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NINTH DISTRICT HIGHLIGHTS

Improved Risk-Focusing: A Federal Reserve Effort to Reduce Supervisory Burden

Ron Feldman

Bank supervisors try to ensure that banks receive the appropriate level of supervisory scrutiny by risk-focusing their exams. Lower-risk banks, all else equal, should receive less intense scrutiny. Improving risk-focusing is one way supervisors can reduce supervisory burden, which is a high-priority effort for the Federal Reserve. The Federal Reserve already risk-focuses its supervision. But we can improve. And the Federal Reserve is in the midst of a major national effort precisely to enhance our supervisory risk-focusing. We want to make sure that the riskiest banks face the most intense supervision, while safer, lower-risk banks face the least. I will explain the key features of one of our current efforts in the rest of this article.

Better Scoping, More Risk-Focused Exams

Getting the scope of an exam right is key to ensuring appropriate risk-focusing of Federal Reserve exams. As a result, the effort to better risk-focus Fed community bank exams has been geared toward targeting the scope of an exam to the risk profile of the bank. Our efforts target risk within each individual risk area, rather than at the bank overall. A bank could, for example, have low risk in the investment portfolio but have a high degree of earnings risk. In such a case, relatively more scrutiny should be provided to earnings than to investments.

A desired measure of interest rate risk, for example, would differentiate banks by the losses they would incur now and in the future, when interest rates move.

Improving Identification of Bank Risk Profiles

The first step in our effort is to improve the empirical support for determining if a bank's risk profile in each risk area is, roughly speaking, high, medium, or low. This analytical exercise is itself multistep. Staff have to identify a good measure of the riskiness for a given type of risk. For example, we have to find a good marker for a bank with high credit or interest rate risk that also identifies a bank with lower credit or interest rate risk. This process involves identifying several potential markers for risk and testing their accuracy using relevant historical data. We are seeking to identify

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STATISTICAL REPORTING UPDATE

Use of Regulatory Report Data in Banking Supervision

Banking organizations submit a lot of data to the Federal Reserve System and other bank regulatory agencies. It is costly to do so. But the benefits of doing so are large even if often unnoticed. This article outlines some of the ways the Federal Reserve uses the data bankers provide and the benefits of this activity, which might otherwise just seem burdensome.

Off-Site Data Review: We monitor the condition of Ninth District financial institutions during periods between on-site examinations or inspections. Reserve Bank staff use this outlier information to investigate the causes of unanticipated performance changes and help determine an appropriate supervisory response. This involves reviewing financial screens that identify institutions with elevated or changing risk profiles. For instance, we use quarterly Call Report and Y-9 data to derive ratios that identify banks or holding companies that report a negative year-to-date return on average assets or a high nonperforming loans to total loans ratio relative to other banks. We also look for changes in asset or liability mix.

We also run these data through models to derive other measures of bank and holding company condition. For example, we model the chance that a bank or holding company's

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Managing Change Effectively

Allison Burns, Examiner

Banks should have an effective change management process to ensure that they properly analyze and respond to the compliance implications of regulatory or product changes. Changes to evaluate may come from an external source, such as new compliance rules and regulations, or internally, such as a new product or service or changes to existing products or services. Recent examinations identified violations that occurred because of regulatory or product changes. An effective change management process can reduce the risk that such violations occur. In this update, we provide guidance on the elements of an effective change management process and discuss some examples from recent examinations related to new compliance rules and internal bank changes.

Compliance rules and bank processes and practices change frequently. An effective change management process detects new or amended rules and regulations, evaluates those rules, understands how the new requirements affect the bank's processes and makes modifications as appropriate. A similar process should apply to changes in bank processes and practices as well. The formality of the change management process will vary based on the size and needs of the institution, however. The table below identifies the primary elements of an effective change management process.

Examples of Why a Change Management Process Can Help

In this section, we provide a few examples where a change management process could have helped prevent violations.

