Banking IN THE NINTH

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NINTH DISTRICT HIGHLIGHTS

Independent Reviews


Ron Feldman

I have used this column over the years to discuss the concerns that bankers express to me. The list of concerns is long, and I understand why. Regulatory and supervisory intensity has gone up—in some cases substantially—since the financial crisis. At the same time, the long-standing trends that have driven down the number of community banks show no sign of abating.

In this column I will focus on a relatively narrow but I think important comment I hear from many bankers concerning requirements for independent reviews. Often bankers express this point as "having a checker to check the checker." This comes up, for example, in the context of interest rate risk modeling. Perhaps true to my role as a bank supervisor, I see the merits to the concern expressed while also finding value in the role that an independent check can provide. The recent confusion at the Oscars may make this point even more strongly than anything else I can offer in this article, but I will elaborate nonetheless.

The value of a second set of eyes

One of my responsibilities at the Federal Reserve is to oversee the independent validation of the empirical models used in the capital stress tests for the largest banks. Such validation is standard, and we hold our model validation program to the same requirements we set for the validation done by commercial banks. That validation experience routinely reminds me about the value of having an independent check on the information that management will use in making key decisions. An outsider can often see a conceptual or implementation error that someone working on a matter cannot. We simply get too close to our own work. I would be making a huge mistake if the first version of my column for *Banking in the Ninth* went out as the final version!

I do not think the idea of having formal checks on important work is controversial among bankers. However, it is fair to ask how many reviews are too many. A risk-focused approach seems the only way to answer this question.

Risk-focused reviews

Independent review (and frankly any other review) can improve the output we produce. But ensuring the highest level of quality has a cost and is not justified in every case. So, clearly not all work needs a second review. This logic means that the most extensive reviews, which could involve a review at the business line, an independent review, and an audit of the process, need to be focused on the most important policies and processes, particularly those involving higher-risk issues. The stress test is at the center of the Federal Reserve's supervision of large banks. It deserves, therefore, our highest level of internal review.

But that standard cannot and should not be the norm; not all

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CONSUMER AFFAIRS UPDATE

Mastering the Challenges of Flood Insurance Compliance Management

Molly Majerle, Supervisory Examiner

Some banks have faced challenges complying with flood insurance-related rules. In 2016, the federal regulatory agencies assessed $85,785 in civil money penalties (CMP) for violations of the flood insurance rules at three financial institutions in the Ninth District. In addition, examiners continue to see flood insurance-related violations during state member bank (SMB) examinations. However, banks can overcome these challenges by establishing consistent procedures and internal controls to manage the process. This article will discuss the strong practices examiners see in effective flood insurance compliance management programs at our SMBs, including at smaller banks that have been able to make these operational improvements with minimal cost.

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Some important challenges

- The flood insurance rules cover a number of business lines at a bank, such as residential real estate loans, commercial loans, agricultural loans and home equity lines of credit. Regulation H, which implements the Federal Reserve System's flood insurance rules, requires banks to complete a standard flood hazard determination form for all loans secured by improved real property. The loans secured by properties in special flood hazard areas have additional requirements; the bank must provide the borrower with a flood insurance availability notice, and the borrower must obtain the appropriate amount of flood insurance coverage prior to closing the loan.[1]
- Compliance with flood insurance requirements covers the life cycle of a loan, from application to origination to servicing. As discussed, banks must comply with several requirements when originating loans secured by improved real property. Banks must also ensure that the borrower maintains an adequate amount of flood insurance during the loan's term. This requirement includes force-placing insurance if the insurance lapses or coverage falls short and the borrower does not obtain adequate insurance after receiving notice of the insurance lapse or shortfall. Some of the force-placement requirements changed with the enactment of the Biggert-Waters Flood Insurance Reform Act of 2012 (BWA).[2,3]
- Assessing the adequacy of insurance coverage levels is complicated. The flood insurance rules describe what constitutes adequate insurance coverage, but determining the appropriate amount of insurance is challenging, particularly for more complicated loans.[4]
- New rules have added to the complexity of understanding regulatory requirements. For example, the BWA added certain escrow requirements for lenders servicing residential real estate loans. Exceptions apply to small lenders that meet certain requirements (see endnote 3).

