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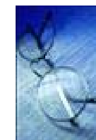
Common Sense Banking for the 21st Century For CEOs, their Executives and Boards of Directors



Welcome to the March Newsletter - Ideas and Strategies to Improve Your Bank's Performance

There's an old adage that the best bad loan is one that's never made. With revelations from the Madoff Ponzi scheme to fraud in loan portfolios, this month's principal article focuses on lender due diligence. And, for those who want to know exactly when the bear market ends, here's my fearless prediction.

- *Know Your Customer Regulations and Enhanced Due-Diligence in a Difficult Lending Environment*
- *The Bear Market Will End On December 9, 2009... Give or Take A Month or Two - Here's Why*

We're pleased Zirkle Blakey, has joined our firm as a Senior Consultant. Zirkle has over 25 years of progressive management experience providing strategic and tactical leadership for the banking industry within the regulatory compliance, merger and consolidation, and organizational process.

We've also updated our website to make previous articles more accessible. As we mentioned when we started FIRSINC, we wanted to stimulate discussion among you and your colleagues. If a particular idea doesn't seem feasible in your plans today, check back in a couple of month for new ideas and strategies.

As always, we appreciate your comments and suggestions.
Mark Riley

Know Your Customer Regulations and Enhanced Due-Diligence in a Difficult Lending Environment

The focus of this article is to speak to the need to ***Know Your Customer (Borrower)*** in these difficult lending times and in today's tough business environment. Simply put, in the US, Know Your Customer (KYC) for banks and federally chartered savings and loan institutions is a due-diligence policy implemented to conform to a customer identification program mandated under the Bank Secrecy Act and the USA Patriot Act of 2001. Bank lending divisions and bank owned commercial finance companies are, therefore, looped into their requirements. As best practices, other lenders have likely by now picked up on the requirements as well, although they are not mandated to do so. Taking this KYC to the appropriate next level for commercial banks and commercial finance entities, Enhanced Due Diligence (EDD) is the common practice of well managed lending

FIRSINC and Bank Resources and Solutions

Sue Riley and I co-founded Financial Institutions Resources and Solutions, Inc. (FIRSINC) to assist financial institutions with improving their performance. FIRSINC, through its principal division, Bank Resources and Solutions, has resources to address all areas of your organization, including Strategic Planning, Budgeting, Operating Efficiencies, IT and Risk Management. In addition, we produce articles and research papers for thoughtful discussion. Our focus is on providing concrete ideas and strategies to raise performance levels in banks.

For more information on how we can assist your bank, please contact me at mriley@bankresourcesandsolutions.com or 757-642-8353.

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Commentary: The Bear Market Will End On December 9, 2009... Give or Take A Month or Two - Here's Why

operations in modern times.

Yes, ***Know Your Customer (Borrower)*** regulations take on a higher meaning to those who manage risk at the level common to all senior lenders. KYC and EDD means consistently assessing the risk that would come from otherwise NOT knowing the real financial character and capacity of a business borrower and its management team. In these days of increased balance sheet risk and uncertain economic times, it can be concluded that it is truly management that repays the loan, and there is no better way to assess management's ability to manage a company than to account for how management has performed in the past. The optimal way to do this is to perform a background investigation. At some predisposed loan amount (which should be addressed in a formal loan policy), the performance of background investigations should be a regular part of a commercial lender's KYC policy and EDD process.

Know Your Customer (Borrower) is really nothing new in the underwriting and due-diligence process and nothing that should ever require a regulatory mandate. Among lenders that have had formal credit training, the 4 C's of Credit -- Collateral, Capacity, Conditions and Character -- have long stood the test of time as the primary factors influencing the credit decision. It is the consistent assessment, measurement and monitoring of these four sacred principles that all lenders strive for today just as they have for decades, if not centuries. Know Your Customer is embodied in these credit characteristics. It is how we perform our due-diligence to address these critical risk assessment factors which has changed over time. I will discuss later how the passage of time has elevated the importance of getting these four aspects of the underwriting process correct.

