

Banking

IN THE NINTH

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NINTH DISTRICT HIGHLIGHTS

Advantages of Partnering with States in Supervising Banks



Ron Feldman

A fortune cookie once provided me this insightful statement: “A committee of one gets things done.” I think we can all relate to the sentiments of this quote. Working with others can sometimes seem to slow down progress.

This view might suggest that the Federal Reserve and state partnership used to supervise state member banks could be problematic. The opposite is true. I believe partnering with the states improves supervision, a bottom line I elaborate on in the rest of this article.

I will highlight five advantages of partnering with the states in the supervision of state member banks, knowing full well that others could certainly add to this list.

A tool for better decision making

Many bad decisions can arise despite good intentions and what seem like reasonable assumptions and techniques. But it is sometimes hard to see past what has become normal and routine. In banking supervision, we may not see an activity as risky if it becomes commonplace, even if the activity could pose a real risk. Alternatively, we may see a problem where one does not exist because of what we have seen in the past. Working with the states is an important tool for avoiding these types of mistakes. The states bring a different set of eyes and perhaps a different take on the same set of facts. This diversity of views is critical for making good decisions over time.

Broad state financial service responsibilities

State supervisory agencies tend to have supervisory authority for a broader range of institutions than their federal counterparts, where responsibilities are divided across separate agencies. Thus, my state counterparts have insights gained from supervising different types of firms, such as credit unions, money transfer firms and pay day lenders. They can bring these insights into our supervision of banks and into policy-related discussions.

Strong regional knowledge

The Federal Reserve Bank of Minneapolis oversees state member banks and holding companies in six states. Of course, each state banking supervisor focuses on the entities in a single state. Many of these states—Montana comes to mind—are very large and have diverse regions. Nonetheless, this more-targeted geographic focus allows the state departments to develop a deep understanding of local conditions

SAFETY & SOUNDNESS UPDATE

Customer Due Diligence Requirements

Shelley Vangen, BSA/AML Risk Coordinator

On May 11, 2016, the Financial Crimes Enforcement Network (FinCEN) issued “Customer Due Diligence Requirements for Financial Institutions” (the CDD Rule).¹ The rule strengthens existing customer due diligence (CDD) requirements and requires banks to identify and verify the beneficial owners of legal entity customers. Essentially, CDD has become the fifth required element of an effective Bank Secrecy Act/Anti-Money Laundering (BSA/AML) compliance program. “BSA/AML programs must now include, at a minimum: (1) a system of internal controls; (2) independent testing; (3) designation of a compliance officer or individual(s) responsible for day-to-day compliance; (4) training for appropriate personnel; and (5) appropriate risk-based procedures for conducting ongoing CDD to understand the nature and purpose of customer relationships, ongoing monitoring to identify and report suspicious transactions, and, on a risk basis, to maintain and update customer information.”² While CDD requirements are not new, banks are now required to collect and verify identification documentation for beneficial owners of legal entity customers. In this article, we summarize key aspects of the CDD Rule to assist banks in their efforts to comply with the rule’s requirements.

Prior to the CDD Rule, banks were not required to know the identity of the beneficial owners that own or control their legal entity customers. This enabled criminals and others looking to hide ill-gotten proceeds to access the financial system anonymously. The beneficial ownership requirement is intended to address this weakness

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and provide information that will assist law enforcement in financial investigations, help prevent evasion of targeted financial sanctions, improve the ability of banks to assess risk, facilitate tax compliance and advance U.S. compliance with international standards and commitments.

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Since CDD remains an area where examination deficiencies are commonly identified, the issuance of the CDD Rule provides banks with an opportunity to review their current CDD programs and make any needed enhancements. The most significant change required by the CDD Rule is that banks must establish and maintain written procedures that are reasonably designed to identify and verify the beneficial owners of legal entity customers who open new accounts on or after May 11, 2018. The rule defines a legal entity customer as a corporation, limited liability company, other entity created by the filing of a public document with a secretary of state or similar office, a general partnership and any similar entity formed under the laws of a foreign jurisdiction that opens an account. The definition also includes limited partnerships, business trusts that are created by a filing with a state office and any other entity created in this manner. The definition does not include sole proprietorships, unincorporated associations or natural persons opening accounts on their own behalf.

