

FINANCIAL INSTITUTIONS

POSSIBILITIES

Q&A with Annie Goodwin

Montana Commissioner of Banking and Financial Institutions

OVERVIEW

As a leader in the banking industry, *Possibilities* recently sat down with Annie Goodwin, Montana Commissioner of Banking and Financial Institutions, to hear her thoughts about the banking industry today and where it's headed.

Annie Goodwin has served as Montana Commissioner of Banking and Financial Institutions since May 2001. Prior to her appointment, she served as Chief Legal Counsel of the Montana Department of Commerce and the Division of Banking and Financial Institutions. Ms. Goodwin brings more than 20 years of legal experience, an exceptionally strong background in banking law and a thorough understanding of Montana's financial system to the position. She also headed the Montana Office of Consumer Affairs and served as defense counsel for the Tort Claims Division of the Montana Department of Administration.

As Banking Commissioner, Ms. Goodwin has jurisdiction over Montana's laws pertaining to state-chartered banks, credit unions, residential mortgage lenders, consumer loan companies, sales finance companies, title lenders, deferred deposit

lenders, mortgage brokers, loan originators and escrow businesses. She oversees the supervision of 64 state chartered banks, nine state-chartered credit unions and more than 1,000 non-depository financial licensees. She serves on the board of directors for the Council on Economic Education and the board of directors of the Montana Financial Education Coalition.

POSSIBILITIES: How do you see the current state of banking?

Ms. Goodwin: While Montana has not gone unscathed in the economic downturn, it has held up relatively well compared to other parts of the country. Loan quality issues are most notable in the high-growth areas of western Montana, and loan loss provisions will continue to dampen bank earnings over the near term.

POSSIBILITIES: What changes do you see coming to the banking industry?

Ms. Goodwin: Further consolidation in the banking industry is a given, especially in light of today's economic environment. The consolidation

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JUST FOR FUN

Do you have a favorite motto you live by?

My father and mother emigrated from Poland to this country in 1951. They have always reminded my two older brothers and me to "love the United States."

What would your dream job be if you could do anything?

It's a coin toss, I would work in my private practice of law; however, motherhood has taught me that I would love to raise a dozen kids.

What was your first job?

At nine years of age, I had my first summer lawn job. By the end of summer, I was mowing full days.

What do you consider your biggest achievement?

Having the ability to be a mother to my five-year-old son, John Paul.

What are your hobbies?

Gardening, skiing and fishing with my husband and son. I also am a classical violinist.

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■ A Lending Revolution

New Changes to Old Regulations

OVERVIEW

The Truth in Lending Act (TILA), implemented by Regulation Z, aims to promote informed use of consumer credit through disclosure of terms and costs. TILA became effective in 1969, but in the next six to 18 months, this Regulation will require significant changes in bank processes in order to comply.



Early TIL disclosures are not required for Home Equity Lines of Credit (HELOCs), business or investment purpose loans, temporary construction loans not subject to RESPA and bridge or other temporary credit.

On July 30, 2008, the Board of Governors of the Federal Reserve System published a final rule amending Regulation Z and Congress amended TILA by enacting the Mortgage Disclosure Improvement Act of 2008 (MDIA). There are several dates to be aware of.

Changes Effective July 30, 2009

New Early Truth in Lending Disclosure Rules

An early TIL disclosure must be provided to borrowers applying for the following types of loans within three business days of receiving a complete application, and no later than seven business days before loan closing:

- Home purchase loans
- Home construction loans with permanent financing
- Home construction loans with lot purchase also covered by the Real Estate Settlement Procedures Act (RESPA)
- Loans to purchase second homes
- Home refinances
- Closed-end Home Equity Loans
- Other consumer-purpose dwelling secured loans

Early TIL disclosures are not required for Home Equity Lines of Credit (HELOCs), business or investment purpose loans, temporary construction loans not subject to RESPA and bridge or other temporary credit.