But first, I would like to recap briefly and categorically the due-diligence process of every senior lender.

The Senior Lender's Due-Diligence Process

Broadly speaking, in addition to management interviews and site visits by the lender, the due-diligence process often includes the following key components, many of which are outsourced today because of the demand for the latest tools, techniques and the need for specialization:

- Background investigations, including investigations performed upon the borrowing entity and the management team.
- Financial statement reviews and analysis, including audits and field examinations.
- Collateral evaluations, including appraisals of personal and real property.
- Legal reviews of corporate fitness and business legitimacy.

A Historical Perspective

My purpose here is to present the case for the utilization of background investigations as a tool to Know Your Borrower and to manage risk and prevent, detect and manage fraud -- *before and after the loan is made*. For the following reasons the performance of background investigations as an integral part of the KYC and EDD process is more meaningful than in the recent past, and should be part of the pre-commitment, post-closing and on-going due diligence:

- Excessive and obsolete inventory levels, slower accounts receivable collections, increased dilution, deteriorating collateral values and reduced advance formulas make it critical that experienced management is at the helm and that it is not burdened by an illegitimate or unsavory past.
- Company owners and managers are involved in more businesses than ever, many of which are across state or country borders and may involve different and multiple partners. These "off balance sheet entities" could be the host of a problem.
- Lenders are more often participating with other lenders and equity providers in the same capital structure, sharing increased risk with each other. Participants are relying upon the lead lender's pre and post-closing due diligence in most cases.

The totally unscientific calculation is taking a look at the last three Bear markets and their duration in months (source: FIG):

1929 Great Depression - 34.2
1973 Oil - 20.7
2002 Tech - 30.5
2008 Current -17.1

There's a near consensus that this current recession is not as severe as the Great Depression and if it were to match the duration, that makes August 2010 the equivalent length. There are fundamental differences in the causes of this recession vs. the Oil and Tech periods. December 9, 2009 represents the conclusion of a 26 month bear market.

The economy began really getting ugly beginning in late 2008 and will remain so through mid-August 2009. Banks have done a good job of identifying their problem credits. These loans (and securities, where applicable) have been written down and provisions made for potential losses. In addition, banks have also identified their potential problem assets and have put in place action plans for their resolutions. We'll know by mid-August how successful these cleanup efforts have been through the June Call Reports.

The federal and state regulators should be given credit for their aggressive efforts to provide capital and liquidity to the markets as well as focusing on credit quality on the bank level. I'm not certain we will all agree on every strategy or program, but I shudder to think if there had been no action taken.

Housing inventories will return to more acceptable levels and for the millions of currently upside down homeowners, historically, most will recover their value in the next five years. Industry and manufacturing should begin to see an uptick in hiring and

- The world market is a greater target for new business and new business partners, and lenders are more in need of the best worldwide information in order to make an informed decision.
- The media plays a more intense role and is ever more *real time*. Lenders must know what the media knows and more.
- The world is ever more litigious, and litigation costs real time and real money. It is best to get the most accurate information up front in order to avoid a legal issue that could have been avoided.
- Information is more readily available within a time frame that *beats the bell* at a cost that doesn't *beat the bank.*
- Lending relationships are frequently more transactional and less relationship driven. Banking services are often accepted by borrowers more a la carte, in spite of banks' best intentions to cross sell expanded capabilities as the best value proposition.
- Time is more of the essence with competition for the same deal ever more intense and coming from ever more financing sources. Lenders and borrowers share the same desire for a speedy decision, requiring the fastest due-diligence possible.
- Corporate fraud, scandals and corporate governance have become more common in our business vocabulary. Corporate scandals are now front page news, and the executives convicted of these illegalities against shareholders, investors and lenders are being held accountable.
- There are now regulations that require a KYC policy and a certain level of background investigation. A few short years ago there were no insurance requirements or federal statutes that required a state or national bank or federally chartered savings and loan institution to check a list for terrorists, narcotics traffickers or those engaged in the proliferation of weapons of mass destruction. The FDIC and the FSLIC changed all of that subsequent to the passing of the USA Patriot Act of 2001.

