Transfer of Problem Assets to BHC

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Transfers of Assets from Bank to Parent Company

- Transfer at fair value, considering in particular:
  - rate of return
  - appropriate risk premium
- BHC exemption for this activity:
  - "Servicing" exemption – Section 4(c)(1)(C) of BHC Act and 225.22(b) of Regulation Y
  - if company intends to engage in lending:
    - FHCs – no prior approval needed
    - others – Section 4(c)(8) approval needed

Transfers of Assets from Bank to Parent Company

- Check with all bank and BHC regulators
- Comply with FRA Section 23B
  - at fair value
  - terms and conditions consistent with safe and sound banking practices
- Banks prohibited from buying back low-quality assets (FRA Section 23A)

Transfers of Assets from Bank to Parent Company-Accounting

- Make sure it is a “sale”
- Recognize any servicing asset necessary – FAS 166 (not yet codified)
- Measure “fair value” in accordance with FAS 157 (FASB ASC 820)
- No ALLL on “day 1”; create ALLL when appropriate

Transfers of Assets from Bank to Parent Company - OREO

- Valid current appraisal
- Holding period at parent level is 2 yrs from date bank acquired OREO plus potential for three 1-yr extensions (plus five 1-year extensions if certain criteria are met)
- If new subsidiary formed to hold assets, file an FR Y-10

Dividend in Kind – Bank to Parent

1st Bancorp

3/31 *Dividends Receivable* $5,000
Investment in Subs $5,000
(Dividend reduces bank capital)

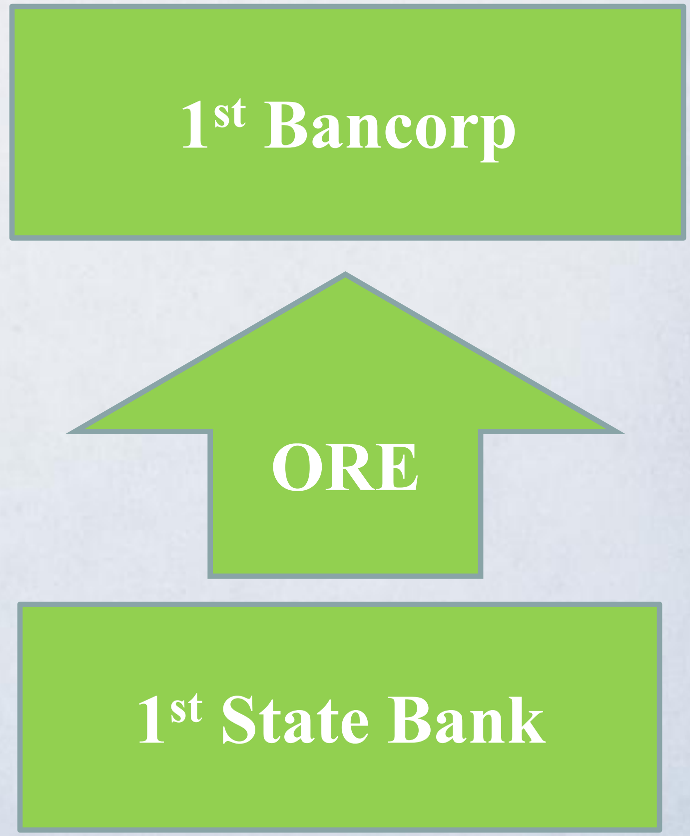
4/01 *ORE* $5,000
Dividends Receivable $5,000

