

# Risk Management Roadmap

Sheshunoff Management Services

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## Compliance is Expensive — Avoid the Top Penalty Producers & Violations

Many industry experts lament the fact that regulation costs financial institutions money, a lot of money. Compliance requires forms to be updated, software to be purchased, training to be conducted, and processes that are done and redone. And the reality is that these costs are passed on to the people they are designed to protect.

However, we always remind our clients that the costs of compliance can multiply if a deficiency is found in the program. Regulators are assessing civil money penalties and ordering restitution at a seemingly record pace. This article looks at the four most common areas for penalties to help you assess your performance.

### I. AML/BSA Violations

Without a doubt, Bank Secrecy Act violations are the number one area for punitive penalties today. In the past five years, several banks have been fined huge dollar amounts for ineffective AML programs. Fines as high as \$25 million, \$70 million, and even \$100 million have been handed out to the poster-child institutions.

While these fines are exceptional in size, it is becoming increasingly common for banks to receive enforcement actions for BSA/AML violations. In the past two years over 120 banks have received a formal enforcement action for failed performance of their program. We see four areas where a bank should focus to avoid joining this group:

- 1. Complete the migration of your program. The new focus requires that your BSA/AML program should be active in detecting suspicious activity, including money laundering. Banks that are behind are still focusing on the currency transaction reporting requirements. Make sure you also have the systems and processes to identify and report the suspicious activity.*
- 2. Ensure the independent test is well done and well documented.*

*The new exam procedures issued in June 2005 focus much attention on independent tests. Your provider or internal resource should benchmark their program against these procedures.*

- 3. Enhance your AML information systems. Technology in AML is moving fast. You should be comfortable that your systems are keeping up with the industry.*
- 4. Keep improving employee knowledge. Your employees are your first line of AML defense. Make sure they are kept abreast of the risks and the schemes money launderers may employ.*

### II. Regulation Z

Some compliance specialists call Regulation Z the granddaddy of compliance regulations. Despite its longevity, bank's still are paying penalties for noncompliance.

We note two specific violations that seem to be the focus of most of the errors. First, banks that originated consumer construction loans must adhere to the requirements of Appendix D of the Regulation. Appendix D provides for the calculation method to be used if, as in the case of construction loans, the finance charge is unknown at the time of closing. Yes, your loan origination platform generally gets this disclosure right; however, the employee inputting the loan is often not aware of the differences.

Second, adjustable rate mortgage (ARM) loans are tricky and often cause restitution issues. Particular focus should be paid to teaser rate loans. Many institutions fail to reflect the teaser rate in the payment stream resulting in APR errors.

Prevention of Regulation Z restitution takes diligence. Compliance professionals at the bank need to be aware of what is and is not a finance charge. The definition in the regulation is complicated, so knowledge is critical. It's also critical that product developers run new products and fees by the compliance function. Too often we see marketing out ahead of compliance, resulting in errors. Finally, quality control and monitoring procedures need to be vigilant to ensure problems are caught early.

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## III. Flood

Pursuant to the National Flood Insurance Act, your regulator is required to assess civil money penalties (CMP) for flood insurance violations. The requirement applies to pattern or practice violations in the following areas:

- *Failure to require flood insurance when required*
- *Failure to escrow for flood insurance as required*
- *Not force placing insurance as required*
- *Not providing notice to the borrowers*

Many institutions received CMPs in the past five years. While a pattern or practice is not an isolated instance, three or four occurrences can lead to a CMP. For example, if you have 10 loans that are in a flood hazard area, and four do not have the proper insurance coverage, expect a fine.

Too often we see lending staff (commercial and real estate) who believe the flood insurance requirements are guidelines that can be circumvented. Compliance officers know this is not the case. In addition to knowledge, a strong quality control or monitoring program that tests performance is necessary.

## IV. Enforcement Actions

The most costly regulatory issue is a failure that results in an enforcement action. As consultants to community banks we are often called in to assist a bank that finds itself in regulatory hot water. Without exception, whatever the underlying reason for the action, those bank CEOs will tell you that the largest cost was the administrative burden related to the action.

Peruse the actions published on your regulator's website. You will routinely find they include:

- *Ongoing reporting requirements to the agency*
- *Need to hire outside consultant*
- *Drafting of numerous policies and procedures*
- *Beyond industry standard monitoring and controls*

Put simply, enforcement actions choke a bank.

If your bank is presented with the opportunity (sounds nicer than it is) to sign such an agreement, seek outside assistance.

