as the President and a Director of a de novo bank, Susan Riley and I started Financial Institutions and Resources Inc. (FIRSINC) to assist community banks.

Please visit our website for past newsletters and to access information about the 2008 Neighborhood Mortgage Stabilization Program. We would appreciate your feedback and be honored to work with you to build a top performing bank.

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Leadership 101 - Layoffs, Limos and Other Loony Ideas

Prior to becoming CEO of my first turnaround bank, I worked for an organization that was hard hit by the late 1980's commercial real estate market. Part of the corporate expense reduction strategy was to impose a 5% staff layoff. Many of us justified this action as being the opportunity to weed

Hundreds of Community Banks Are Now Offering High Interest Checking Accounts - Are These Guys Nuts, or What?

Never before in community banking have profitable core deposit growth and strong income been more important. So why the heck are more banks every month getting into paying high interest rates on consumer checking accounts when margins are already under pressure? As it turns out, it can be a very powerful and profitable weapon in the war for deposits. But to understand it, we need to closely examine the way we think about checking accounts, for the old business model is rapidly falling apart. Here are a few ugly truths that underpin the need for us as bankers to take a different approach to deposits:

- Most banks have little net DDA account growth, and half of all banks are closing more accounts than they open.
- Millions of dollars are spent on branches, but the average branch opens only 10 checking accounts each month.
- 71% of all households choose their next bank on the internet.
- 80% of all checking accounts in the country are opened by the top 25 banks.
- One in five households already bank with an "internet only" bank like ING

What are the near-term and long-term implications of those trends? If 16,000 banks and credit unions are fighting over just 20% of the business, how does a community bank stay in the game? How do we compete with million-dollar research and product development budgets to create profitable products that customers want? How can smaller banks hope to have the kind of robust internet marketing presence that attracts the customers who no longer visit the branch to do business? Based on extensive market research, the REALChecking system of consumer accounts is bringing the power of world-class product design, marketing and performance consulting to community bankers around the country at a cost of less than one frontline FTE. If that sounds "too good to be true", that's understandable, because almost everything about these products and their performance defies conventional thinking.

The flagship product, REWARDChecking, now has over 5,000 months of client performance data that is constantly mined to learn how to pull the right performance levers in the program to optimize the results.

As many bankers have already seen in their markets, this product is a unique and powerful offer to the potential customer. If the customer agrees to do a few simple things every month that improve the banks income, the bank shares part of that improvement with the customer in the shape of a high interest rate (4 -5%) and free ATM's anywhere in the country. All of this in a free checking account with no minimum balance.

For most of us, this initially sounds like a sure way to drive the bank off a financial cliff, but here's the kicker... these accounts are twice as profitable as traditional free checking and are the lowest all-in cost source of meaningful incremental deposits.

Focus group research has made it clear that the 70% of the market who bank at a "big" bank do so even though they know that the service will frequently be poor. They bank with them anyway because they think the products will be better and sadly, they're often correct. On the other hand, the 30% of the market that banks with community banks do so even though they know that the products will largely be unexciting, but they think that the service will be much better. The REALChecking products are a carefully engineered and profitable way to help bankers offer a value proposition that is superior to the mega banks and INGs of the world, while

out the under performers and create a more efficient operation. What I learned, however, was that in laying off 5% of the workforce, regardless of the intentions, we ended up terrorizing the remaining 95%. More interesting, though, was the remaining staff most affected by the action were generally the most conscientious employees. To make matters worse, there was another 5% staff reduction. If we didn't think morale could plummet any further after the first round, the second round was devastating. At that point, I vowed that when I became CEO, I would never use layoffs as a bank management tool.

The far more effective approach, especially during this time, is to build a culture around making your employees the best bankers in the marketplace. Many bankers pay lip service to how important their employees are to the success of the bank. In your bank, make it an integral part of the story. The best way to do this is to recognize your best colleagues and get rid of the under performers. Your employees know who contributes and who doesn't. In my own experience, after documenting the poor performance of a supervisor, I terminated the employee and the immediate feedback from my staff was "What took you so long?"

If you currently have a limo on call, we need to talk. In the meantime, there are symbolic actions that executive officers and the board can take to demonstrate their commitment to watching expenses. Examples include:

- Company cars should be purchased by the executive officers that use them.
- Board fees should be reduced or eliminated until earnings return to expectations.
- Monthly country club dues

also offering the touchstone level of service and local presence that is already present.

