

Current Regulatory Hot Spots

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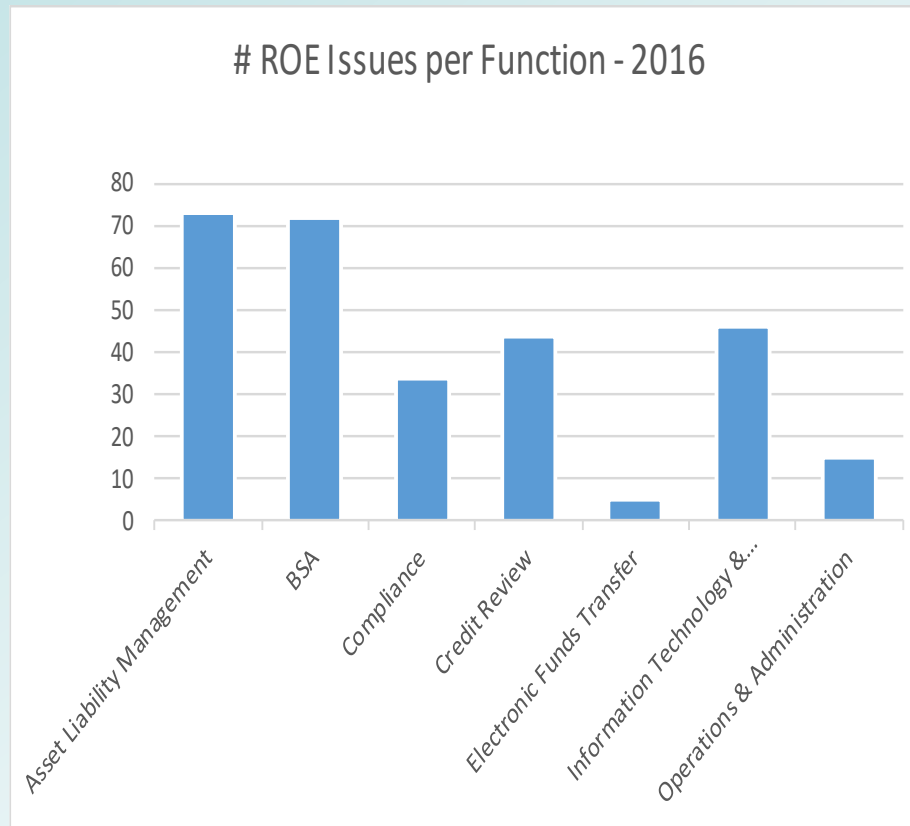
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Introduction

- Our business provides us regular insights into what regulators are emphasizing, their expectations for financial institutions (FIs), etc.
- Insights obtained from:
 - (Safety & Soundness, Compliance) exam reports
 - Client discussions
 - Auditor feedback
 - Conversations with regulators
- Data shows as 2016 exam reports; 2017 results still only partially reflected in our audit reports
- More information on AuditOne is provided in the Appendix to this presentation

From a Sample of 79 2016 Safety & Soundness Reports of Examination



Start with Governance Issues

- More of a FRB/OCC concern, but percolating down
- Strategic planning
 - Board involvement
 - Time horizon – at least 3 years
 - Integrate with budget
- Succession planning
 - Short-term emergency procedures
 - Longer-term succession
- Risk appetite
 - Sets concentration and other risk limits
 - Incorporates stress-test results
 - Accounts for constraints (capital, liquidity, etc.)