In general, we advocate to:

1. *Negotiate from a formal action to an informal action. Informal actions, such as memorandums of understanding or board resolutions, are considerably less onerous than written agreements or cease and desist orders.*
2. *Limit the administrative reporting. Regulators like reporting on actions, however, for the bank these ongoing reports take significant time away from improving performance. If requirements can't be reduced, the bank should set expectations with their regulator that limits the reports.*
3. *Seek an understanding on lifting the agreement. Many banks find that enforcement actions seem to be perpetual. Negotiating a completion date for the action can prevent onerous administrative costs from continuing.*

We like to think all of our bank clients will avoid compliance penalties; however, reality is that even high performing, well-managed banks occasionally have issues. The best prevention is a strong compliance management program that includes a training component, strong policies, and consistent monitoring. Contact your SMS consultant sooner rather than later if a compliance issue causes you concern.

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## Why Outsource Internal Audit? Ask this Massachusetts Banker.

In 1999, John O'Connor III took the reins at South Coastal Bank in Rockland, MA. At the time, the bank which was founded in 1868, was a \$75 million dollar community bank. To survive into the 21<sup>st</sup> century, O'Connor knew the bank needed to grow. With the support of his Board, John achieved significant growth by turning South Coastal into a full-service community bank that could hold its own in any competitive marketplace.

Today South Coastal is a \$275 million bank, and still going strong. And despite the phenomenal growth he achieved, O'Connor focused on growing the bank right, not fast.

As O'Connor led his bank into retail lending, electronic banking, sweep accounts, retail deposits, and other new territory, no investments were made in costly systems until the revenue was there to support the expenditure. Focusing on getting the details right also helped them keep an eye on their policies and procedures and other compliance issues. As the bank's operations became more complex however, the need for a more robust and objective internal audit function became a priority.

"A first rate internal audit function is the threshold to operating in a safe and sound manner," says O'Connor. Even though the bank had been passing muster with the examiners, they were hearing consistent recommendations to enhance their internal audit function. They were at a crossroads: should they keep the function within the bank or outsource it?

There was no contest as far as O'Connor was concerned. "There is no question that an outsourced internal audit function is more independent and objective. Maintaining a sound system of internal control is one of our biggest challenges and we need outside help to be sure we're doing it right." He also felt it was an advantage to have a team of experts working for him. "Had I hired one person to do this job inside the bank I wouldn't have had the depth of experience or independence I was looking for," says O'Connor.

With that decision made, the next question was who to hire.

### Quality Trumps Cost

With the agreement of his Board, O'Connor set out to find the best internal audit consultants to present to the audit committee for consideration. He did his homework — he talked to regulators, the bank's external audit partner, and eight bank presidents.

One name kept coming up. "Everyone mentioned Mike Lewis and The Harcourt Group Ltd. of New England (a subsidiary of Sheshunoff Management Services since 2005)," says O'Connor. And the bank presidents who had worked with Mike spoke about him and his team in glowing terms. "Word was that he was the toughest, and the best. He didn't compromise and "he was a straight shooter, no matter how painful the news."

O'Connor presented the audit committee with three choices, but strongly endorsed Harcourt based on everything he'd learned while doing his research. The audit committee reviewed his recommendations and agreed with his conclusion that Harcourt was their best choice for outsourcing the Bank's internal audit function.

The service Harcourt provided was more expensive than the other internal audit firms O'Connor interviewed, but he believed the audit function was no place to cut corners. "They cost more, but I have no regrets," says O'Connor. "I'm getting what I'm paying for and we've been very satisfied. In fact, we've renewed our arrangement with them for the second time."

### Transition Smoother Than Expected

Any time you make changes you can expect resistance and South Coastal's move to outsource the internal audit function was no exception. Some initially saw the transition as an imposition, but the Harcourt team worked with them and helped them see the benefits of outsourcing this work. Most now see Harcourt involvement as a relief and many find that their performance is validated by the internal audit's findings.

"The nature of the people Mike sent, especially Bill Pritchard and Carl Shelley, made a significant difference in effecting a smooth transition," says O'Connor. "They feel more like partners, although we never forget they are auditors."

The regulators have been very pleased with South Coastal's performance, and O'Connor says the relationship continues to work very well.


"With the advent of BSA, Sarbanes-Oxley, the USA PATRIOT Act and all the other requirements banks have to keep up with, you have no choice," says O'Connor. "You can't rely on yourself to do it right."