Exciting products are great, but they need unbeatable marketing support to drive market share and lower deposit costs. Both traditional bank marketing and e-marketing are carefully designed into the REALChecking system, including web-based "microsites" that often produce more accounts than branches do.

Each product in the REALChecking system has its own flash-movie web site that can educate and motivate new customers to do business with your bank. Let's face it, from the customer's point of view, who the heck wouldn't move their account to get 4%-5% interest and free nationwide ATM's on a free checking account? They'll move not only their checking, but savings, CDs and any other accounts that are paying less than that (which would be pretty much everything).

This article certainly can't fully cover all aspects of the program, or its financial model, though here is a brief list of the benefits of a REWARDChecking account:

- Average balance of $8,700 or higher in the free checking account
- 300% increase in debit card usage and interchange income
- Average lifetime of the relationship doubles over normal free checking, improving net account growth
- Penetration of direct deposit, e-statements, and other services improves substantially, allowing for lower costs of customer service
- Account profitability twice that of traditional free checking

Each bank has its own unique set of goals, demographics, and competition, so world class analysts and consultants are an integral part of the REALChecking system. Each program is designed to create the most compelling product possible while also ensuring the best possible financial success for the bank. Both pre-launch design and ongoing performance consulting and peer-based benchmarking are included with each program to ensure long-term success.

While REWARDChecking is designed to attract and retain rate-sensitive customers, equally powerful products are already launched to appeal to younger customers (REALTunes), people who want to do a better job of saving (REALSaver) and socially conscious customers who care about either national or local charities or their church (REALGiving).

So as it turns out, those 600 bankers aren't so crazy. They've opened nearly 1 million new accounts for customers who are thrilled with finally being rewarded for their business.

They've grown market share and reduced their banks overall funding costs. Instead of just vanilla, me-too products, they now offer a whole suite of products supported by the kind of research, development, testing, marketing and consulting that only multi-billion dollar banks could afford. And, they're doing all of that for the cost of one mid-level FTE. Just in case you think this is still a bit dubious, the program also has a profitability guarantee.

The financial success of our community banking model has always depended more than just a bit on people being "lazy" with their money, but those days are just about at an end.

The REALChecking system is not the future of community banking, it's the very real present. It's the only way this 30-year banking veteran has seen for community banks to compete successfully with megabanks and internet banks for lifeblood core deposits.

Readers of *the Riley Report* will receive preferred pricing for REALChecking, and if you would like a full information package, simply

should be paid by the executive officers (business development expenses continue to be paid by the bank).
- Re-examine the cost benefit of out of town workshops and conventions.
- Share in any salary freeze - better yet, freeze the executive salaries and continue the staff increases - the incremental impact is far greater to the lower compensated staff members.

Now, more than ever, the executive officers need to be in front of their employees. Quarterly staff meetings are a must, but lavish parties are not. Celebrate when your bank's performance is great and in the meantime, focus on making sure your colleagues know how important they are to the bank and each other.

MSNBC - Here's Why It's So Hard to Modify a Mortgage

The Mortgage Modification Mess

December 18, 2008
http://www.msnbc.msn.com/id/28147389/

President-elect Obama, congressional leaders and various regulators, lenders and community groups are proposing more aggressive measures to try to stop the rising pace of home foreclosures.

No matter what measures are enacted, these programs will likely encounter the same financial and legal hurdles that have slowed public and private foreclosure preventions for the past year.

Here are some of the roadblocks lenders and homeowners have faced as they try to work out more affordable loans that will

send an email to mpotter@strunklp.com. I'll be glad to fully brief your bank on all aspects of the program, and even create a full multi-year proforma for the program at your bank.

Mike Potter is Senior Vice President of Strunk & Associates, which is an investor in Austin, TX based BancVue, the developer of REALChecking. For more information on this unique program, and the Riley Report *preferred pricing, contact him at 703-850-9560 or via email.*

Insuring to a Better Tomorrow - Utilizing Operational Risk Management to Decrease Costs and Increase Efficiency.