FinCEN intends that the legal entity customer identify its ultimate beneficial owner(s) and not “nominees” or “straw men.” Bank management has questioned

the level of reliance the bank can place upon the beneficial ownership information provided by the legal entity customer. FinCEN is specific that it is the responsibility of the legal entity customer to identify its ultimate beneficial owners, and the bank may rely upon the information provided unless the bank has reason to question its accuracy. This information should be collected from the individual seeking to open a new account on behalf of the legal entity customer. This individual could, but would not necessarily, be a beneficial owner.

Bank management has asked if the bank needs to collect beneficial ownership information on all beneficial owners of a legal entity customer. Banks must collect and verify the beneficial ownership information of *each* person who meets the definition under the ownership prong and of *one* person under the control prong. The rule utilizes a two-pronged approach to defining a beneficial owner—an ownership prong and a control prong. Under the ownership prong, a beneficial owner is defined as each individual, if any, who, directly or indirectly, owns 25 percent or more of the equity interests of a legal entity customer. However, the rule recognizes that there may be instances when no single individual owns 25 percent or more of the equity interest of the legal entity; in such instances, the bank is still required to collect the required information for one individual who controls, manages or directs the legal entity customer. Under the control prong, a beneficial owner is defined as a single individual with significant responsibility to control, manage or direct a legal entity customer, including an executive officer or senior manager (e.g., a chief executive officer, chief financial officer, chief operating officer, managing member, general partner, president, vice president or treasurer) or any other individual who regularly performs similar functions. Under this definition, a legal entity will have a total of one to five beneficial owners (one person under the control prong and zero to four persons under the ownership prong).

Banks must develop procedures that contain the elements required for verifying the identity of customers that are individuals under applicable customer identification program (CIP) requirements,³ including Office of Foreign Assets Control (OFAC) sanction requirements. As with CIP for individual

customers, banks must collect the name, date of birth, address and Social Security number or other government identification number (passport number or other similar information in the case of foreign persons) for any individuals who own 25 percent or more of the equity interest of the legal entity (the ownership prong), and they must collect the same information for an individual with significant responsibility to control and/or manage the legal entity at the time a new account is opened (the control prong). Unlike CIP requirements, for the CDD Rule, the banks may use photocopies or other reproductions of the required documents.

FinCEN provides a Certification Form⁴ as an optional document that banks may use to document the required beneficial ownership information. Bank management has asked if the bank must use the Certification Form to document beneficial ownership information. Banks may choose to comply by using this sample Certification Form, or they may use a form created by the bank, or any other means that complies with the substantive requirements of this obligation.

For additional assistance, banks should refer to FinCEN’s frequently asked questions (FAQs) regarding the scope of the CDD requirements for financial institutions.⁵ While FinCEN provided banks with an additional year to comply with the requirements of the CDD Rule, we encourage bank management to begin implementing necessary changes to meet the requirements of the CDD Rule in order to be in full compliance by the May 11, 2018, applicability date.

Endnotes

¹ 31 C.F.R. Parts 1010, 1020, 1023, et seq. Customer Due Diligence Requirements for Financial Institutions; Final Rule.

² 31 C.F.R. Part 1020.210(b)(1-5).

³ See 31 C.F.R. 1020.220(a)(2), 31 C.F.R. 1023.220(a)(2), 31 C.F.R. 1024.220, and 31 C.F.R. 1026.220(a)(2) for applicable CIP requirements.

⁴ 31 C.F.R. Parts 1010, 1020, 1023, et seq. Appendix A.