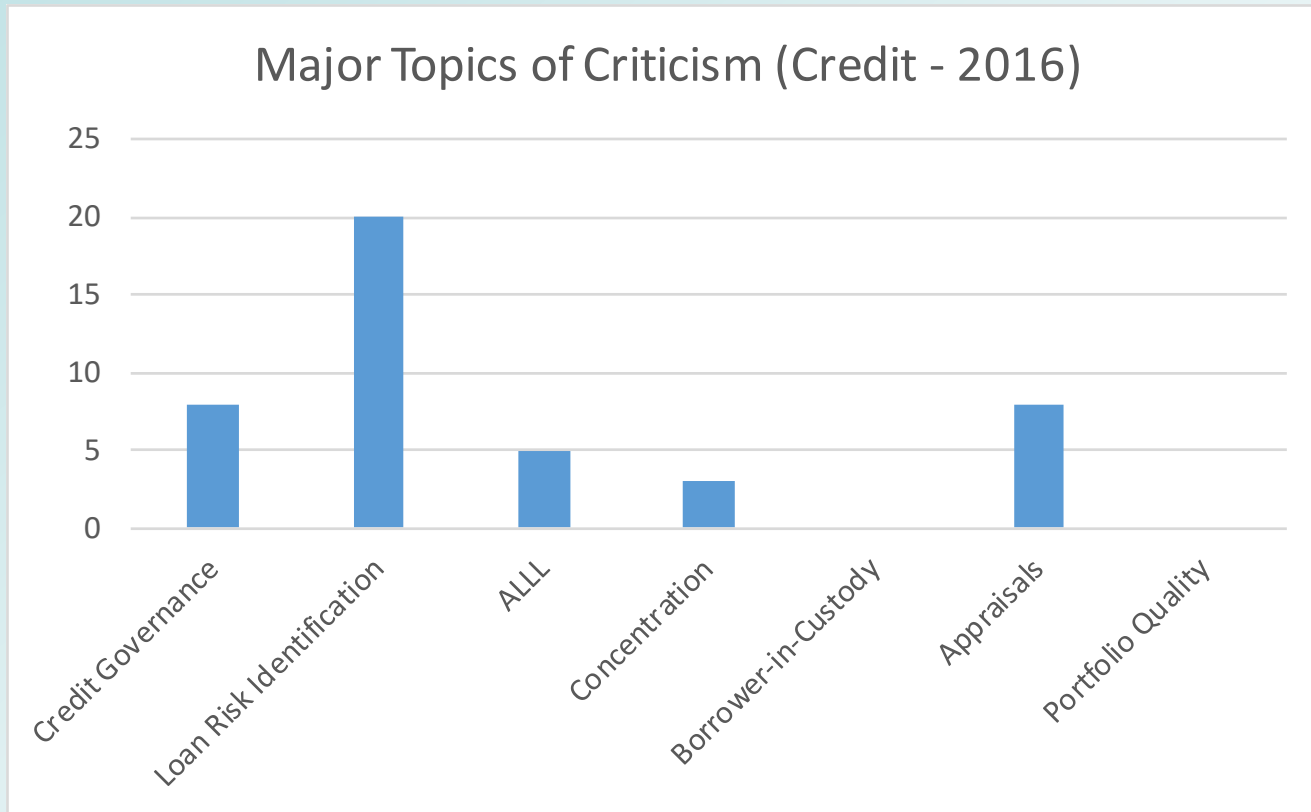
ERM, ERA

- Enterprise Risk Management (ERM)
 - No roadmap, but some regulators looking for moves
 - ERA (see below) is a core component; so is risk culture and communication, plus tools and processes for monitoring and reporting on risk profile
 - Big challenge: standardized risk measurement
- Enterprise Risk Assessment (ERA)
 - Required for annual audit plan foundation
 - Based on inherent risk across each functional area, but should also reflect control environment (residual risk)
 - Determination of audit needs independently of mgmt.

Board Oversight

- Ensure meeting minutes capture relevant discussion
- Annual review and approval of policy docs
- Exception reporting, limit violations – including strategy to address violations
- Corrective action tracking
- Audit and Supervisory Committees gets particular attention
- Importance of direct communication between AC/SC and auditors, incl. presentation of results
- Executive session with auditors (in minutes)

Credit and Lending: Sampled S&S ROE Criticisms



Credit and Lending Issues

- Loan risk identification (i.e., sampled loan file review): getting more attention again, esp. for (indirect) auto, multifamily, leveraged loans – has overtaken ALLL in ROE comments
- Concentration risk management becoming ever more important (and not just for CRE)
- Stress-testing: percolating down-market
- TDRs: getting the accounting right (e.g., what's a modification), and the required reporting (e.g., Call Report vs. ALLL reporting)
- Timely receipt of borrower financial info