Overcoming challenges

Financial institutions that effectively manage flood insurance compliance risks use some or all of the following internal controls:

- Consolidate expertise and oversight when and where applicable.
  - A centralized procedure or process for all business lines can help decrease the risk of noncompliance related to having a number of lenders and/or loan processors with flood-related responsibilities. For small banks, having another loan officer or loan processor review the loan checklist is an effective control. In addition, a uniform procedure or centralized process helps ensure that borrowers receive the flood insurance notice with sufficient time to purchase flood insurance before the loan closing. This process also helps minimize the risk that loans could close without adequate flood insurance in place.
- Conduct second reviews of loans with flood insurance before origination.
  - Establishing a second review of loans before origination will ensure that lenders do not close loans with insufficient flood insurance coverage and that borrowers have acknowledged receiving the flood insurance notice. As noted, completing a document processing checklist prior to loan closing is one way to conduct second reviews.
- Clearly articulate to staff that covered loans cannot close without sufficient flood insurance coverage.
  - Some institutions have made this a performance-related job objective.
- Provide tools that help staff members calculate sufficient flood insurance coverage amounts, especially for more complex transactions such as loans with multiple structures and condominium loans. Several compliance websites have flood insurance coverage worksheets and worksheets for calculating coverage for condominiums.
- Establish escrow accounts when needed for serviced loans according to the new rules adopted in January 2016
- Track covered loans and adopt a centralized tickler system for ongoing monitoring of insurance coverage.
  - Centralizing a tickler system for monitoring the expiration of flood insurance policies helps ensure that borrowers maintain adequate insurance coverage during the loan's term.
- Ensure timely responses, including force-placement when required, if flood insurance lapses.

Overall, establishing clear policies and procedures as well as strong internal controls helps minimize the likelihood of noncompliance with the flood insurance requirements of Regulation H. Financial institutions should also consider providing periodic training to all lending staff on the flood insurance requirements. As discussed, violations of the flood insurance provisions of Regulation H can be costly.[5]

Compliance resources

Several agency resources provide guidance on complying with flood insurance regulations, including the following:

- The 2011 Interagency Questions and Answers: https://www.federalreserve.gov/newsevents/press/bcreg/20111014a.htm
- Consumer Compliance Outlook Newsletter Articles
  - Flood Insurance Compliance Issue: https://consumercomplianceoutlook.org/2015/third-fourth-quarter/note-from-editors
  - Interagency Flood Insurance Regulation Update Webinar Questions and Answers: https://consumercomplianceoutlook.org/2016/first-issue/interagency-flood-insurance-regulation-update-webinar-questions-answers/
- Consumer Compliance Outlook Live Webinar
  - October 2015 Interagency Flood Insurance Regulation Update: https://consumercomplianceoutlook.org/outlook-live/2015/interagency-flood-insurance-regulation-update/

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[1] Regulation H, sections 208.25 (f) and 208.25(i).
[2] Regulation H, section 208.25(g).
[3] "Agencies Issue Flood Insurance Rule," June 22, 2015, available at www.federalreserve.gov/newsevents/press/bcreg/20150622a.htm.
[4] *Consumer Compliance Outlook Newsletter*, Third/Fourth Quarter 2015, pp. 7-8.
[5] The maximum civil money penalty for flood insurance violations is $2,000 per violation, with no statutory cap.

