

Banking

IN THE NINTH

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NINTH DISTRICT HIGHLIGHTS

My First 100 Days (and Beyond)



Christine Gaffney

In my younger years, I never understood what my mother meant when she used the phrase “time passes so quickly.” She told me one day I would understand. I was convinced it was a phrase that only old people used. If that is true, I’m now officially old, as I find myself wondering how I have already passed the 100-day mark in my new position! In my inaugural article for this publication, I

explained my intent to build upon the good work of my predecessor and listen to key stakeholders—internally and externally—to determine the areas where I can best focus my efforts. In this article, I will reflect on what I have learned in my first 100 days (and beyond). To get back to time passing so quickly, it’s actually more than 150 days for those who are counting. I will group my observations into three broad categories: relationship building, regulatory reform/burden, and Ninth District conditions. I will also provide my views on how the Federal Reserve System will address or support each of these categories.

Relationship building

I have already had the opportunity to meet several regulatory and industry counterparts through various conferences and meetings. I have also met with a handful of District bankers in similar

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gatherings. Almost without exception, each person I talked with made a point of stressing the importance of partnering and working together. I am encouraged that everyone has this common view. My takeaway here is easy—we will continue with these partnerships and expand them where possible.

Regulatory reform/burden

The relationship-building piece naturally leads to conversations with stakeholders about regulatory and industry concerns. At a high level, the dominant feedback I am hearing from the financial industry in the Ninth District involves the uncertainty of regulatory reform. Of course, the views on regulatory reform

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SAFETY & SOUNDNESS UPDATE

BSA Independent Testing Compliance

By *Tori Walker, Assistant BSA Risk Coordinator*

Independent testing is one statutory requirement of an effective Bank Secrecy Act/Anti-Money Laundering (BSA/AML) compliance program. Independent testing assists a bank’s board of directors and management to evaluate the effectiveness of their BSA programs and

implement stronger controls as needed. Ninth District institutions often struggle to understand independent testing requirements; specifically, when employing outside firms. In this article, we discuss several key aspects of independent testing, considerations for those

institutions outsourcing independent testing, and examples of red flags that can alert the board or management to potential issues.

Key aspects of independent testing

The Federal Financial Institutions Examination Council (FFIEC) BSA/AML Examination Manual comprehensively outlines independent testing

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District Banking Conditions

Banking & Policy Studies

In this issue of *Banking in the Ninth*, we begin a regular column that will highlight information about banking and economic conditions in the Ninth District. This article focuses on the health of banks in the District as measured by their examination ratings. We show that by this measure, the industry has returned to its precrisis state after suffering severely during the financial crisis. The key reasons for this turnaround have been strong capital accumulation along with improvement in asset quality.

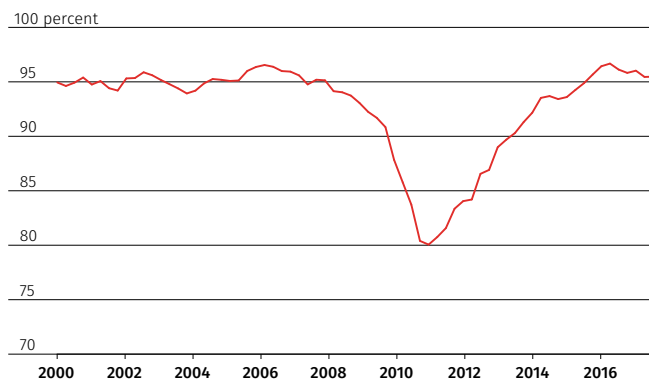
One measure that provides a holistic assessment of a bank's condition is the supervisory ratings that are assigned to banks after official examinations. These ratings incorporate both financial and nonfinancial characteristics of a bank and focus on six broad areas: Capital adequacy, Asset quality, Management capability, Earnings quality and level, Liquidity adequacy, and Sensitivity to market risk. Each of these areas—along with a composite rating for the overall institution—is assigned a score during the examination ranging from 1 to 5 (lower scores indicate better conditions). The composite rating is commonly referred to by the acronym **CAMELS**.