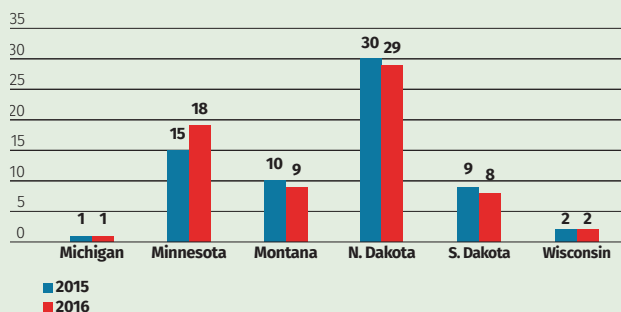
⁵ https://www.fincen.gov/sites/default/files/2016-09/FAQs_for_CDD_Final_Rule_%287.15.16%29.pdf

The Fed Can Help Meet Seasonal Credit Needs

The Seasonal Credit Program provides a reliable source of funding to small depository institutions that lack access to national money markets and experience seasonal fluctuations in deposits and loans. Under the program, depository institutions can obtain funds through the Discount Window during periods of seasonal need, allowing them to carry fewer liquid assets in the off-season and to make more funds available to meet the credit needs of their local communities. Credit can be obtained for periods of up to nine months in a calendar year, and there are no commitment fees or other expenses involved in setting up and maintaining a seasonal line of credit, even if it is never used.

The Ninth District is proud to be a leader in the Seasonal Credit Program, with the highest level of participation in the Federal Reserve program in 2015 and 2016. Sixty-seven Ninth District depository institutions were approved for the program in 2016, and so far this year 34 institutions have taken 249 loans totaling more than \$387,800,000. In 2015, the Ninth District had 67 depository institutions approved for the Seasonal Credit Program, with 34 institutions taking 455 loans totaling \$886,129,000 during the full year. The largest number of Seasonal Credit Program participants is in North Dakota, with Minnesota institutions coming in second in approved applications.

Approved seasonal credit applications



One of the benefits of the Seasonal Credit Program is an institution's ability to borrow funds for up to 30 days at a rate generally lower than the primary credit rate. An institution can use all or some of the allocated funds each month, or it may be able to request a change to its allocation to meet changing needs.

Do you need supplemental funding to complement your seasonal business?

The Seasonal Credit Program may be of interest to you if your institution experiences regular fluctuations in liquidity because of your customers' seasonal types of businesses, such as:

- Agriculture
- College
- Construction
- Municipal financing
- Tourism

Does your institution qualify?

If your institution holds less than \$500 million in deposits and can demonstrate a clear pattern of recurring seasonal swings in funding needs, then your institution may qualify for the Seasonal Credit Program.

Are you ready to get started?

The first step is to establish access to the Discount Window by completing the required Operating Circular 10 (OC-10) agreements found on the Discount Window website (www.frbdiscountwindow.org) if you haven't already done so. Contact one of our analysts if you have any questions about how to complete the agreements.

The next step is to read more about the program requirements and follow the directions to complete an application on the Discount Window website. Applications should be submitted at least three weeks prior to the requested seasonal line start date. Note that all loans must be fully secured and that adequate collateral must be pledged prior to initiating a loan request.

Do you need more information?

Our staff is ready to assist you. For additional information on this or any other credit program, contact the Discount Window team at the Federal Reserve Bank of Minneapolis, as follows:

Email: Mpls.Credit@mpls.frb.org

Mail:

Federal Reserve Bank of Minneapolis
Credit/PSR Section
P.O. Box 291
Minneapolis, MN 55480-0291

Phone: Toll free: (877) 837-8815

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and markets. This knowledge provides immense benefits to our partnership, by adding to our understanding of issues facing state member banks in the Ninth District.

Timely response

States can try new approaches or techniques at a speed and with a range of options that can sometimes elude federal agencies, particularly when the federal agencies have to come to agreement with a wide range of federal counterparts. The federal agencies can then learn from the range of state efforts.

State collaboration and the Conference of State Bank Supervisors (CSBS)

Our state partners participate actively in the work of the CSBS, an entity that brings together the state agencies to collaborate on supervision and the key policy issues facing supervisors and supervised firms. This collaboration not only provides us with the expertise of the states in the Ninth District, but also gives us the chance to learn from states across the country and from the CSBS organization itself.