Primary Credit from the Discount Window

Melissa Norwood and Stefanie Aschenbrenner, Financial Analysts

Primary Credit is a key lending program of the Federal Reserve Banks' discount window. Primary Credit is a convenient source of contingency funding for eligible depository institutions, and extensions to institutions support the orderly operation and liquidity behind domestic financial and payments markets. Nevertheless, we are aware that some institutions are reluctant to borrow from the discount window because of a perceived stigma that can be associated with previous Federal Reserve Bank lending. Specifically, some associate an institution's discount window usage with a troubled financial condition or poor financial performance. While potentially true of historic and/or other Fed credit programs, in the current case of Primary Credit, the exact opposite is true. The eligibility and use characteristics of the Primary Credit program are designed and administered in ways that are intended to specifically counteract this stigma. This article briefly summarizes the Primary Credit program and provides information for institutions to consider on the benefits of using Primary Credit.

The Federal Reserve System established the Primary Credit program in 2003, largely to provide a funding alternative with minimum administrative burden for financially healthy and adequately capitalized depository institutions. Institutions in unsatisfactory financial condition or with less than adequate capital are not eligible for Primary Credit. This fact alone helps dispense any negative financial condition or performance stigma associated with borrowing under the Fed's Primary Credit program. Primary Credit extensions are intended as a source of immediate contingency funding for an institution's unexpected needs. The terms of Primary Credit include the following:

- The interest rate is set slightly above the federal funds rate.
- Credit is typically extended overnight.
- No administrative or additional fees are charged for establishing or using borrowing capacity.
- Sufficient collateral must be pledged.
- Generally, no explanation or justification is required to obtain Primary Credit.

For financially healthy and adequately capitalized depository institutions, Primary Credit can be a key component of an institution's liquidity or funding risk management program. Banking supervisors generally encourage banks to consider the Fed's Primary Credit program as one source of contingency funding appropriate under a risk management program. The Federal Reserve Bank of Minneapolis has noted gradual increases in usage of Primary Credit among Ninth District institutions over the past several calendar quarters without any adverse effect. Increased usage is largely attributable to more institutions operationally testing their processes for borrowing Primary Credit and to gradually declining or normalizing reserve account balances. These trends are expected to continue. Indeed, in an environment where reserves are scarcer than current levels, the Federal Reserve has encouraged depositories to borrow from the discount window and lend to other depositories in cases where short-term funding rates spike. Such lending helps "arbitrage" away temporary movements in short-term funding markets, typically driving down rates to the rate targeted by the Federal Reserve.

For financially healthy and adequately capitalized depository institutions, Primary Credit can be a key component of an institution's liquidity or funding risk management program.

As mentioned, it is important to consider that only financially healthy institutions are eligible for Primary Credit extensions and that actual extensions carry a low administrative burden to the borrowing institution. While there are duration limitations on the use of Primary Credit and actual use is subject to public disclosure after a two-year lag, an increasing understanding of eligibility requirements and intended uses has alleviated and will continue to alleviate misconceptions involving depository institutions' use of the program.

The Federal Reserve's discount window serves many purposes for depository institutions and contributes to economic and market stability. Ninth District institutions are encouraged to find out more about the Primary Credit program and to potentially consider it as a component of their institution's risk management tool set. For more information, including how to establish and test Primary Credit discount window access, visit https://www.frbdiscountwindow.org/ or contact discount window staff directly at (877) 837-8815.

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reviews require the three levels of defense noted above. Sometimes it is more than sufficient to have someone at the bank who is generally removed from the task at hand provide the second set of eyes. I know that many of the smaller banks in the District simply are not staffed to allow any other approach. And that is typically fine for these generally less complex and lower-risk banks.

Now there are going to be cases where some level of review is mandated by either law or by regulation. Banks may not always view those reviews as having high value, but they must be done. The question in these cases is what constitutes an effective level of review. We welcome working with banks and holding companies so that they do not do more than necessary.

Measure twice, cut once

In sum, there is often good reason to measure a few times before one cuts. Measuring twice or even three times is justified if an uneven cut would be very costly. But sometimes the returns on measuring twice or even once do not justify the cost, and supervisors should be open to that view.