Currently, more than 95 percent of banks within the Ninth District have a CAMELS rating of 1 or 2, which we classify as being in “satisfactory” condition. The following figure shows the percentage of Ninth District banks rated in satisfactory condition back to 2001. The low point occurred at the end of 2010, when only 75 percent of the District’s banks were deemed to be satisfactory. This measure rose steadily during the 2011-15 period and is now back to levels typically seen in the precrisis period.

What factors have driven the significant improvement in the conditions of District banks since 2010? First, Capital adequacy at Ninth District banks has steadily increased over this period. For example, the median bank in the District currently has an equity-to-asset ratio (a broad measure of capital) of 10.7 percent. Contrast this with the median bank level of 9.7 percent that was measured at the end of 2010.

Second, Asset quality (the quality of a bank's loan portfolio and credit administration program) has also improved considerably during this time frame. Asset quality can be assessed in a number of ways, but one simple metric is to measure the amount of “problem loans” (those in which the

Share of Ninth District Banks in Satisfactory Condition



Source: Federal Reserve Bank of Minneapolis

borrower has missed a payment) relative to the amount of resources available to cover such losses. Lower values for the metric indicate better asset quality, and the measure at the median bank in the Ninth District currently stands at 6.8 percent. During the financial crisis, the same metric soared to 22 percent. The improvement in asset quality is broad-based. All major lending categories (residential real estate loans, commercial real estate loans, commercial and industrial loans, and agricultural loans) have seen their problem loan measures decline to some of the lowest levels recorded in the past 25 years.

Overall, the vast majority of banks within the Ninth District are in satisfactory condition. Supervisory ratings for a number of firms have returned to their precrisis levels. Recent improvement in capital levels and asset quality provide solid support for this conclusion, as both are stronger today than at any time before the crisis. One potential area to watch would be the quality and level of earnings, though. Many banks continue to struggle in the low-interest rate environment, and most measures of earnings performance continue to lag behind their precrisis levels.

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requirements and expectations. While it is important to address all requirements and expectations, we specifically highlight three critical elements that often come up during examinations: the importance of qualified auditors, the need for communication with the board and management, and third-party access to work papers and documentation.

Internal audit departments, outside auditors, consultants, or other qualified parties may conduct independent testing. The key point is that individuals involved in the independent testing function should not be involved in other BSA/AML functions that may present a conflict or lack of independence, including training or developing

policies and procedures. Auditors should be qualified and have a thorough understanding of requirements and expectations of the BSA through periodic training and work experience. The depth of knowledge and level of ongoing training for persons completing independent testing should be commensurate with the level of complexity and risk of the institution they are reviewing, but in all cases, training should ensure that their knowledge is up to date with industry standards.

Auditors should note any violations, policy or procedures exceptions, or other deficiencies during independent testing. The final report should include these important findings, and the

board or a designated committee should review the report in a timely manner. For example, we have observed auditor work papers documenting gaps to expectations outlined in the FFIEC BSA/AML Examination Manual, but audits did not bring them to the attention of the board or management, which limits the usefulness of independent testing. Not all issues identified during independent testing will rise to the level of a finding or recommendation status. However, an audit report containing sufficient detail of weaknesses in a BSA/AML program will allow the board and management the option to take action.

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A good practice is to make independent testing documentation and work papers available for third-party review. Examiners, for example, often need to review documentation and work papers to fully assess independent testing. Reviewing the scope and final report does not allow for a complete analysis of compliance.

Outsourcing independent testing

Many institutions choose to outsource independent testing. This is an acceptable practice, but the board remains responsible for ensuring that testing is timely, thorough, and accurate. While the FFIEC BSA/AML Examination Manual details requirements and expectations for independent testing, additional risk management practices are needed to ensure compliance. These practices include vendor risk management, involvement throughout the entire engagement, and thorough review of the final report.