Now that the bank has its internal controls in good shape, and growth targets have been met, O'Connor has moved on to his next challenge: transitioning the balance sheet. His relationship with Sheshunoff is helping him here, too. "I've been part of the Sheshunoff Affiliation Program for four or five years," says O'Connor. "The things I've learned there have really helped develop me to lead South Coastal. In particular, the insights on balance sheet management and structure, risk management, and regulatory interaction have been very helpful. Sharing ideas with a peer group made up of bankers like me but not competing with me has also been a great benefit. And it's been great to be able to bring the materials given out at the meetings back to my board."

When something works well, you stick with it. O'Connor expects his relationship with Harcourt/Sheshunoff to continue into the foreseeable future.

*Harcourt was founded by Mike Lewis in 1989 in Boston, MA. It was acquired by SMS in 2005, and continues to operate as an independent subsidiary currently serving over 60 banking clients in New England.*

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 South Coastal Bank - Rockland, MA  
[www.southcoastalbank.com](http://www.southcoastalbank.com)



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 John O'Connor, III  
 President, Chairman & CEO

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## Ask The Expert

You have questions, we have answers. In each issue our experts answer risk management questions about compliance, internal audit, and loan review. We encourage you to send us your questions and we will answer them in a future issue. To submit a question, go to [smslp.com/riskq&a](http://smslp.com/riskq&a). If your need is more immediate, call us at (800) 477-1772 ext. 560.

### Compliance

**Question:** Is there a requirement for a bank to use consistent terminology between the initial disclosure and the deposit periodic statement?

**Answer:** Yes. According to Section 203.4(a) of Truth in Savings, a fee must be described using the same terminology. For example, a bank cannot call a monthly fee a "service charge" on a periodic statement and a "maintenance fee" on a deposit disclosure.

**Question:** How can a bank monitor the pricing on mortgage loans for fair lending?

**Answer:** Banks are required to report a rate spread on the Home Mortgage Disclosure Act loan application register (HMDA-LAR) for home purchase, refinancing, or dwelling-secured home improvement originations. An average rate spread can be computed for each racial category or by gender by reviewing codes for government monitoring information on the HMDA-LAR.

A table can be developed to show the average rate spread and number of applicable loans identified for each category. The bank should analyze whether rate spreads are higher for minorities or females and determine the reason for the disparity or if higher rate spreads are being charged by specific loan officers. If the bank has a large volume of HMDA reportable loans, this analysis should be shown separately for home purchase, refinancing, and dwelling-secured home improvement loans.

**Question:** I keep hearing about Phishing? What is it and what do I need to do?

**Answer:** Phishing is a type of Internet fraud in which criminals go "fishing" for confidential information. In this scam, information is obtained and then used to perpetuate a fraud, such as identity theft, removing funds from deposit accounts, or putting charges on credit accounts.

A typical phishing scam may start out as an email that appears to originate from a bank or government agency requesting an immediate response that includes confidential information. This serious crime has the attention of the regulators. Bankers should be aware of this type of crime and be able to discuss this with their customers. Customers should be advised not to respond to suspicious requests for information over the Internet. If a customer feels they have fallen victim to phishing, they should contact one of the three major credit bureaus to discuss the placement of a fraud alert on their file. They should also be advised to monitor their account statements closely.

### Internal Audit

**Question:** Why do you recommend that we recalculate a sample of loan and deposit interest and service fees posted on customer statements? What control purpose does this achieve? Our core loan and deposit applications are outsourced and managed by a service bureau.

**Answer:** The periodic (quarterly or semi-annually) testing of the accuracy of system interest (income and expense) and fee calculations is a worthwhile quality control process that will validate that there were no unrecognized system parameter changes, inflicted by the Servicer, that affect customer loan or deposit interest/fee calculations.

In addition to ensuring the mathematical calculation, this process should also verify that the numbers are based on the bank's expected basis for calculating the average daily balance and the daily interest. The method of fee calculation should match the current service fee published in the bank's brochure. The testing of system interest and fee calculations is normally a standard recommendation in many service providers' SAS 70 "Client Control Considerations or User Responsibilities" section.

**Question:** How can we be assured that outsourcing the internal audit function will help us fulfill the responsibilities required by the “Interagency Policy Statement on the Internal Audit Function and its Outsourcing”? The Board of Directors and senior management of our bank is responsible for ensuring that the system of internal control operates effectively. This seems to be especially important in today’s environment in light of the emphasis on internal control placed by regulators and the accounting industry.

**Answer:** A well-managed, properly structured internal audit function provides directors and senior management with vital information about any weaknesses in the control environment and system of internal control so that management can take prompt, remedial action. An effective internal control system can help a bank achieve performance and profitability goals, prevent loss of resources, ensure reliable financial reporting and assist in compliance with laws and regulations.