1st State Bank

3/31 *Retained Earnings* $5,000

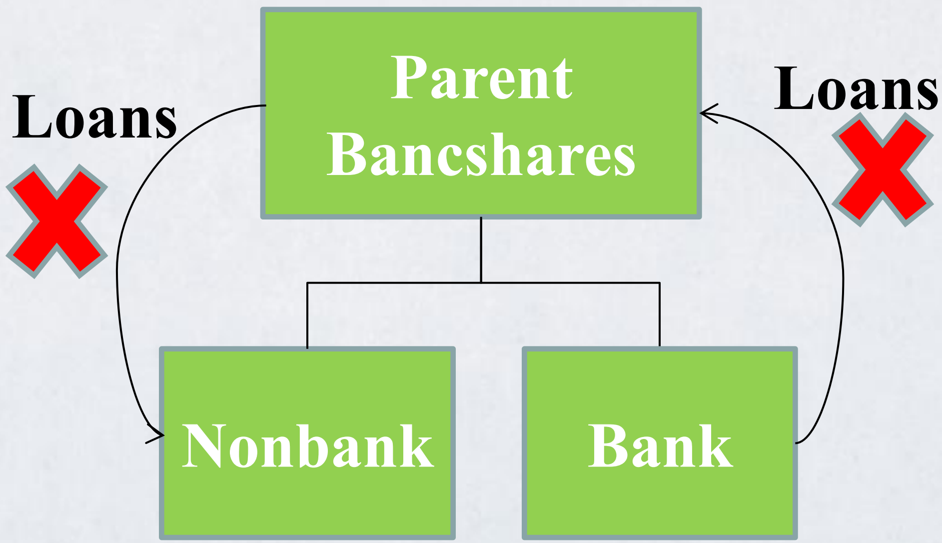
Dividends Payable $5,000
(Declare Dividend)

4/01 *Dividend Payable* $5,000
ORE $5,000



Dividend in Kind/Equity Injection

Loans transferred to the nonbank as a capital contribution.



Loans transferred to the parent as a dividend.

Gains and losses recognized at bank and transfer is at fair value.

The goal is to transfer bank loans to a nonbank subsidiary

* Bank pays a dividend-in-kind to the Parent
* Parent down streams the loans to the nonbank as a capital contribution

The bank's loss on the sale of loans is reflected on the Call Report but eliminated on a consolidated basis against the parent company's land account, returning it to historical cost.

Allowance for Loan and Lease Losses

(FASB ASC Section 310-10-35 and FASB ASC Subtopic 450-20)

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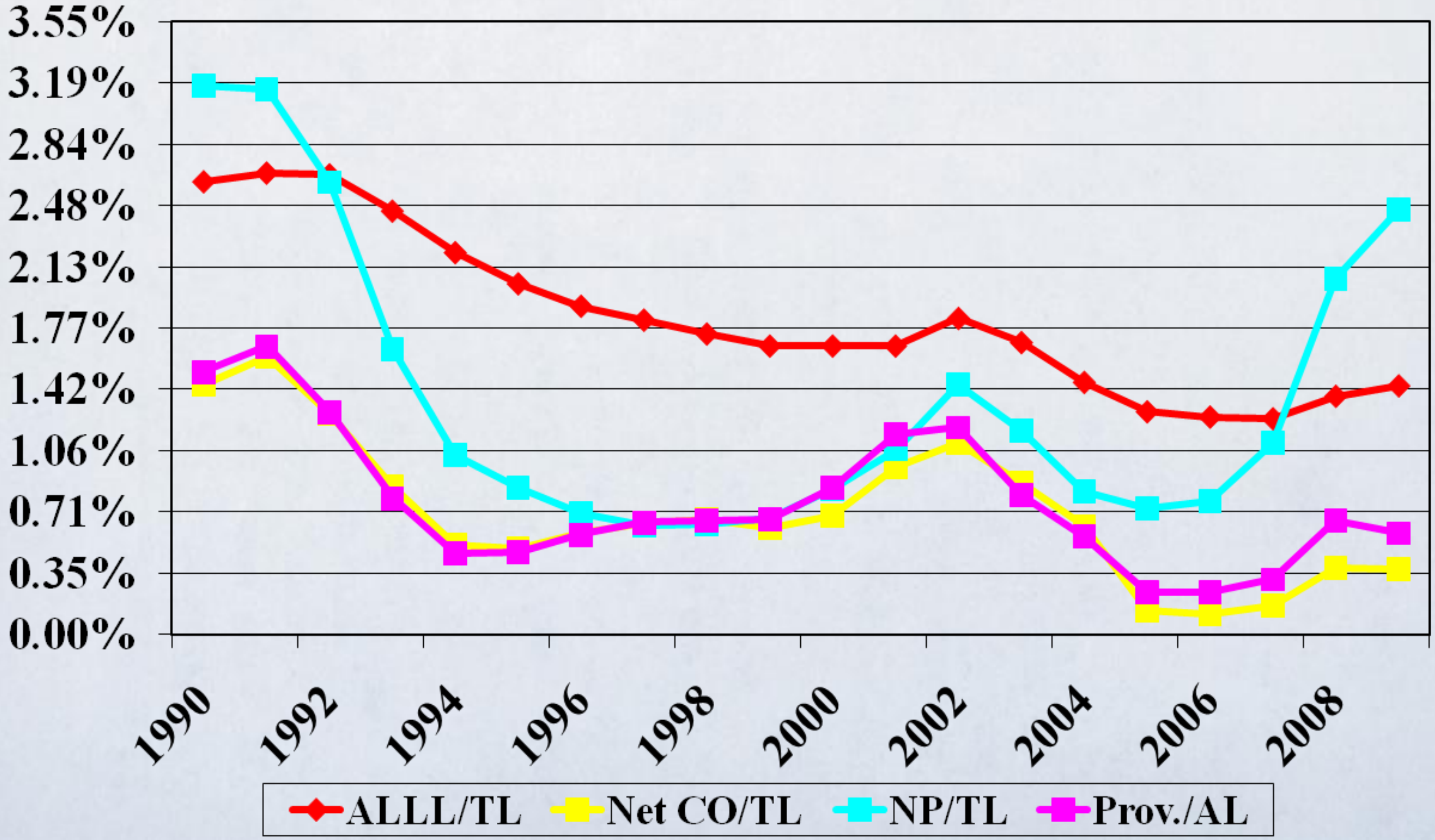
Credit Quality Down with Inconsistent Increases in Provisions