Given the current pressures on asset quality and earnings, sound and thorough operational risk management has never been as important. With an eye towards protecting already fragile balance sheets, it is time that community banks utilize some tactics employed by the largest institutions in the country while making sure their risk management advisors are partners now and going forward. Bringing in an experienced brokerage group to work with senior management or existing local agencies can significantly improve efficiency.

Many financial institutions are examining their complete operations structure, hoping to squeeze non-interest income from all profit centers while simultaneously reducing operating costs. They would do well to review their current insurance supply lines to ensure that they are being as competitive as possible. This review doesn't necessary require a move from local agencies or state sponsored providers as most large collateral protection brokers will work with these groups to find the best path forward, which can preserve existing relationships

With the recent increases in foreclosure filings and recorded lapses in primary insurance it is prudent that collateral protection, with a special focus on real property, is reviewed. Luckily, this is an area where there are many avenues to reduce costs and increase collateral stability.

When we discuss collateral protection optimization we generally like to establish the banks retained risk tolerance, current operations, future operations and cost sensitivity. Of paramount concern is crafting a policy bundle that allows the insured to remain compliant with any government regulating body, as well as the secondary market and GSE's depending upon the operating structure. Having a brokerage group with extensive expertise in this area can save considerable funds and heartache that result from underinsured or uninsured losses, especially with regards to seller servicer liability. Along with basic avoidance of balance sheet crippling losses a solid brokerage group can navigate the greater property casualty market to find the best possible rates and coverage terms for your institution.

Over the last six years or so there has been a considerable softening in the property and casualty insurance market. Soft markets are characterized by a lot of competition, which collectively drives down insurance rates. There is considerable evidence that this trend is going to slowly reverse beginning in the second quarter of 2009. Insurers are reeling from a poor investment performance coupled with traditional underwriting losses. This has created a scenario where insurers are tightening underwriting standards and in some instances reducing their risk footprint by extricating themselves from high risk areas, such as coastal counties, or by reducing wind or flood coverage available. In fact, our group has seen reinsurance rates priced higher than expected resulting in across the board premium increases at some carriers. When rate increases appear imminent it becomes even more important that banks have a solid brokerage group

slow the foreclosure rate and keep more people in their homes:

At the heart of the problem is the financial alchemy lenders used to stretch borrowers into mortgages beyond their means. Hundreds of mortgages -- and sometimes other loans -- were bundled and placed in separate trusts. Wall Street then sold investors bonds backed by that mortgage pool. The monthly payments from homeowners are used to pay back the holders of those bonds.

Wall Street bankers believed they had minimized the risk to any one investor that an individual loan would go bad. The problem is that no single lender owns a specific mortgage. So there's no one party for a homeowner to negotiate with when it comes time to modify a loan. Their loan could be owned by thousands of investors.

"It may just be hard to contact all these folks," said Adam Levitin, a Georgetown University law professor who recently wrote a paper on the problems servicers are having modifying loans. "They can be spread all over the world, and getting approval can be very difficult. This is Humpty Dumpty, and all of Paulson's horses and Bernanke's men can't put this one together."
Recent programs announced by private lenders like Bank of America and government regulators like Fannie Mae only apply to whole loans that are owned directly by a lender.

Most mortgages written during the peak of the lending bubble were bundled into pools of loans whose monthly payments are paid to the holders of a series of mortgage-backed bonds. The original lender no longer has an interest in the mortgage.

Payments from homeowners are collected by "servicers" and paid to investors holding the bonds backed by that mortgage. So it

supporting them to keep additional costs at a minimum. The very best brokers have invested heavily in technology and have staff with experience in both insurance and community banking -- this allows the insured to operate more efficiently, which in turn can drive down the costs of monitoring, placing and removing insurance over collateral, when necessary.

When we discuss collateral protection we are generally referring to several different policies including Mortgage Impairment, Lender Placed Hazard, REO Hazard & Liability, Excess & Forced Flood, as well as a suite of Auto coverage's. All of this form a policy bundle that should, in theory, provide a gapless shield over your loan based collateral. We will focus on the mortgage impairment and lender placed hazard & REO polices below.