The Lender cannot collect any fees other than for the reasonable cost of obtaining the applicant's credit report until the early TIL disclosure is provided. Disclosures must also contain the following statement, "You are not required to complete this agreement merely because you have received these disclosures or signed a loan application."

A new TIL disclosure must be provided three days before closing if the previously disclosed Annual Percentage Rate (APR) was understated by more than 1/8 of 1 percent for regular transactions and 1/4 of 1 percent for irregular transactions.

Changes Effective October 1, 2009

Higher Priced Mortgage Loans

As of October 1, 2009, banks will need to have procedures in place to identify higher priced mortgage loans. A High Priced Mortgage Loan (HPML) is any consumer loan secured by the borrower's principal dwelling with an APR of 1.5 percent for first-liens and 3.5 percent for subordinate-liens above the "average prime offer rate" of a comparable maturity loan. The "average prime offer rate" is based on a weekly survey of a representative sample of creditors and can be found at <http://www.ffiec.gov/ratespread>.

Lenders originating HPMLs are prohibited from:

- Relying on collateral without regard to the borrower's ability to repay;
- Extending credit without reasonable verification of the borrower's income and assets through reliable third-party documentation;
- Imposing prepayment penalties after two years, or anytime under certain circumstances; and
- Failing to escrow for property taxes and mortgage-related insurance for first-lien loans. (Escrow requirements are effective April 1, 2010, for sight-built homes and October 1, 2010, for manufactured homes).

We have provided a brief summary of some of the many changes taking place. To gain a greater understanding you can read more about these changes in §226.19 and §226.35 of Regulation Z. ■



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Estate Planning Gridlock or Green light—Go Ahead and Step on the Gas

Estate Planning is often difficult for people to do. Several factors make it even more difficult for people in the current economic environment. The financial markets and closely held business valuations have pulled back and people feel less wealthy than they did 18 months ago. The estate tax rules for 2010 and following are not clearly delineated in tax law, and Congress seems focused on other issues. The result for many people is gridlock, or in other words, they are not advancing with their estate plans.

At times in which action is difficult, it is often the best time to move forward. Now may be an opportune time to take advantage of estate planning opportunities; there are several reasons why individuals should see a green light and move forward with their estate plans:

- Valuations of businesses and securities are low compared to 18 months ago. They may have declined to artificial lows and this is an opportunity to transfer assets before they rebound in value. It is always advantageous to transfer assets at the lowest possible value to allow future appreciation to avoid gift and estate taxes.
- The IRS issues monthly interest rates that are relevant to the success of several valuable estate planning strategies. Some of these strategies are more attractive when interest rates are low. The current IRS rates are near historical lows. Strategies such as Grantor Retained Annuity Trusts, Installment Sales to Intentionally Defective Grantor Trusts and Charitable Lead Annuity Trusts are particularly attractive in the current valuation and interest rate environment.
- It seems highly likely that, before the end of 2009, Congress will address the scheduled one-year repeal of the estate tax in 2010. They will likely address it with a patch that will temporarily extend the current 2009 estate tax rate of 45 percent and the \$3.5 million applicable exemption equivalent—the amount that can be transferred at death, including lifetime taxable gifts, without any estate tax being paid. It seems almost definite that the estate tax will continue.
- Congress may implement more far-reaching legislation that would significantly curtail the ability to take advantage of marketability and minority discounts on transfers of interests in many family entities. They are also considering changing the minimum term that must be used for Grantor Retained Annuity Trusts or increasing the taxable gifts associated with such trusts. These changes would make transfers more difficult and less attractive after the changes are enacted into law.

The combination of low current interest rates, low asset valuations and the possibility of significant unfavorable estate tax changes makes now the opportune time to move forward with an update of your estate plan. In particular, transfers to Grantor Retained Annuity Trusts, Installment Sales to Intentionally Defective Grantor Trusts and other transfers of closely held business interests may be more likely to be successful if done today, rather than in a few months. ■



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OVERVIEW

Now may be an opportune time to take advantage of estate planning opportunities. This article explains several reasons for updating your estate plan now.