Bank Secrecy Act Training Requirements

Shelley Vangen, BSA/AML Risk Coordinator

Training is a core requirement of a satisfactory Bank Secrecy Act and Anti-Money Laundering (BSA/AML) compliance program.[1] At a minimum, a BSA/AML training program must provide training for all personnel whose duties require knowledge of the BSA. While BSA/AML training is required, banks have flexibility in the way they design the training program. Effective training programs provide employees with a clear understanding how BSA/AML and OFAC[2] regulations affect their specific jobs.

While the regulatory requirement for providing BSA/AML training is clear, examiners often receive questions about how to adjust training programs to address employees' job responsibilities. This article is intended to provide general guidelines for developing BSA/AML and OFAC training programs that address employees' specific job responsibilities.

Staff training

Many community banks provide training programs that cover all BSA/AML and OFAC-related regulations and topics. In this type of training, employees in various positions receive the same training even though their BSA/AML and OFAC responsibilities are generally different. The training would include an overview of the primary BSA/AML and OFAC regulations and the bank's corresponding policies, procedures and processes. This approach is particularly useful for banks where staff is limited and employees may have several job functions, requiring each employee to have a broad-based understanding of BSA/AML and OFAC-related requirements. For instance, an employee in an operation role would receive basic BSA/AML and OFAC training sufficient for the employee to understand the applicable requirements for a teller position. This methodology provides greater flexibility in staffing and gives bank management the assurance that staff receives training on all BSA/AML and OFAC fundamental requirements.

A general training approach is acceptable, and in many cases preferred, by management at smaller banks. However, management at larger banks may find it more efficient to provide training programs that address BSA/AML and OFAC-related responsibilities by job category. If all employees within a job category have the same or very similar BSA/AML and OFAC responsibilities, bank management may choose to provide training that addresses the specific BSA/AML and OFAC-related responsibilities of individuals in each job category. Examiners are often asked how to structure training to address employees' specific job responsibilities. Here are some training topic suggestions for common bank positions. We hope you find them helpful!

Frontline staff and tellers:
Depending on the duties of frontline staff, training typically includes requirements for OFAC (if applicable), Currency Transaction Reports (CTR), monetary instruments, identifying suspicious activity and Suspicious Activity Reports (SAR). If frontline staff open accounts and perform account maintenance, they are also trained on the customer identification program (CIP) and customer due diligence (CDD) requirements, including examples of suspicious activity.

Lenders:
Training often includes requirements for OFAC (if applicable), CIP, CDD, CTRs, SARs and identifying suspicious activity related to lending.

Operations staff:
Training usually includes requirements for OFAC (if applicable), wire transfers, automated clearinghouse (ACH), debit/credit transactions, international transactions, SAR requirements and identifying suspicious activity related to various financial products and services provided by the bank.

New staff:
New employees typically receive an overview of BSA/AML requirements during employee orientation. Employees who have positions that require them to perform BSA/AML and/or OFAC duties also receive thorough training related to these duties prior to starting in the position.

BSA officer:
The BSA officer is expected to be fully knowledgeable about the BSA and all related regulations. Training is ongoing and may include BSA/AML-related conferences, seminars, webinars or training associated with acquiring BSA-related designations. Due to the heightened knowledge and expertise required for BSA officers, their training requires resources beyond reading periodicals and online articles and/or completing general staff training.

Board of directors:
In order to provide oversight to the organization, directors need a basic understanding of BSA/AML and OFAC, including the importance of the regulatory requirements, the ramifications of noncompliance and the risks posed to the bank. The board should be informed about changes and new developments in the BSA, its implementing regulations and directives, and the federal banking agencies' regulations.

Conclusion

Regardless of how BSA/AML and OFAC training programs are designed, it is important to ensure that staff training is ongoing, is documented and incorporates current developments and changes to BSA/AML-related regulations.
The training program should ensure that all employees understand their role in maintaining effective BSA/AML and OFAC compliance programs.

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[1] 31 USC 5318(h)(1)(c) and 31 C.F.R.1020.210 (b)(4).
[2] FFIEC BSA/AML *Examination Manual*, "OFAC Compliance Program," p. 145.