

Community Banking

A D V I S O R

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Handle mergers with care

The possibility of rising regulatory capital requirements has prompted many banks to consider a merger as a potential compliance strategy. These complex transactions raise a variety of corporate, financial, valuation, regulatory, tax and liability issues. Following is an introduction to the merger process — with a focus on tax-free transactions — but it's important to consult qualified advisors to fully explore these issues.

Also, keep in mind that mergers don't necessarily improve capital ratios. And, depending on their structure, they may create capital only at the holding company level.

Structuring a merger

Banks typically prefer to structure mergers as tax-free reorganizations under federal law. Each structure has different requirements, but a common thread is the continuity of shareholder interest (COSI) requirement. To distinguish a tax-free transaction from a taxable "sale or exchange," the target bank's shareholders must obtain a significant interest in the postmerger institution. The most common structures are straight mergers, forward triangular mergers and reverse triangular mergers.

Straight merger. In this transaction, the target bank merges into the acquiring bank, the target bank's shareholders receive acquiring bank stock, and the acquirer receives all of the target's assets and assumes all of its liabilities. Generally, to meet the COSI requirement, at least 40% of the consideration to the target's shareholders must be acquirer stock.

Keep in mind that mergers don't necessarily improve capital ratios.

Assuming the reorganization qualifies as a merger under applicable state or federal law, there are no tax consequences to either bank. Nor will the target's shareholders be taxed on their receipt of bank stock, although any cash or other nonstock consideration will be taxable.

Straight mergers are attractive because of their flexibility. The acquirer can fund the transaction with any type of equity consideration, including voting or non-voting common stock and qualified preferred stock. Also, the target is permitted to divest itself of assets or make distributions to shareholders or creditors *before* the transaction, which provides opportunities for pre-merger planning.

Forward triangular merger. This structure is common when the acquiring entity is a holding company. It's similar to a straight merger, but the target is merged into a first-tier subsidiary of the acquirer, and the target's shareholders receive holding company stock. The subsidiary, which is the surviving institution, acquires the target's assets and assumes its liabilities.

To qualify for tax-free treatment, the holding company must own at least 80% of each class of the subsidiary's



stock. And the subsidiary must acquire substantially all of the target's assets — generally, at least 90% of the target's net assets and 70% of its gross assets (the “90/70 test”). This requirement limits premerger planning.

Reverse triangular merger. Here, the parties are similar to those in a forward triangular merger, except the acquirer's subsidiary is merged into the target and the target becomes the surviving entity (as a holding company subsidiary). This may be desirable, for example, if the target owns valuable licenses or has better name recognition.

These transactions can be challenging because regulatory approval is harder to obtain and the rules are stricter. In addition to the 90/70 requirement, the holding company must acquire control of the target solely in exchange for holding company voting stock. That means at least 80% of the consideration to the target's shareholders must be voting stock; nonstock consideration can't exceed 20%.

Considering liability issues

As you explore merger opportunities, it's important to consider liability issues. In a tax-free merger, the surviving entity obtains all of the target's assets and liabilities, so thorough due diligence is critical to avoid any ticking liability time bombs. See “Being diligent” at right.

If a tax-free reorganization isn't feasible, or if the buyer is concerned about potential liabilities, a cash purchase might be preferable: The buyer acquires the target's assets for cash, and the parties agree on which liabilities will be assumed.

Understanding tax implications

If you're considering a cash purchase, be sure you understand the tax implications. If the target is a C corporation, structuring the deal as an asset sale can result in double taxation: The target pays taxes on the sale proceeds and its shareholders are taxed when the proceeds are distributed to them. Sellers generally prefer to sell stock rather than assets, because they avoid double taxation and pay capital gains taxes only on the stock sale.

Being diligent

Due diligence is an ongoing process, not a one-time event. It begins with a general background check of potential merger partners and moves into more specific valuation and pricing issues as you identify leading candidates and begin formal negotiations.

Your advisors can help you put together a checklist to ensure that you cover all the bases during each phase of the merger process. Critical due diligence activities include:

- Obtaining appropriate confidentiality agreements,
- Reviewing and evaluating potential liabilities,
- Reviewing deferred taxes,
- Reviewing loans and evaluating the adequacy of the allowance for loan and lease losses, and
- Reviewing data processing contracts for early termination clauses and other issues.