Accounting for Other Real Estate

OVERVIEW

With the downturn in residential real estate and its domino effect on the commercial real estate market, financial institutions are seeing foreclosures at a pace they have not seen for many years. The accounting for other real estate can be different depending on the bank's regulator. The following comments focus on the regulatory aspect of accounting for other real estate (ORE).

The FDIC drives the accounting for other real estate through the filing of the call report. The call report instructions generally indicate that loans in foreclosure, even those waiting for the redemption period to expire, should be treated as other real estate for call report purposes. The FDIC has taken the position that real property acquired through the foreclosure process will generally be treated as "held for sale," irrespective of the general criteria provided for under FAS 144. The OCC and the OTS have generally taken the same position as the FDIC regarding the redemption period and the "held for sale" treatment.

After the sheriff sale, other real estate should be recorded at its fair market value, less cost to sell. If the financial institution has been properly handling the impairment calculation for a loan in foreclosure that is collaterally dependant under FAS 114, there should be little difference between the net carrying amount of the loan and the value of the property once it is transferred to the other real estate account under FAS 144.

Once the foreclosed property is moved to other real estate, it establishes its own new basis. Any future reductions in the appraised value of other real estate should be charged to an expense account with the credit going to a contra account on the balance sheet labeled "allowance for other real estate." Subsequent recoveries in the appraised value of the other real estate may be recorded, but only to the extent of any amounts allocated to

the allowance account; there should be no entries recorded to the loan loss reserve account after the property is transferred to other real estate. Any increases in appraised value above the dollar amount when it was originally transferred to other real estate cannot be recorded unless the property is sold and meets the requirements of FAS 66, "Accounting for Sales of Real Estate."

At the time of transfer to ORE, the appraised value, less cost to sell, may exceed the basis in the loan resulting in a gain upon transfer to ORE. The various federal regulators generally allow this, but a gain on the transfer to ORE is the exception, rather than the norm. Such a gain would typically be recorded as an increase to the loan loss reserve account if there had been previous charge-offs. If there were not previous charge-offs, then it would be recorded as noninterest income.

Additionally, certain state regulators have their own interpretation of the proper accounting for loans in foreclosure. In Minnesota, the loan cannot be recorded as other real estate until after the redemption period, and at the lower of the fair market value of the property, less cost to sell, or the basis in the loan. Capital improvements in ORE that exceed 10 percent of the amount originally booked as ORE must be expensed under Minnesota Rules. However, for federal regulatory purposes, these costs may be capitalized as long as the FMV, less cost to sell, continues to exceed the original basis of the ORE, plus capitalized improvements. All operating costs must be expensed as incurred under regulatory and GAAP rules.

Because there can be different state rules, it is paramount that state chartered financial institutions be familiar with the rules in their state. Those financial institutions not subject to state charter rules should generally be safe in following the guidance of their respective federal quarterly reporting guidelines as outlined above. ■



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Highlights of Form 1099-A and Form 1099-C

In today's financial environment, many banks are experiencing the acquisition of abandoned property and cancellation of debt. Both of these events have specific IRS reporting requirements.

Acquisition or Abandonment of Secured Property

Obtaining an ownership interest in secured property or the abandonment of secured property, in any amount, triggers the reporting requirements of Form 1099-A. The reporting requirements apply to all property other than tangible personal property used for personal use, such as household furniture, personal automobiles, etc. All real estate is covered by the reporting requirements, including personal residences.

Abandonment occurs when the facts and circumstances indicate that the borrower intended to and has permanently discarded the property from their use. The reporting requirement is the earliest of: 1) the date an interest was obtained in the property; 2) the date a third-party purchased the property at a sale; or 3) three months after the date there was knowledge of the abandonment. The amount to be reported is the balance of the unpaid principle and does not include accrued interest.