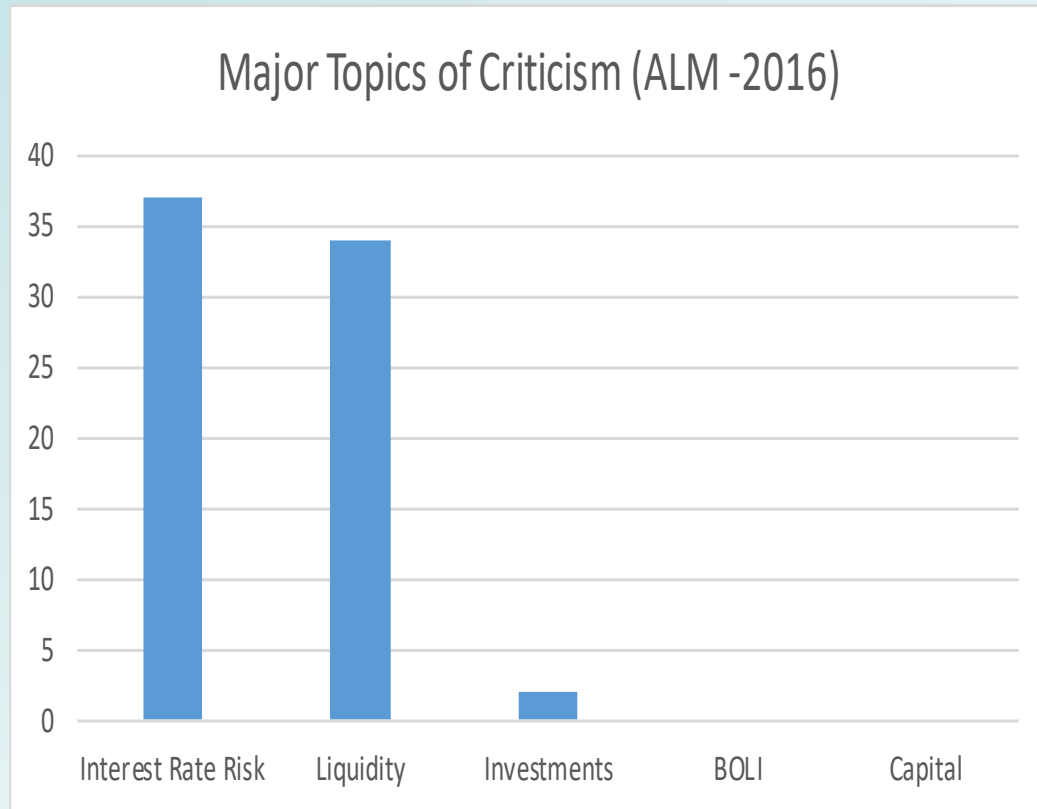
Credit Issues – Cont'd

- HELOC end-of-draw risk
- Cash flow calculations
 - Global
 - Living expenses
 - Exclude non-recurring items
- Annual term loan review process
- Risk rating system clarity
- Avoid incentives for risky lender behavior
- Participations (re-underwrite to purchaser's standards) plus due diligence on pool purchases
- Board reporting: exceptions, stress test results

ALLL

- Use internal loss history, and with longer look-back (at least 3 – 4 years)
- Two-dimensional loss factors, differentiated according to 1) loan type, 2) risk grade
- Use Q&E adjustments (per 2006 Guidance) to bridge between look-back period and today; directional consistency, ballpark reasonableness
- Impairment documentation/support
- Off-balance sheet reserving per ASC 450-20
- Prepare for CECL: more granular data collection for more variables, as far back as possible

Asset/Liability Management: Sampled S&S ROE Criticisms



Interest Rate Risk

- ALCO: meeting frequency, reporting of policy (incl. limit) exceptions, detailed minutes
- Emphasis on model assumptions: customize and validate, with regular ALCO presentation
- Non-maturity deposits: repricing, average life
- “Surge deposits” = recent deposit growth at risk of departing as rates rise, with implications for funding cost, NII
- Non-interest income effects, NII back-testing
- EVE-at-Risk: not so user-friendly, but regulators expect education, discussion

Liquidity Risk

- Getting heavy emphasis (even though liquidity is mostly strong) – due to surge deposit risk
- Contingent funding plan, liquidity stress-testing: tie the two together, in particular to address significant loss in deposits
- NII impact via cost of funds, net interest margin
- Core deposits vs. wholesale funding
- Brokered deposits: some easing in treatment of CDARS, but more scrutiny of Internet deposits
- Test borrowing lines annually
- Inaccurate ratio calculations

Investments

- Most small FI investment portfolios remain low credit risk, even as they absorb excess liquidity
- Credit analysis (pre-purchase, plus post-purchase updating) for all but Treasuries and Agencies: not just agency ratings (per Dodd-Frank)
- Regulators watching for duration extension (“reaching for yield”)
- Policy limit for investment portfolio impact on EVE under specified (e.g., +300 bps) rate shocks

Capital

- Basel III phase-in (began Jan./15), with more complex calculations, reporting requirements
- Most small FIs still comfortably above required minimums, even allowing for 2.5% Capital Conservation Buffer (to avoid dividend and bonus restrictions)
- More attention to capital policy, including contingency planning
- Lots of capital = less concern with other CAMELS weaknesses
- EGRRC Act gives banks < \$3B more options, incl. minimum Community Bank Leverage Ratio