Managing the Regulation E Error Resolution Process

Dan Schultz | Associate Examiner

Regulation E, which implements the Electronic Fund Transfers Act, provides protections for consumers when they engage in transactions known as electronic fund transfers (EFTs), which includes transfers through automated teller machines (ATMs), point-of-sale terminals and automated clearinghouse (ACH) systems. Regulation E outlines procedures that banks must follow when investigating and resolving EFT errors reported by consumers.¹ Institutions occasionally miss completing all steps when resolving errors subject to Regulation E.

Examiners find that bank staff members may struggle to comply with these requirements, particularly if the bank receives EFT error notices infrequently. Banks that comply with the regulation tend to have detailed procedures on how to handle EFT error investigations. They also tend to provide staff training and track compliance with procedures. The rest of this article describes some key compliance program elements that examiners find at banks that effectively manage this Regulation E-related risk.

Prepare detailed EFT investigation procedures

The procedures should address several areas.

1. What errors trigger the EFT error resolution process?

The procedures should help staff understand what types of errors fall within the procedures. In general, the bank must investigate several types of errors under Regulation E. Common EFT errors include:

- An unauthorized EFT transaction, such as an unauthorized withdrawal from an ATM account.
- An incorrect EFT to or from a consumer's account, such as an ACH withdrawal for an incorrect amount.
- A consumer's incorrect receipt of money from an ATM withdrawal.²

2. How should bank staff conduct these investigations?

Internal bank procedures should explain how the EFT error resolution investigation should work. Specifically, the procedures should outline the tasks bank staff members need to complete and when they need to complete them. Banks generally have an initial period of 10 days to investigate an EFT error; however, they can extend this to 45 days under certain conditions. Most importantly, the bank needs to provisionally credit the customer's account for the amount of the error (and make these funds fully available) to extend the investigation time frame. It must also provide the consumer with notice of the amount and date of the

credit, something that banks sometimes fail to do. Under limited circumstances, the bank can extend the investigation to 90 days.³

3. What should bank staff do upon completing the investigation?

Internal bank procedures should also describe what processes bank staff should follow upon completing an investigation to ensure compliance with Regulation E requirements. Examiners occasionally see banks miss some aspects of this post-investigation process. It is important that procedures distinguish between how to respond if confirming an error and determining that no error occurred. Different notice and timing rules apply to these findings. For example, the bank must correct the error within one business day after confirming that an error occurred and inform the consumer (either orally or in writing) within three business days of the completed investigation that the bank has corrected the error and, if applicable, made the provisional credit final.⁴ Examiners see situations where banks will complete some of these tasks, such as making the provisional credit final, but not notify the customer that this occurred.

If an error has not occurred, the bank must explain its findings in writing within three business days after concluding its investigation. Upon debiting the provisional credit, the bank must notify the consumer of the date and amount of the debit. Banks occasionally miss this notice requirement as well.⁵

Confirm internal practices and monitor vendors

As discussed, bank staff may miss certain error resolution steps or not complete the steps in a timely way. Developing a process for tracking the completion of the error resolution timing and notification requirements can serve as an effective control for ensuring that bank staff complete all steps in the error resolution process as required.

In addition, some banks rely on third-party vendors to investigate errors and streamline the error resolution process. Such vendors can provide valuable support for the bank as long as the bank confirms that the vendor's error resolution practices comply with Regulation E. Bank staff should monitor these investigations to ensure compliance with applicable timing requirements.

Provide staff training

Another key aspect to having strong error resolution practices is ensuring that bank staff receive training on Regulation E requirements. Training should cover regulatory requirements and help familiarize staff with the bank's internal Regulation E error resolution procedures.

Endnotes

¹ Section 1005.11

² Section 1005.11(a)(1)

³ Section 1005.11(c)

⁴ Section 1005.11(c)

⁵ Section 1005.11(c) and (d)

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