This is also the time to start thinking about legal steps needed to consummate the transaction, including drafting the merger agreement, preparing proxy statements, obtaining regulatory approval, addressing “day one” accounting issues and developing a postmerger integration plan.

From a buyer's perspective, however, an asset purchase is often preferable because a stock purchase means assuming the target's liabilities. Also, purchasing assets gives the buyer a stepped-up basis, reducing the tax impact if assets are sold.

A capital idea?

Whether a tax-free reorganization is appropriate for your institution depends on several factors, including the desirability of issuing new stock, the ability of each party to obtain shareholder approval and the availability of regulatory approval.

If you're contemplating a merger — either to boost capital or for other reasons — be sure to consider all of the alternatives, including tax-free and taxable transactions. ▲

Mobile banking: How do we get there?

With the advent of the smartphone and tablet computer, mobile banking has become the next step in the evolution of online banking. Many banks now allow customers to access their accounts, make transfers and payments, and conduct other transactions — all from their mobile devices.

But with these technological advancements come some challenges. Despite the many benefits of mobile banking, customers are still wary of electronic banking methods. As a result, many community banks are reluctant to fully plunge into the mobile arena.

Keep an eye on the prize

For customers, mobile banking offers convenience. For banks, it offers reduced servicing costs, enhanced customer retention, opportunities for cross-selling services and other benefits. A December 2010 Nielsen Company survey found that mobile banking customers have a higher average net worth and maintain higher account balances.

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Another potential benefit is that mobile banking may appeal to customers who don't use online banking and may not even have computers. To attract them, banks need to provide a mechanism for signing up without the need for an online banking account.



Don't confuse the terms

Don't confuse mobile banking with mobile *payments*. Although the terms are used interchangeably, mobile banking is relatively established while mobile payments are in their infancy. The latter allows customers to make point-of-sale or other payments using near-field communications (NFC) chips embedded in, or attached to, their mobile devices.

Mobile payments are being pushed by several companies — including Google, Facebook, and several credit card and cell service providers. The banking industry has been slower to embrace the technology, however, in part because the industry hasn't developed a cohesive business model for implementing and monetizing mobile payments. But the future for mobile payments looks bright. Juniper Research forecasts that by 2015 the number of users will reach 2.5 billion and that the value of the mobile payments market will reach \$670 billion.

Educate your customers

Customer fears about security are one of the biggest challenges for banks that wish to provide mobile

services. According to Javelin Strategy & Research, the number of customers who view mobile banking as “unsafe” increased from 25% to 40% from 2009 to 2010.

To ease these concerns, banks must educate their customers about their role in security. The most sophisticated technology is useless if customers choose easily guessed passwords or access their accounts through unsecured Wi-Fi hotspots. Multiple-factor authentication (such as temporary codes sent via text message) can help, but it’s also important for customers to protect themselves.

Customer education also can help build trust in mobile technology. For example, even though many people view mobile payment technology as unsafe, experts say that it’s safer than credit cards because the data is encrypted.

Take a proactive approach

To prepare for an increasingly mobile world, conduct surveys or take other steps to understand what your customers want and expect from a mobile banking

platform. It’s also a good idea to educate management and staff about mobile platforms and services and to review and update your policies and procedures to keep pace with technological changes.

Make sure you work with reputable, experienced vendors. To minimize your risk, vet providers thoroughly and review contracts closely.

Develop a strategy

Mobile banking advancements continue being made. Some very large banks, for example, now permit remote deposit capture, which enables customers to scan checks using a device’s built-in camera and deposit the funds wirelessly.

If you’re taking a “wait and see” approach to mobile innovations, it’s a good idea to begin thinking about mobile strategies now. Not only will this position your bank to take advantage of the technology, but it also should ensure that your infrastructure investments can support mobile banking down the road. ▲

Lending to start-up businesses

In this down economy, it pays to be more cautious than ever when lending to start-up businesses. Here’s a review of some of the factors to look for when a potential customer walks in your door — and what to require of the borrower.

What’s the industry?

A startup’s industry can provide clues as to whether it will fail or succeed. The recession hit certain industries especially hard. Be skeptical of industry underdogs, such as auto dealerships, restaurants and homebuilders. More recession-proof sectors — such as health care — can improve a newcomer’s odds in today’s economy.