Cancellation of Debt

Form 1099-C is required to be filed when there has been a cancellation or discharge of debt of \$600 or more.

A cancellation or discharge occurs on the date an identifiable event occurs and when the facts indicate that the debt will never have to be paid by the debtor. Triggering events include:

1. Discharge in bankruptcy.
2. Cancellation or extinguishment which makes the debt unenforceable in receivership, foreclosure or similar court proceeding.
3. Expiration of the statute of limitations for collection or upon the expiration of a statutory

period for filing a claim or commencing a deficiency judgment proceeding.

4. Election of foreclosure remedies by a creditor that, by law, end or bar the creditor's right to collect the debt.
5. Cancellation or extinguishment due to a probate or similar proceeding.
6. Discharge under an agreement between the creditor and the debtor to cancel the debt at less than full consideration.
7. Discharge pursuant to a decision by the creditor or the application of a defined policy of the creditor to discontinue collection activity.
8. Expiration of the non-payment testing period.

Note: The charge-off of a debt through the reserve for loan losses incurred is not an identifiable event and would not, by itself, trigger the filing of Form 1099-C.

The amount of discharged debt includes principal, interest, penalties, administrative costs and fines. Where loan activity requires both the filing of a 1099-A and a 1099-C, filing the 1099-C meets the 1099-A filing requirement. While this article addresses the general reporting requirements for abandoned property and cancellation of debt, each circumstance is different and you may have specific reporting questions. ■

OVERVIEW

Banks are facing increased reporting requirements related to IRS Forms 1099-A and 1099-C due to the acquisition or abandonment of secured property and the cancellation of debt.



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Intangible Assets: Impaired or Not Impaired

OVERVIEW

The Financial Accounting Standards Board's (FASB) rules surrounding intangible assets can often be as difficult to understand as Shakespeare's prose. As the end of 2009 draws nearer, and with the increased media attention on the "mark-to-market" accounting rules, it will be increasingly important that banks understand what is needed for impairment testing of its goodwill and other intangible assets for upcoming regulatory exams, audits and/or reviews.

According to the FDIC's Quarterly Banking Profile, goodwill impairment and intangible asset write-offs in the fourth quarter of 2008 amounted to \$21.9 billion, an increase from \$11.5 billion and \$1.6 billion in fourth quarters of 2007 and 2006, respectively. The first two quarters of 2009 have shown similar trends and write-offs are expected to continue through the end of 2009.

Key Concept

When determining the value of an intangible asset (i.e., goodwill, core deposit intangible, etc.), it is important to remember that Statement of Financial Account Standard (SFAS) 157, *Fair Value Measurements*, defines fair value based on the "exit" (selling) price to a third party and not on the "entry" (purchase) price.

Steps Performed

Intangible asset impairment testing is covered under SFAS 142, *Goodwill and Other Intangible Assets*, and is a two-step process. The first step is to determine the fair value of the bank. If the fair value of the bank is greater than the book value (including goodwill) as of the measurement date, no further testing is necessary, as no impairment exists. If the fair value of the bank is not greater than the book value, the second step must be completed.

The second step is to allocate the fair value of the bank to all of the assets (excluding goodwill)

and liabilities of the bank as if it were acquired by a market participant on the measurement date. The excess of the fair value of the assets and liabilities over the book value excluding goodwill is compared to the book value of goodwill to determine the amount of write-off.

Inputs Used in Determining Fair Value

There are two generally accepted methods of supporting the fair value of a bank and its intangible assets—a market approach based on level 1 or level 2 inputs (see table on page 7) and an income approach based on a present value of expected future cash flows.

The market approach inputs typically are harder to apply as most banks are not actively traded and private transaction data is difficult to deem comparable in today's economic environment given the lack of activity and wide disparity loan portfolios and operational strategies. The income approach inputs require management to forecast cash flows for a reasonable period and present value them back to the measurement date using a reasonable discount rate (or rate of return).