Vendor risk management of external firms consists of initial and ongoing due diligence to verify qualifications and expertise of outsourced firms. Due diligence includes the review of qualifications of the firm and résumés of the auditors involved in the independent testing engagement. The engagement letter and scope should be reviewed to make certain the

vendor will address all of the minimum testing requirements. In addition, the engagement letter should include a provision allowing access to independent testing documentation and work papers.

It is essential that management be involved throughout the entire independent testing engagement. Management will have the most contact with auditors during the on-site portion of the engagement. Ongoing communication between management and the auditors is critical to ensure a comprehensive review. Ideally, auditors will bring concerns and deficiencies to management as soon as possible. This allows the institution to make sure the scope is fully addressed and to address any questions or discrepancies prior to the conclusion of the engagement and issuance of the report.

A thorough review of the final report is vital. While attention naturally focuses on conclusions and recommendations, reviewing the narrative of the report will ensure that critical details are not overlooked. The narrative includes how the vendor addressed the scope and describes deficiencies that did not rise to the level of a finding, but were nonetheless noteworthy. It is important that the board and management identify any inconsistencies and incorrect statements made in

the report narrative, as well as in the findings and recommendations. If management determines that conclusions are inconsistent or incorrect, immediate discussions between the board and the external firm are necessary.

Independent testing red flags

Red flags that can alert the board and management to potential issues with outsourced firms include:

- The auditors scheduled to perform independent testing have limited or no BSA/AML training, experience, or work history.
- The engagement letter and scope are vague and do not detail the specifics of the engagement.
- The auditors have very little communication with management.
- The final report contains inconsistent or incorrect information.
- The outsourced firm is reluctant to provide documentation and work papers when requested.

We suggest referencing the FFIEC BSA Examination Manual for additional information.¹

¹ https://www.ffiec.gov/bsa_aml_infobase/pages_manual/OLM_008.htm

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vary greatly, depending on the size of an institution or the complexity of its operating model, but I did hear loud and clear that everyone at all levels agrees that the industry needs regulatory reform. The challenge here is the uncertainty about what will be scaled back and whom it will directly affect.

The complaints about regulatory burden are not new. Since our District consists mainly of community banks, we are well aware of the challenges and costs associated with regulation for these institutions. What we can and will do is continue our partnership to help our institutions understand and comply with any changes that are to come. While many stakeholders point out the uncertainty of regulatory reform, and we can't control the outcome, I would be remiss if I did not point out the Minneapolis Federal Reserve Bank's plan for addressing too-big-to-fail financial institutions. One part of this plan allows the government to reform its current supervision and regulation of community banks to be a simpler and less burdensome system while maintaining its ability to identify and address bank risk-taking that threatens solvency.

Ninth District conditions

By and large, the primary concerns I hear about conditions in

the District right now are directly related to agricultural lending and, more specifically, what will happen if commodity prices continue to remain low much longer. An interesting aspect that I learned from these discussions is not just concerns with drought conditions and low prices, but concerns with bankers and farmers who have not experienced such adverse conditions because they did not live through the agricultural crisis of the 1980s. I grew up in the Red River Valley, which consists of very rich farmland in eastern North Dakota, so this concern resonated with me. While I was not working in banking or agriculture at that time, I can recall the impact of the crisis on my rural community. I have benefited from the experience of my predecessor and peers through knowledge transfer. The conversations I have had on agricultural conditions lead me to believe the industry needs to have this same type of knowledge transfer. How can we best prepare farmers and agricultural lenders who have never seen these conditions? In short, with information based on past experience from those who have seen these conditions, like many of you.

In closing, a common question I am asked is about banking conditions in general. In an effort to respond to the query, this issue of *Banking in the Ninth* includes an overview of banking trends. Our intent is to include information on banking trends as a recurring section. I welcome feedback on the types of information you would find useful.

Preparing for the 2018 Home Mortgage Disclosure Act (HMDA) Changes

Next year will bring significant changes for HMDA reporters. Effectively implementing such significant regulatory changes requires a focus on how the changes will affect your institution and a solid implementation plan. This article provides suggestions to help your institution implement HMDA changes effectively. Hopefully, many of you are well along in your efforts to prepare for these changes and will find this article a helpful check on the work you've completed.