Allowance for Loan and Lease Losses

- National and District trends demonstrate an apparent lack of directional consistency
  - Coverage of noncurrent loans has declined to an average 66 percent nationwide; in District, only Nebraska banks have a coverage ratio > 1:1
  - Banks with losses are up dramatically, exceeding 20 percent in Colorado and Missouri
  - Colorado and Missouri – weak earnings and high construction and land development (CLD) concentrations
  - Kansas and Missouri – high levels of nonperforming CLD loans

Allowance for Loan and Lease Losses Common Issues

- Confusion of classified and impaired loans
- Measurement of no loss on impaired loans
- Lack of directional consistency of ALLL with loss indicators (taken as a whole)
- Distinguishing the portion of the impaired loan balance deemed **uncollectible**, i.e., the confirmed loss (normally the amount above appraised value), from the amount of the FAS 114 **impairment**

Allowance for Loan and Lease Losses Common Issues – (Cont'd)

- Removal of impaired loans from historical loss rate calculations
- Inadequate adjustments to historical loss rates to address environmental and qualitative factors
- Inadequate migration records
- Inadequate credit administration

Allowance for Loan and Lease Losses Other Thoughts

- Tenant concessions and cut-rate prices make vacancy rates a less reliable indicator
- Use of the high side of loss estimates may be appropriate during stressful periods
- Loss histories from similar economic periods probably should be incorporated

Allowance for Loan and Lease Losses Example

- Stalled RE development project
  - guarantors paying interest out of pocket
  - no assurances they can continue to do so
  - current collateral value < loan amount
  - project is on hold and no sales activity in 18 months

Allowance for Loan and Lease Losses – 1999 FASB Viewpoints Article

"Losses should not be recognized before it is probable that they have been incurred, even though it may be probable based on past experience that losses will be incurred in the future."

Allowance for Loan and Lease Losses

TODAY:

- New CFO Letter – August 2009

THE FUTURE:

- Expected Loss Model?
  - IASB seeking comment on a proposed "expected loss" impairment model
- Loans at fair value with no ALLL?