No matter which inputs (or approaches) are used to determine a bank's fair value, it is important to remember to document the rationale for assumptions and inputs selected; be aware of historical trends that may impact forecast assumptions; obtain and apply data from

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reliable sources that could be reproduced; and communicate with your auditor to understand what they are looking for.

In today's economic environment, it can be challenging to support your rationale, assumptions and fair values; be prepared. Having the proper understanding, calculations and supporting documentation will allow you to use your resources efficiently and effectively when examiners and auditors start asking whether or not your intangible assets are impaired. ■

Fair Value Inputs

Level	Attributes	Comments
Level 1	Active market, observable quoted values.	Stocks traded on public exchanges would meet this definition.
Level 2	No active market in the same assets but observable value markets for similar assets.	Parallel markets exist to judge fair value using observable inputs. Private transaction data of banks is an example that meets this definition.
Level 3	No active market and few observable external inputs.	Fair values are based on internal information and management assumptions and estimates.



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Q&A with Annie Goodwin—continued from page 1

of financial regulators for all federal and state chartered banks is a mistake. Different regulators bring different perspectives which enhance, not reduce, regulatory accountability. Throughout the market turmoil over the past 18 months, many local and regional banks have continued to lend to creditworthy individuals and businesses. This ongoing lending will drive economic development and recovery in Montana and throughout the country. Montana consumers and the banking industry will be best served by the coordination and cooperation between regulators, not the elimination of regulators through consolidation.

POSSIBILITIES: Are there any legislative recommendations you are considering?

Ms. Goodwin: The Montana Legislature convenes biannually. We have just completed the 2009 legislative session. Our Division assured the passage of legislation to implement the Secure and Fair Enforcement of Mortgage Licensing Act, known as SAFE. The law provides for all mortgage brokers and lenders to be licensed with the National Mortgage

Licensing System throughout the U.S. It requires prelicensing education, examination, continuing education and criminal and financial background checks of mortgage loan originators. The division was also successful in the passage of two bills strengthening the consumer protection provisions of the Deferred Deposit Loan and Title Loan Acts.

POSSIBILITIES: What advice would you give to community bankers today?

Ms. Goodwin: Stick to your conservative banking principles. Loans that are soundly underwritten to creditworthy individuals and businesses benefit the local community, as well as the bank and its stockholders. Our bankers have managed our banks with values that have allowed us to avoid many of the serious difficulties experienced by other banks in the nation. Our bankers are committed to these values and I am confident in our ability to navigate through these challenging times.

Q&A with Annie Goodwin—continued on page 8

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Q&A with Annie Goodwin—continued from page 7

POSSIBILITIES: What three regulatory issues are most common?

Ms. Goodwin: I'm not sure these are most common, but the following are current "hot topics."

1. Regulatory Restructuring – Various proposals are out for some type of consolidation of the federal banking regulators. We are against the creation of a single federal banking regulator. Different regulators bring different perspectives, enhancing—not reducing—regulatory accountability. The natural tendency of a single financial regulator would be to tailor its regulatory approach to its largest institutions and to devote the bulk of its regulatory resources to overseeing such institutions, disadvantaging smaller institutions, many of which are state-chartered.

2. Mortgage Regulation – The implementation of Montana's Residential Mortgage Brokers, Lenders and Loan Originators Act has been a priority in this

Division, to assure compliance with the SAFE Act, and nationwide licensing system for mortgage lenders/originators/brokers.

3. Recruitment and Retention of Quality Workforce – The recession is temporary, but the largest challenge faced by Montana's economy is a long-term shortage of workers as baby boomers retire. Starting in 2013, the working age population of 18-63 year olds will decline. Recruiting bank talent and management is going to be a challenge, yet the key to the success of an institution is strong management.

A special thank you to Annie Goodwin for taking time to talk with Possibilities. If you have a question for Annie, you may contact her at 406.841.2920 or angoodwin@mt.gov. ■