Mortgage impairment, in its most basic form, is a contingent protection policy that steps in to make the bank whole in the event primary insurance, required of the borrower in the mortgage agreement, has lapsed and there is a covered loss. The policy has expanded beyond this form to include many lender liability and seller/servicer liability provisions. A lender placed hazard/REO program is supposed to work in concert with mortgage impairment and is used to place coverage over known uninsured or owned properties.

Now that we've taken a look at what an optimal risk management relationship might look like, and a few reasons why this can be of great service, let's review some tactics that larger institutions use that can be employed, with great success, at the community or regional bank level.

Groups such as Hub Financial Services can work with existing personnel to move insurance to an online environment, including outsourced mail cycles for placement notices. This can be extended to include full outsourcing of tracking with a state of the art, well qualified call center and mail center in Texas. A thorough cost benefit analysis should be conducted as part of the annual risk management audit to determine if there are significant savings available through partial or full outsourcing of tracking. At the community bank level we have seen great success when institutions remove the need for their tracking department and then turn those individuals outward to solicit new accounts in a front line capacity, or supporting front line operations.

It cannot be overstated how large institutions can leverage their size and risk retention abilities to demand lower rates from carriers. It is imperative that community banks have well respected brokers working for them who can aggregate many risks to gain a similar leverage set with underwriters. With close carrier relationships these brokers can present the bank in a way that might result in premium stability year to year, even in the face of rising premiums similar to larger institutions.

A recent development that we have championed for some of our larger clients is an experience rating endorsement. This attaches to policies and essentially states that if a banks loss record is satisfactory then they can enjoy either rate reductions or a return of premium. While this provision is not common it is indicative of how a creative risk manager can tailor policies that reduce overall costs. Another creative provision allows for a direct rate balance between REO and lender placed hazard rates. For example, if a bank decides to increase their lender placed rates by 15% (which are passed along to a borrower) they can conversely reduce their REO rates by 15% (which are usually borne directly by the bank), therefore total incurred costs can be reduced. Another great option is multiyear policies that can hedge against large loan growth by freezing premium figures. Such clauses can result in significant cost savings, with some recent examples saving over twenty thousand dollars in premium costs the first year.

Direct reduction in incurred premium costs goes hand in hand with

has fallen to these loan servicers to try to modify mortgage terms for homeowners whose loans were sold into these pools. So far, that process has involved a painstakingly slow review of each loan, something most servicers weren't originally set up to do.

Each mortgage pool comes with different guidelines for how to deal with bad loans. Some don't spell out clearly who has the authority to make changes in individual loans. Some trusts are managed by two layers that include both a 'servicer' and a 'master servicer.' If a servicer decides to modify a loan, it still faces a potential legal challenge from investors.

"That is not a resolved issue and potentially subject to litigation," said William Longbrake, who recently retired as vice chairman of Washington Mutual. "And that makes servicers more conservative about how aggressive they're willing to be." The securitization of home mortgages has complicated public and private efforts to modify loans because mortgages bundled into pools are backed by many different classes -- or 'tranches' - of bonds.

Each tranche comes with different rules that govern which investors get paid first if some mortgages default. One set of investors may benefit from a foreclosure, for example, even as other investors would profit from avoiding it. Some mortgage pools are backed by dozens of different tranches.

Now, as the companies charged with managing these mortgage pools try to modify terms on individual loans, they're finding it difficult to get these multiple classes of bondholders to agree.

Industry insiders have dubbed this process 'tranche warfare.' During the height of the lending boom, many lenders accepted a second mortgage in place of a down payment. After all, the

increases in operational efficiency, which a strong broker relationship can guarantee. In many cases utilizing an insurance group that allows for direct reporting of properties online can save many hours otherwise spent filling out hardcopy reports. Not only does this reduce time spent placing coverage, it also is more secure, can reduce errors and allows for compressive real time tracking of properties and premiums. Most well qualified groups can then extend this to full outsourced tracking of loans to ensure that required insurance is in place and if not that coverage for the banks benefit is placed.

The bottom line is that most, if not all, additional broker services such as audit support, on site risk analysis, policy review, policy and market education, as well as aggressive support of your account are absolutely free and available from most high quality brokerage groups. So why not take advantage of them? The worst case scenario is that you test the waters and find you are happy with your current arrangement; best case scenario is you realize potential savings that strengthen your balance sheet now, and in the future.