Example 1: We identified a recent violation because a regulatory change triggered additional disclosure requirements. Specifically, recent Regulation B amendments now require lenders to provide a copy of the appraisal or written valuation to the borrower within a certain time frame.[1]

In addition, lenders that provide the appraisal or valuation by email must now also follow the requirements of the Electronic Signatures in Global and National Commerce Act (E-SIGN Act) because the appraisal is a required disclosure.[2]

In this example, an effective change management process would ensure that the compliance officer or another employee

- reviews the regulatory change,
- identifies changes in the way the bank provides appraisals (including electronically),
- determines the impact on any other regulatory requirements,
- updates all applicable procedures, and
- provides training to the lending staff on the change.

In addition, conducting an audit or internal review a few months after implementing the change could help identify any need to enhance training or procedures further.

Example 2: We see situations where a bank's business decision has unintended compliance implications. Adding or changing a loan fee could lead to an examination finding or restitution if the loan disclosures do not treat the fee properly as a finance charge.[3] Fees that meet the definition of a finance charge under Regulation Z have specific disclosure requirements, depending on loan type.[4]

This is important for banks that offer consumer-purpose loans with fees, including home equity lines of credit (HELOC) where borrowers may finance loan fees through the first draw. Regulation Z requires banks to individually itemize and identify finance charges on the first HELOC periodic statement in such cases.[5]

In this example, an effective change management program would ensure that a knowledgeable staff member, most likely the bank's compliance officer, reviews any fee changes to determine if they meet the definition of a finance charge. The compliance officer or management would then ensure that appropriate bank staff updates parameters in the loan-processing and disclosure software systems to reflect this fee change. Someone would also review the disclosures to ensure that the system accurately reflects the change. A similar process should be followed for other types of changes as well.

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1 1002.14(a)(1)
2 1002.14(a)(5)
3 Joint Policy Statement on Administrative Enforcement of the Truth in Lending Act Effective July 21, 1980; revised September 8, 1998.
4 Section 1026.4(a) defines the term finance charge and 1026.4(b) provides examples.
5 See the commentary to 1026.7(a)(6)(i).

Change Management Process Elements

Element	Actions
Identify changes	• Identify regulatory changes and business process changes through risk-monitoring practices
Create action items	• Research the change • Evaluate the impact to the bank's policies and procedures, software, vendors and internal controls • Update processes and procedures where needed • Assign training to staff
Establish responsible parties	• Assign responsibility for action items to staff members • Appoint someone to monitor the entire change process from start to finish
Track due dates	• Report progress to senior management and the board of directors
Evaluate effectiveness of changes post-implementation	• Verify that implementation of changes was effective using internal and external audits or more targeted reviews
Establish a repeatable process	• Use a similar process for future changes

those markers that are able to predict future risk, in addition to identifying those banks currently facing elevated risk. A desired measure of interest rate risk, for example, would differentiate banks by the losses they would incur now and in the future, when interest rates move. Choosing any particular measure of risk involves trade-offs, of course. Ideally, one would find a metric that minimizes the number of false negatives (banks that really are risky but are not identified) and false positives (banks that are not risky but which are identified as risky). But no measure is perfect. The key is picking a measure of risk that sorts banks into high, medium, and low groups of risk better than our current practice. And we are meeting that objective; we have identified ways of improving the Fed's ability to identify which banks pose the most risk and which do not.

Linking Scope Intensity to Risk Profile

Simply identifying banks' risk profile will not change the supervisory experience of banks if the follow-up exam work does not differ between banks. We ensure that this outcome occurs by preparing a different scope of exams for a given risk that depends on the risk that bank poses. A bank that our measures show poses a high level of risk in a particular risk area will face a more comprehensive exam scope in that area than a bank that poses a low level of risk. There is field testing of the new scopes before they go into production to make sure that we have gauged their likely effect correctly. The final step is to move the new scopes into the automated systems that examiners use to support their work. This system ensures that the riskiness of the bank is accurately assessed and that the proper initial draft scope is selected.

