Banking in the Ninth

September 2012

Ninth District Highlights

Three cases of confronting "this time it will be different" in the Ninth District

Humans' ability to forget past errors is often a tremendous asset. The inventor who persisted through tens or even hundreds of failed experiments is a staple of news accounts and history books. Personally, I would have one child and not three, but for repression of sleep deprivation. Thinking "this time it will be different" can be a virtue.

But not always. And not in particular with regard to bets on asset prices investors are sure "have to" go up. Forgetting such past bets that did not pan out can be a very serious mistake, one that can crater the balance sheet of a firm, a household or a bank.

There are three cases in the Ninth District in which bankers and regulators face the potential—so far not realized—for "this time it will be different" thinking.

One case concerns agricultural land values. These values continue to rise in real levels. Price-to-rent ratios continue to exceed records only recently made.

The second concerns the oil boom in western North Dakota and eastern Montana, which could spread to other adjacent locales. Here, too, we hear reports of and see data describing rising housing values and unprecedented demand for investment in development, supported by anticipated high rates of economic growth. (I encourage all readers to visit the Minneapolis Fed's Bakken website for an excellent source of data on developments in that region.)

Finally, and admittedly of a different nature, bankers face the temptation to "bet" on interest rate risk. This time, some might think, funding longer-term securities with short-term money must pay off.

Fortunately, many bankers in the Ninth District have experience with or at least knowledge of agricultural land values that fell from record levels, oil boom investments

Ron Feldman

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SAFETY and SOUNDNESS UPDATE

Although part of the basic "blocking and tackling" of running a bank, internal controls frequently get overlooked during stressful times as management focuses on visible and critical problems. But such controls are critical for preventing the types of fraud at financial institutions that have gained local and national attention. We have seen several cases of fraud at smaller institutions that have had devastating effects on the institution and the community over the past few years. In light of such reminders and with banking conditions improving across the country and in the Ninth District, now is a good time to review internal controls to ensure that they continue to serve the bank well going forward.

Internal controls are the systems, policies, procedures and processes implemented by the board and senior management to safeguard bank assets, limit or control risks and achieve the bank's objectives. Effective internal controls may prevent or detect mistakes, potential fraud or noncompliance with bank policies. Banks should also maintain an effective internal or external audit program to help detect any deficiencies in the bank's internal controls.

In a small community bank, officers and staff have multiple jobs, making it challenging to effectively segregate duties. However, all banks should strive to establish and maintain

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a strong system of internal controls to minimize the potential for errors or internal fraud. When we review internal controls, we focus on the following factors based, in part, on what we and others have learned from fraud cases.

- Segregation of duties. This reduces the risk that employees will be able to carry out and conceal errors or fraud without detection. Segregation of duties typically focuses on three areas:
  * Custody of assets (e.g., cash, official checks).
  * Authorization or approval of transactions.
  * Recording or reporting of these transactions, which ensures that the same employee does not originate a transaction, process the transaction and reconcile the transaction to the general ledger.
- Dual controls and/or joint custody (e.g., wire transfers).
- Annual two-week vacations with no remote access to the bank's MIS.
- Internal review of employee accounts and expense reports.
- Reliance on one person for a key area or business line.

When banks cannot effectively segregate duties or establish dual controls, banks should implement compensating controls, such as having another person spot check entries and reports for accuracy. Audits should focus on areas where segregation is lacking. These controls can vary based upon bank resources, but they should provide an independent review of entries, transactions or reports. Additionally, management may consider periodically rotating duties to provide a fresh perspective.

Also, in many small community banks, management teams have been together for years and effectively run the bank, trusting that others on the team will do their jobs well. In rare cases, however, this trust can be abused. Such possibilities should prompt management to "trust, yet verify." Management teams are well served not only by establishing and maintaining a strong system of internal controls, but also by avoiding complacency.

No matter how strong the internal controls, determined individuals can perpetrate internal fraud. However, a strong system of internal controls and a "trust, yet verify" perspective minimizes the risk of internal fraud or errors.

Ninth District Highlights continued

that did not pan out and long-term securities that lost value as interest rates rose earlier than expected. As a result, we see in our exams and hear from bankers about the steps followed to take on risk but in a prudent fashion. I am thinking here of bankers who assume below-record land values when taking collateral or financing land acquisition or bankers who monitor and actively manage potential exposure to energy-related investments.

We fully support banks extending credit in the face of rising asset values; banks in agricultural areas or in the Bakken should make loans that depend on local activity. But doing so in a way that recalls the lessons from the past and does not assume a new world where prices always rise is perhaps the best antidote to the "this time it will be different" curse.

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APPLICATIONS FILING TIPS

The Federal Reserve recently announced a process to review submitted information prior to the filing of a formal application or notice. The optional "pre-filing" process, outlined in Supervisory Letter SR 12-12 (see http://www.federalreserve.gov/bankinforeg/srletters/sr1212.htm) allows Federal Reserve staff to provide feedback on potential issues relating to acquisitions or other proposals.