Also consider the level of demand for a prospect’s products or services. A new building supplies franchisee, for example, might prosper in an underserved



market with an above-average per capita income. Or the manufacturer of a patent-protected product might fill a specific, emerging consumer need.

Is the entrepreneur qualified?

The most important predictor of a startup's outcome is the caliber of the entrepreneur. Factors to consider include the individual's years of industry experience, qualifications, work ethic and reputation.

Consider how much money the owner has put into the business. Those with a vested financial interest in a startup venture are less likely to walk when the going gets tough — and more likely to protect your loan with personal guarantees.

Finally, evaluate the individual's skill set. Too often entrepreneurs generate ideas but lack the finesse to handle human resources or the financial acumen to manage cash flow. Successful owners are likely to recognize their shortcomings and fill gaps with new hires or professional advisors.

Is the customer overly optimistic?

Startups have limited operating history, so they typically submit business plans to bridge the gap. But because entrepreneurs generally have great expectations, these plans — subjective compared to financial statements — may be overly optimistic.

Too often entrepreneurs generate ideas but lack the finesse to handle human resources or the financial acumen to manage cash flow.

This tendency underscores the importance of your professional skepticism when performing due diligence. For example, consider requesting formal valuations of hard assets (such as inventory and equipment), intangible assets (such as patents and licenses) and the business itself.

Set benchmarks and reporting requirements

Determine what the benchmarks for success will be, and have the borrower agree to these in writing. You



should both know what the triggers are for cutting staff, adding staff, requiring additional capital injections from the principals or shutting down.

Also establish forward-looking reporting requirements to ensure that you're getting timely and reliable financial data. Have the borrower sign a clearly written covenant that requires providing monthly financial information. And set requirements for audits, reviews, comps or collateral-based inspections by independent third parties.

Then monitor closely

Once the information starts coming in, watch it closely. Monitor your startup's progress in terms of actual vs. budgeted results each month. Timely reviews are critical if you want to unearth problems early. And demand corrective action if, for example, management fails to meet deadlines or nears its credit limit. ▲



TIGHTER CYBER-SECURITY RULES IN PLACE FOR 2012

Take note: Your bank will need to step up its cybersecurity to comply with updated federal banking rules that take effect Jan. 1. Banks must add control measures to make Internet banking safer for customers.

The Federal Financial Institutions Examination Council recently updated its 2005 guidance, *Authentication in an Internet Banking Environment*, to address “significant changes in the threat landscape.” Among other things, the guidance cautions banks to rely on more than “simple device identification,” which involves loading a cookie onto a customer’s computer. Fraudsters, as you might know, can easily copy and use the cookies.

The guidance also advises banks to use layered security — that is, the “use of different controls at different points in a transaction process so that a weakness in one control is generally compensated for by the strength of a different control.” Examples are dual customer authorization through different access devices and out-of-band verification (that is, confirming online transactions via a phone call or text message). ▲

PREPARE FOR UPDATED TDR RULES

FASB has amended its guidance on determining whether a debt restructuring is a troubled debt restructuring (TDR). For nonpublic entities, the amendment is effective for annual periods ending after Dec. 15, 2012, including interim periods within those annual periods. For most community banks, that means the guidance will apply to all restructurings after 2011.

Whether a restructuring constitutes a TDR has a big impact on the way it’s reported on your bank’s financial statements. Generally, to classify a restructuring as a TDR, a bank must find that 1) the restructuring constitutes

a concession, and 2) the borrower is experiencing financial difficulties.

In the first test, your bank should consider all aspects of a restructuring to determine if it has granted a concession. Additional guidance notes that:

- A borrower’s inability to access funds at market rate for a loan with risk characteristics similar to those of the restructured loan may indicate that the bank has granted a concession.
- A temporary or permanent increase in the contractual interest rate as a result of a restructuring doesn’t preclude it from being considered a concession, because the new rate could still be a below-market rate.
- A restructuring that results in an insignificant delay in payment isn’t a concession.

Also, a bank may conclude that a borrower is experiencing financial difficulties, even though it isn’t currently in default. The bank should evaluate the probability that the borrower will default in the foreseeable future absent the modification. ▲



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