Best Practice Tips

1. Lenders should be consistent about the KYC and EDD methodology that they employ. Lenders that perform background investigations by exception rather than as a standard practice could be compromised exceptionally -- if and when it happens.
2. Hire a background investigations firm that is consistent about its best practice methodology as well, and be sure it includes items 3, 4 and 5, below.
3. A background investigation firm's best practices must include a thorough research effort into determining all of the jurisdictions (counties or countries) in which the subject has resided, owned property and done business. Research must be performed in every jurisdiction where it has been determined the subject has resided, owned property and done business. To except even one jurisdiction could be to leave out the one where the *deal killer* issue resides.
4. An investigation into public records (i.e., civil and criminal litigation histories, tax liens, judgments and bankruptcies) should always include a combination of independent on-site and on-line research. We find adverse public record information in approximately 30% of the cases as a result of performing on-site research that we don't find when performing on-line research only, a percentage too high to ignore.
5. Always check the Office of Foreign Assets Control (OFAC), a Division of the U.S. Department of Treasury, for Blocked Persons and Specially Designated Nationals. Those on this list are known fraudsters, terrorists, money launderers and financiers of these activities. This information is updated at least monthly.
6. Establish a consistent monitoring system and track borrowers and managers periodically against their known history or "Risk Profile." Things can change quickly over time, especially in a tough economy.

A Few Truths to Live By

production as the stimulus plan begins to take effect. Tangible benefits may be seen as early as the second quarter 2009.

That's all cautiously good news for banks. Here's the scary stuff. Net Interest Margins continue to decrease and current investment products barely cover the cost of funds, much less overhead. With an anticipated continued contraction in commercial real estate construction and related loans, there are few alternative loan products that will provide satisfactory yields. I'm certain the mark to market issues will be resolved shortly and ameliorate the current mess. However, there will be more above historical loan loss provisions made in 2009 and these pressures will adversely impact earnings for 2009. While 1,700 FDIC FIs lost money in 2008, the number will be lower in 2009 for two reasons:

1. We are over the worst in identifying problem loans. Additional provisions will be required on credits that don't meet their repayment plans.
2. In addition to continued bank failures, many boards will choose to sell their bank. That will be a difficult choice for bank boards, especially as the estimated prices today (123% Price to Tangible Book) are far lower than in 2007 (216% Price to Tangible Book) (Source:Danielson Capital New Bank Report Fourth Quarter 2008, Eastern Edition).

Having been involved on both sides of purchases and sales, if I can be of assistance in working through the issues, please let me know.
I've circled my calendar for December 9, 2009. In spirit of true disclosure, though, while I was confident Richard Nixon would win the 1972 election, I incorrectly predicted George McGovern would win more than

- Establish written KYC and EDD risk management, due-diligence and background investigations guidelines to live by, and follow them without exception.
- Back up your best interviewing skills and intuition with the best information available.
- When in doubt, it's always better to walk away from a deal.
- It's always management that ultimately repays the loan. Discover the *real* truth about who the business owners and managers are.
- Maintain your sense of humor because, when the collateral is gone and you're left to work out a deficiency with a known felon who has ravaged his last three ventures and committed untold acts of indiscretion, you'll need it!

17 electoral votes. That's the reason for the 'Give or Take a Month or Two' caveat.

About the Author: Know Your Customer Regulations and Enhanced Due-Diligence In a Difficult Lending Environment

Jerry Oldham is co-founder, Chairman and CEO of 1stWEST Financial Corp. Oldham has a broad senior management background in commercial banking and corporate and real estate finance. He frequently serves as a consultant or expert witness in litigation and settlement negotiations involving complex corporate finance, real estate banking and lending practice issues. Oldham often acts as a consulting team leader to manage the overall due-diligence process on investment decisions for 1stWEST clients. He received a B.S. in Finance and Real Estate from The Pennsylvania State University and an M.S. in Banking and Finance from Colorado State University.

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