The pre-filing process provides an opportunity for an applicant to receive feedback on specific potential issues in a proposal and may enable an applicant to address such matters in a final filing. As such, we believe the pre-filing process would particularly benefit applicants whose proposals involve

complex ownership or capital structures, for example, those involving limited liability companies, limited partnerships or significant amounts of nonvoting or preferred stock. Such proposals can raise control issues as well as safety and soundness concerns. Pre-filing reviews will also be beneficial for addressing questions as to which individuals would be required to join a control group as part of the filing of a notice under the Change in Bank Control Act. Likewise, it would be useful for determining whether an entity such as a trust that proposes to acquire shares of a banking organization would be considered a "company" and potentially a bank holding company under relevant law.

Pre-filings involving Ninth District institutions should be submitted to the Applications section of the Federal Reserve Bank of Minneapolis. Depending on the nature of the inquiry and the issues raised, the length of the pre-filing review will vary. Submitters of pre-filings will be contacted upon completion of the review, but no later than 60 days after we receive the pre-filing.

We encourage applicants to review SR 12-12 for a complete description of the pre-filing process and the Federal Reserve's expectations. Questions pertaining to the pre-filing process can be directed to staff of the Applications section. Contact information is available at http://www.minneapolisfed.org/banking/apps/info/contacts.cfm.

Simplifying Reserves Administration

The Federal Reserve is in the process of simplifying the administration of reserve requirements. The Federal Reserve eliminated as-of adjustments and contractual clearing balances in early July of this year. At the end of January of next year, we will complete two other important changes. In this article, we will highlight the upcoming changes and respond to questions we have received or expect to receive regarding the changes.

1. Creating a common two-week maintenance period

Currently, some depository institutions (DIs) satisfy their reserve requirements on a one-week maintenance period, while others satisfy their requirements on a two-week maintenance period. This change will eliminate the one-week maintenance period and move all DIs to a two-week period beginning January 24, 2013. This change will not alter the reporting frequency or the method of reporting the FR 2900 report.

2. Creating a penalty-free band around reserve balance requirements in place of carryover and routine penalty waivers

Some DIs rely on the carryover provision to meet their reserve requirements. This will change going forward, and DIs should pay particular attention to the new structure. The carryover provision—which allows a small amount of a reserve deficiency or excess to be carried into the next maintenance period—will be eliminated and replaced with a penalty-free band that will give institutions similar flexibility. A penalty-free band is a range on both sides of a reserve balance requirement that is equal to the greater of $50,000 or 10 percent of an institution's reserve balance requirement. A DI that maintains balances above its reserve balance requirement, but within the penalty-free band, will be remunerated at the interest rate paid on balances maintained to satisfy reserve balance requirements. Balances maintained above the top of the penalty-free band will be remunerated at the interest rate paid on excess balances. The change to a band will allow the payment of interest to be accelerated.

Any delays in the January 24, 2013, implementation date will be announced no later than November 1, 2012. If you have any questions, please contact Jean Garrick at 612-204-5862.

CONSUMER AFFAIRS UPDATE

Financial institutions increasingly rely on third-party vendors to provide consumer compliance-related services. Such vendors can provide banks with valuable services. At the same time, community banks can face challenges and costs in effectively overseeing them. Weak oversight of third-party vendors exposes a bank to a number of risks, including legal, reputational and financial, if the provider fails to comply with legal and other requirements.

Based on weaknesses examiners find in vendor management oversight, we offer a few suggestions for how banks can improve their oversight of vendors and limit their compliance-related risks.

- **Assess vendor's effectiveness**. When checking a vendor's references, a bank should consider the following.
  - How does the vendor handle and respond to individual bank requests?
  - Does the vendor respond in a timely way to such requests?
  - Are there concerns about the quality of the vendor's products?
  - How effectively and timely does the vendor respond to systemic or other problems?
  - How are disputes or complaints handled?

  Ongoing monitoring of the vendor's effectiveness is also important. For example, does the vendor have any outstanding lawsuits or enforcement actions, particularly any that would raise concerns about treatment of consumers or other issues that could subject the bank to reputational and other risks? Also, bank employees can test a vendor's customer service practices by receiving customer mailings or calling customer service numbers.

- **Monitor regulatory changes**. A bank should monitor regulatory changes and ensure that any vendor-provided products comply with new requirements. Reviewing disclosures and testing systems after a regulatory change helps ensure that a vendor has incorporated the change appropriately. Banks are ultimately responsible for ensuring that vendors' practices comply with applicable regulations and laws and should adopt policies and procedures to ensure that desired outcomes occur. These communications include additional information on compliance vendor management.

  - *Consumer Compliance Outlook*, First Quarter 2011, http://www.philadelphiafed.org/bank-resources/ publications/consumer-compliance-outlook/2011/first-quarter/vendor-risk-management.cfm

  - Outlook Live Webinar, May 2, 2012, http://www.philadelphiafed.org/bank-resources/publications/consumer-compliance-outlook/outlook-live/2012/vendor-risk-management.cfm