To be clear, Federal Reserve scoping of exams includes both empirical and qualitative factors. Exam staff must have discretion to incorporate factors that are not captured by the empirical measure of risk, to make the scope more intensive or less intensive. We will monitor the implementation of the new scopes to determine if and how they could be modified going forward. We have created a continuous process by which to risk-focus exams.

Status of Improved Risk-Focusing Efforts

The first step I described of identifying key metrics of risk has been nearly completed for almost all the key risks that an exam would review, such as interest rate and liquidity risk. New scopes have been completed for a smaller number of the risks, and only interest rate risk has gone through the complete process. We anticipate completing the full process for risks like credit and earnings over the next several months.

By the end of the process, we think the Federal Reserve will have completed a major effort to further risk-focus our exams. Perhaps more importantly, we will have established a program to continually ensure that we target our supervisory resources to the highest-risk banks while reducing the burden on the least risky.

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rating would deteriorate if an examination or inspection had occurred as of the most recent quarter-end period. This model also estimates the probability that a bank may become critically undercapitalized (fail) within the next two years. A distinct model evaluates the potential interest rate risk exposure of a bank, based on Call Report data and standardized assumptions.

This off-site analysis allows a more effective response to bank and holding company risk-taking, and also allows lower-risk organizations to receive an appropriately light touch between exams. Supervisory staff also use models to identify changes in financial condition between examinations and determine whether an accelerated supervisory response is needed.

Discount Window Lending: The Reserve Bank serves as a lender to Ninth District banking organizations in support of financial and economic stability. Reserve Bank condition monitoring staff review bank capital and other related reports and financial models derived from Call Report information to determine credit eligibility, including eligibility for the seasonal lending program.

Compliance with Supervisory Enforcement Actions: The regulatory reports submitted by banking organizations also assist Reserve Bank staff in assessing compliance with certain provisions of supervisory enforcement actions, such as a cease and desist order or a memorandum of understanding. For instance, we monitor a provision requiring certain minimum capital ratios for a bank by reviewing capital ratios on the Uniform Bank Performance Report (UBPR), which is derived from Call Report information.

Compliance with Banking Laws and Regulations: We also use financial reports to identify potential violations of certain banking laws and regulations. One example is the monitoring of transactions among affiliated entities. Holding companies are required to file the Bank Holding Company Report of Insured Depository Institutions' Section 23A Transactions with Affiliates—FR Y-8 on a quarterly basis. A review of this report can reveal potential violations of the quantitative limitations on covered transactions by a bank with its affiliates for supervisory follow-up.

Aggregate Banking Condition and Trends Analysis: In addition to off-site monitoring of individual financial institutions, Reserve Bank staff use data provided by banking organizations to assess overall condition and trends. For instance, during the first three quarters of 2015, this financial data showed improvement in earnings and a continued decline in the level of problem loans at Ninth District banking organizations. Further details regarding overall performance of these banks is available on the Minneapolis Fed's public website at **minneapolisfed.org/banking/community-banking-research/banking-conditions.**

Efforts to Reduce Reporting Burden: The Federal Financial Institutions Examination Council announced an initiative to streamline the reporting burden on community banks on September 8, 2015. An ongoing part of this effort requires agency users of data reported on the Reports of Condition and Income to identify the need for and frequency for each line item on these reports. This initiative began in July 2015 and is ongoing. While there may certainly be room to improve our collection of data and reports, organizations should know that we put the data they provide to good use.

The District's Increasing BSA/AML Risk Environment

Shelley Vangen, BSA/AML Risk Coordinator

The District's Bank Secrecy Act and Anti-Money Laundering (BSA/AML) risks are increasing, which requires banks to properly mitigate these risks in order to comply with BSA/AML regulations. All community banks face some degree of inherent BSA/AML risk, which falls into three main categories: (1) products and services, (2) customers and entities, and (3) geographic location. Effective BSA/AML compliance programs incorporate appropriate controls to mitigate these risks through comprehensive analyses of these categories. The results are then detailed within the BSA/AML risk assessment in order to arrive at an accurate BSA/AML risk profile. A BSA/AML risk profile that is reflective of the bank's BSA/AML risks and controls allows management to identify and mitigate control gaps and apply appropriate risk management processes to comply with regulatory requirements.