Outsourcing the internal audit function to a quality firm is a cost-effective and efficient way to provide an independent and impartial assessment of the institution’s control environment. In choosing an outsourced internal audit firm, a banking institution should determine that the firm has quality staff with the experience to assess the control system. An effective control system must be comprised of the following components:

- *Control Environment - Management’s philosophy, operating style and overall degree of “control consciousness” and the degree of management oversight provided over operations.*
- *Risk Assessment - The identification and analysis of relevant risks towards achieving expected operating results and management’s objectives.*
- *Control Activities - The adequacy of operating policies and procedures, which ensure that management’s directives are carried out.*
- *Information and Communication - The adequacy of information and management reporting systems and the timeliness with which pertinent information is reported.*
- *Monitoring of Operations - Management and supervisory action taken by personnel in the performance of their duties.*

**Question:** Why is it considered important for a client to advise the Internal Audit Firm, when the next regulatory exam is scheduled?

**Answer:** Most examinations now begin with a careful assessment of a bank’s control environment and system of internal control. Regulators specifically evaluate the quality of a bank’s risk management system (i.e. active board and senior management oversight; adequate policies, procedures and limits; adequate risk management monitoring; and comprehensive internal controls) as an integral part of its overall assessment of management. In fact, their assessment of internal control and the quality of a bank’s internal audit function are key ingredients in determining the scope and depth of its Safety and Soundness Examination and the management grading in the overall CAMELS rating.

It is prudent for the internal auditors to meet with the regulators during the above process to answer any questions they may have about the internal control environment, the internal audit process and its reporting system. This proactive approach of meeting with the field examiner to answer any questions or concerns should reduce the possibility of any negative conclusions they may have if left to their own devices.

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### [Loan Review](#)

**Question:** Why are the regulators interested in our appraisal process?

**Answer:** The regulators are interested in the appraisal process because of the reliance by the financial services industry/lending institutions and lenders alike on the value attributable to various types of collateral taken to secure indebtedness. The independence of the appraisal, therefore, is critical.

It is important that the ordering process regarding the appraisal be an independent function contained within credit/loan administration. This is important from the perspective of an “unbiased request” for the appraisal by the institution. This then establishes an “arms length” request without any undue or unintended direction for the results of the appraisal being inadvertently delivered

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to the appraiser. The appraiser then can clarify the scope without getting into inferences about the subject property. The appraiser then can send his report to the originator of the request, or to some other designee other than the loan officer.

Once the appraisal is received by the originator of the request, it can be assigned to a reviewer. The review needs to be done in accordance with the request based on the scope. The review must be performed by someone with experience relating to the policies and procedures of the bank regarding appraisals, as well as the type of collateral being appraised. This process validates the integrity and independence of the appraisal ordering, appraisal review and reliance by the bank.

**Q**uestion: Are loan agreements really necessary?

**A**nswer: Let's review the purpose of a "loan agreement". Its purpose is to define, identify, quantify and qualify the parameters of the loan relationship. What we mean is, that it defines the purpose of the credit, the terms of the arrangement, and the collateral securing the loan(s) involved in the credit arrangement, and it sets forth certain expectations for the borrower on behalf of the lender and certain expectations for the lender on behalf of the borrower. Further, it stipulates that there are no "other agreements in effect either oral or written" between the parties.

The loan agreement sets the stage for monitoring and establishes timetables for performance by the borrower in accordance with the agreement. The financial services institution must monitor for compliance with the loan agreement for it to be effective.

Loan agreements should be required on credit arrangements when the arrangement is conditioned on performance by the borrower, and when the expectation of the bank is that the performance indicators are to be measured on a predetermined timetable.

**Q**uestion: Structural weaknesses – what is it really?

**A**nswer: Structural weaknesses are deficiencies in the underwriting of a loan. These deficiencies can, if not resolved and addressed, compromise a financial institution's ability to control a credit relationship if economic or other events adversely affect a borrower.

### ROAD SIGNS

*What to watch for in the road ahead.*

- HMDA filing date is fast approaching. The March 1st deadline is always busy for compliance officers with HMDA accountability. Work hard on it this year; data accuracy is critical to your bank's compliance program. And next year, resolve to keep on top of your HMDA data by keeping up with your monthly monitoring.
- Speaking of HMDA, the 2006 threshold for reporting banks has been raised to \$35 million in assets (as of year end 2005). We bet your CEO will not agree to shrink to get under the threshold.
- On January 20, regulatory agencies offered guidance on sharing SARs with parent companies. The short story is be careful who in your organization has access to SAR. You can share the information with the parent company or other related entities, but do look at the guidance before doing this.