Chris Riley is Program Manager -- Mortgage Services, HUB International Limited. HUB International Limited is a leading North American insurance brokerage that provides a broad array of property and casualty, life and health, employee benefits, reinsurance,investment and risk management products and services throughout offices located in the United States and Canada. For further information, Chris may be contacted at 908-596-0241 or christopher.riley@hubinternational.com.

thinking went, home prices never fall, so how could they lose?

Now, homeowners with second mortgages face a tough time getting a loan modified. In many cases, there isn't enough home equity to cover both mortgages. So the investor holding the second mortgage, who takes the biggest hit, has no incentive to agree to new terms.

Without that approval, the holder of the first mortgage can't modify its terms.
Since the tidal wave of failed home mortgages swamped the credit markets this year, falling home prices have created a major roadblock for millions of homeowners trying to modify loans that are now bigger than their house is worth. Some loans -- based on inflated appraisals -- were 'underwater' from the day the deal closed.

Now, with one in five mortgage holders in the same boat, public and private foreclosure prevention programs and proposals have run into the same critical question: Who should bear the loss when the principal balance of a loan is reduced to reflect the loss of the home's value?

Some lenders have voluntarily agreed to take this "haircut." But many investors holding bonds backed by mortgages have refused to go along. When a mortgage is part of a pool of bundled loans, all of the investors have to agree to reduce the principal.

The issue has been at the heart of the political debate over the government's response to the crisis. Opponents of aggressive housing relief involving taxpayer funds have balked at the idea of bailing out borrowers who took on more debt than they can afford. Some foreclosure relief proposals would split the loss. Lenders and investors who agree to give up principal would share any future gains from the sale of

the home.

Because the process of creating mortgage-backed securities was loosely regulated, there are no standard terms governing how these mortgage pools were bundled or how mortgage defaults would be handled.

The complex terms and financial structures of these mortgage pools vary from one offering to the next. In some cases, bonds from multiple mortgage pools were mixed together in yet another trust - which created yet another series of bonds twice-removed from the original mortgage.

As a result, there are no widely agreed-upon rules for modifying a mortgage owned by these pools.

Companies servicing these loan pools - originally tasked with managing payments to investors from a stream of monthly mortgage payments - now find themselves caught in the middle of a monumental mess as they try to balance the interests of individual mortgage holders at risk of default and the hundreds of investors who may hold a piece of that loan.

When a mortgage is modified to make it more affordable, that means lowering the interest rate or cutting the total loan amount -- or both. And that means the investor who bought bonds backed by a mortgage pool will have to agree to accept a lower return on their investment.

Companies that service these mortgage-backed investments fear they may get sued if the investors later claim the borrower could have afforded the loan after all.

The legal structures of the trusts used to bundle mortgages can present further roadblocks. In some cases, efforts to modify the terms of a single loan may run afoul of a Depression-era law designed to prevent issuers of

bonds from changing the terms after a bond offering is first issued. Changing the terms of even one loan in a pool could also remove favorable tax treatment for the entire pool.

The decision to modify mortgage terms is also clouded by the goal of limiting loan modification to only those borrowers who will eventually default -- a prediction that's extremely difficult to make in many cases. Loan servicers use complex formulas to judge both a borrower's risk of default and the financial impact on investors who bought that loan.

Those calculations typically involve crunching historical data on home prices, credit risk and economic forces like unemployment. But those historical statistics turn out to be inadequate when trying to model the worst housing market in 75 years.

That's why two homeowners with similar financial situations may get two very different responses when they try to modify their mortgage terms.

"There are a zillion and one assumptions you have to make and the calculation depends on how you do the math," said Mark Zandi, chief econmist at Moody's Economy.com. "One of the problems is that each servicer has their own math and each one uses their own set of assumptions. And to some degree, they're not sure which assumptions to use and how to do the math."

For a significant number of homeowners, no amount of loan modification will make them viable. During the peak of the credit bubble, lenders approved mortgages that were only sustainable in a rising housing market. As those mortgages reset to reflect the true cost of the loan, borrowers are simply swamped with too much debt.

"Many people were qualified for

these loans with the expectation they would refinance based on home price appreciation," said William Longbrake, retired vice chairman of Washington Mutual. "That hasn't happened. So they can't refinance and they can't make the higher payment."

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