How will the HMDA changes affect your institution?

Some of the key changes involve the types of applications covered by HMDA and the data reported for these applications.¹

Identifying HMDA-reportable applications

A first step in preparing for the changes is identifying which applications need to be reported for HMDA, since these rules will change. For data collected on or after January 1, 2018, Regulation C generally applies to the following types of applications:

- Consumer-purpose, closed-end loans secured by a dwelling.
- Consumer-purpose, open-end loans secured by a dwelling.²
- Business-purpose, closed-end, and open-end loans secured by a dwelling that are home purchase, home improvement, or refinance loans.

Regulation C identifies a number of excluded transactions in section 1003.3 that bank staff should review in determining which applications to report. Institutions with agricultural loans should note that Regulation C now excludes loans with an agricultural purpose from HMDA reporting requirements. The applicable commentary to Regulation C describes an agricultural purpose as (1) funds used for an agricultural purpose, or (2) a loan or line of credit secured by a dwelling located on real property that is used primarily for agricultural purposes.³

The bank's implementation plan should ensure that the bank determines which applications to report under the new rules as

well as which applications it no longer needs to report, such as agricultural purpose loans that may have been reported under the previous rule. Part of this process should involve identifying which business lines originate the types of loans covered by the new rules and ensuring that the bank captures all of these covered applications as part of its updated HMDA reporting processes.

Collecting information for new data fields

Under the new HMDA rules, the number of data fields has increased. Some examples of new data to be reported include the borrower's age, credit score, and debt-to-income ratio, and the loan's term. In addition, some rules related to collecting applicant information have changed. Bank staff should familiarize themselves with these changes and determine the most effective and accurate methods for collecting these data.

How should your institution implement these changes?

The bank's plan for implementing these HMDA changes should be comprehensive and will likely need to include updates to all aspects of the bank's HMDA reporting processes.

Policies and procedures and tools

The bank will want to update any internal policies, procedures, and tools to reflect the HMDA changes. Questions to consider could include:

- What applications will need to be reported?
- What processes will need to change, and how should procedures be updated to reflect these process changes?
- Who has responsibilities for various parts of the HMDA data collection and reporting process?

Training

Given the nature of these HMDA changes, training will be an important part of implementing the new rules. The bank should consider providing training to all staff affected by these changes. Staff with direct HMDA reporting responsibilities should receive the most in-depth training on the changes themselves and how the bank's processes

will change. Lenders and others involved in originating and processing HMDA-reportable transactions should receive training so that they understand their role in helping the bank capture needed applicant data and other information.

Internal controls and audit

Banks with effective HMDA-reporting processes frequently have multiple layers of internal controls to make certain they report accurate data. These controls will be particularly important going forward to ensure that the bank reports HMDA data accurately under the new rules. Effective controls for making sure the bank reports complete and accurate data for all HMDA-reportable applications may include:

- Centralized reporting functions.
- Electronic data collection.
- Second reviews of data, preferably by comparing reported data to source data, such as applications and loan documents.

Many banks will likely need to include system changes and third-party servicers in the scope of their implementation plans. In the end, a bank's implementation plan should reflect the risks and complexities of its operations.

¹ This article does not discuss all of the changes to HMDA, including new volume thresholds. It focuses instead on certain significant changes (most of which are stated in Regulation C, sections 1003.2 to 1003.4) to consider in implementing the new HMDA rules. For more information, refer to Regulation C, section 1003, and Consumer Financial Protection Bureau guidance for additional details on these changes. <https://www.consumerfinance.gov/data-research/hmda/>.

² Institutions will only need to report open-end lines of credit if loan thresholds are met. The threshold will be 500 covered lines of credit for the preceding two calendar years beginning on January 1, 2018, and will decrease to 100 lines for the preceding two calendar years as of January 1, 2020.

³ Commentary to Regulation C, section 1003.3(c) (9). Refer to commentary to Regulation Z, section 1026.3(a)-8, for guidance on what is considered an agricultural purpose.