Banks in the Ninth District are exposed to specific risk factors, including the state legalization of marijuana in conflict with federal law[1] and the potential development of marijuana businesses on tribal lands. We have also identified BSA/AML compliance programs that have not kept pace with evolving BSA/AML risks. This article helps bankers understand and address these risks.

Marijuana Risk

The money laundering risk posed by certain states' legalization of marijuana has increased in the District. Currently, three District states have legalized some marijuana-related activity. More states could also take this step given national trends. The legalization of marijuana at the state level presents particular BSA/AML risks. The cash-intensive nature of the business increases the opportunity for fraud and criminal activity, and the conflict between state and federal law creates legal ambiguity.[2]

If a bank decides to provide services to marijuana-related businesses, bank management must also stay alert to changes in state and federal marijuana laws. For example, in December 2014, the Department of Justice issued a memorandum[3] allowing tribal nations to grow and sell marijuana. Press reports suggested potential interest in the Ninth District for the development of tribal marijuana businesses. Since tribal marijuana is so new to the banking industry, and specific guidance limited, bank management might consider the BSA/AML risks and challenges presented by providing services to tribal marijuana businesses before customers ask for such services. If banks decide to provide banking services to tribal marijuana businesses, they would be required to conduct comprehensive risk analyses, adjust their risk profiles, and implement appropriate policies, procedures and controls in order to address the specific risks posed by tribal marijuana businesses. Furthermore, bank management that decides to provide such services should comply with the Financial Crimes Enforcement Network's guidance[4] regarding marijuana-related businesses.

BSA/AML Compliance Program Risk

Not all bank BSA/AML programs kept pace with the greater risks that certain activities pose to violating BSA/AML rules. Examination findings have identified programs that have remained unchanged, in spite of

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the banks' growth, expansion and shifting risk profiles. The result is stagnant programs that fail to comply with the required elements[5] of an effective BSA/AML compliance program. Banks can avoid the potential fallout from BSA/AML compliance program failures that may result. The bank's board and senior management must begin by emphasizing the significance of BSA/AML compliance. The appointment of a knowledgeable BSA officer who possesses sufficient authority and resources to provide effective program oversight is a critical step in creating the appropriate compliance culture. Ongoing training also reinforces the importance of BSA/AML compliance. We have seen cases where banks do not adequately fund their BSA/AML programs. This management decision can lead to an ineffective program and exam findings.

Risk assessments should be reviewed on an ongoing basis, by comparing the assessment with the bank's current products, service offerings and customer mix to ensure that the risk assessment is comprehensive and to identify areas that currently pose risks to the institution. Integral to this process is a strong customer due diligence program in which customer information is collected on an ongoing basis to maintain current information on activity and associated risks.

Conclusion

While core BSA/AML program elements have remained the same, banking products and services have become more complex and electronic in nature, making an accurate risk assessment more challenging and crucial. Effective BSA/AML compliance programs supported by the banks' board of directors, senior management and knowledgeable BSA officers, as well as ongoing training and risk assessments, will assist banks in complying with regulatory requirements.

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[1] Controlled Substances Act, 21 U.S.C. § 801, et seq.

[2] For a more expansive discussion of banking marijuana-related businesses, reference "BSA Expectations for Marijuana-Related Businesses," Banking in the Ninth, June 2015, available at minneapolisfed.org/publications/banking-in-the-ninth/bsa-expectations-for-marijuana-related-businesses.

[3] Memorandum from Monty Wilkinson, Director, Policy Statement Regarding Marijuana Issues in Indian County (Oct. 28, 2014).

[4] See .fincen.gov/statutes_regs/guidance/pdf/FIN-2014-G001.pdf

[5] BSA/AML programs must include the following minimum requirements (also known as the four pillars): (1) a system of internal controls, (2) independent testing of BSA/AML compliance, (3) designation of an individual or individuals responsible for managing BSA compliance (BSA compliance officer), and (4) training for appropriate personnel.