Compliance

- Compliance Mgmt. System (CMS) = Board/mgmt. oversight + Compliance Program (CP) + audit
- CP = policy & procedures + training + monitoring
- Risk Assessments: for Compliance overall and for key regs individually
- Management oversight of third party providers in terms of consumer compliance
- Reviewing for regulatory violations is important, but those are problems that have already happened; reviewing CMS helps prevent future problems

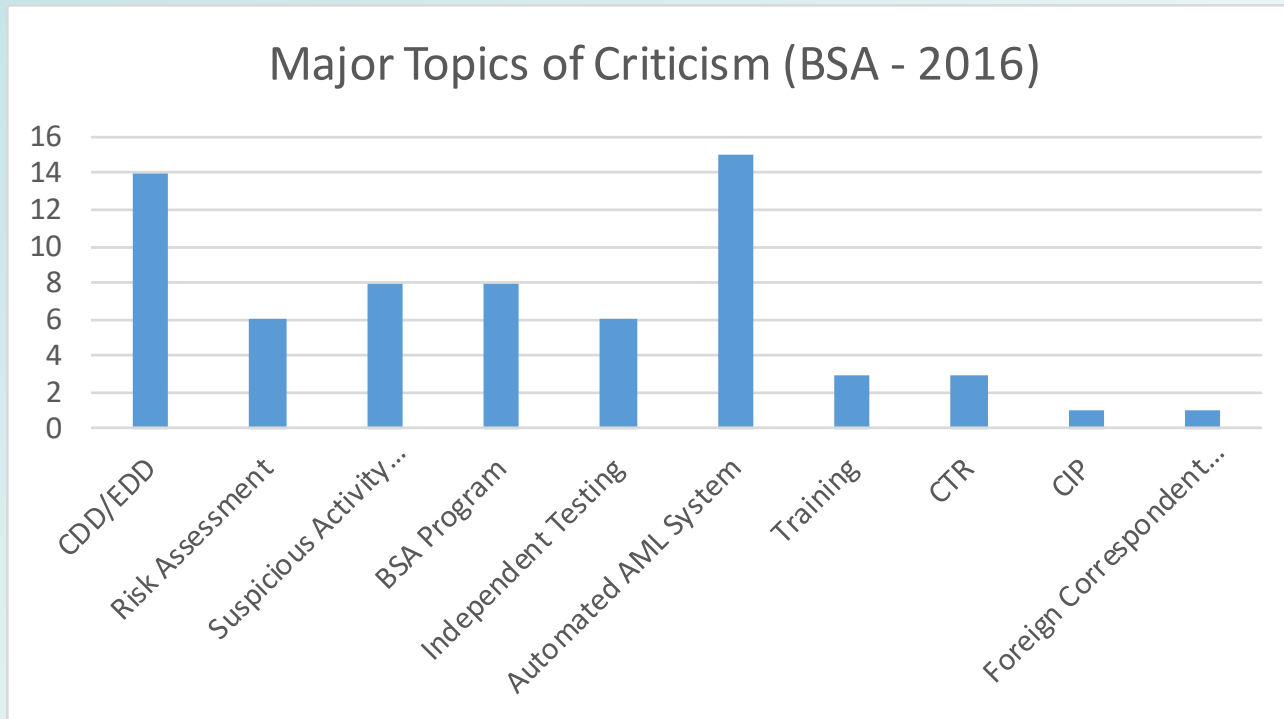
CFPB/Dodd Frank Focus on Lending Regs

- ... Especially mortgage and consumer lending
- HMDA: low tolerance for LAR errors ... and now increased GMI reporting requirements
- Fair Lending: looking for disparate impact, not just for mortgages (using GMI) but also for consumer and other loans (using “surrogates”)
- Fair Lending Risk Assessment, training
- Flood insurance: continued pickiness
- 2016 FFIEC’s UICCRS (Uniform Interagency Consumer Compliance Rating System)

Lending Regs – Cont'd

- Reg Z/RESPA: getting TRID disclosures right
- Appraisals: criticism of appraiser calculations; internal review process (incl. reviewer qualifications); independence (re: ordering appraisals); updates for OREO properties
- Reg O: verifying non-preferential treatment
- UDAAP: early days, only preliminary indications of CFPB aggressiveness (overdrafts, credit cards, payday loans) but more to come?

BSA/AML: Sampled S&S ROE Criticisms



BSA/AML – Pillar Issues

- Adequacy of AML Program resources, incl. BSA Officer qualifications, trained support staff
- Fifth Pillar, Customer Due Diligence (CDD): documentation of expected vs. actual transaction activity, consistent/accurate customer risk ratings
- Preparation for beneficial ownership (May/18)
- Independent testing (audit):
 - depth of testing
 - customization for the FI's risk profile
 - workpaper review
- Board reporting

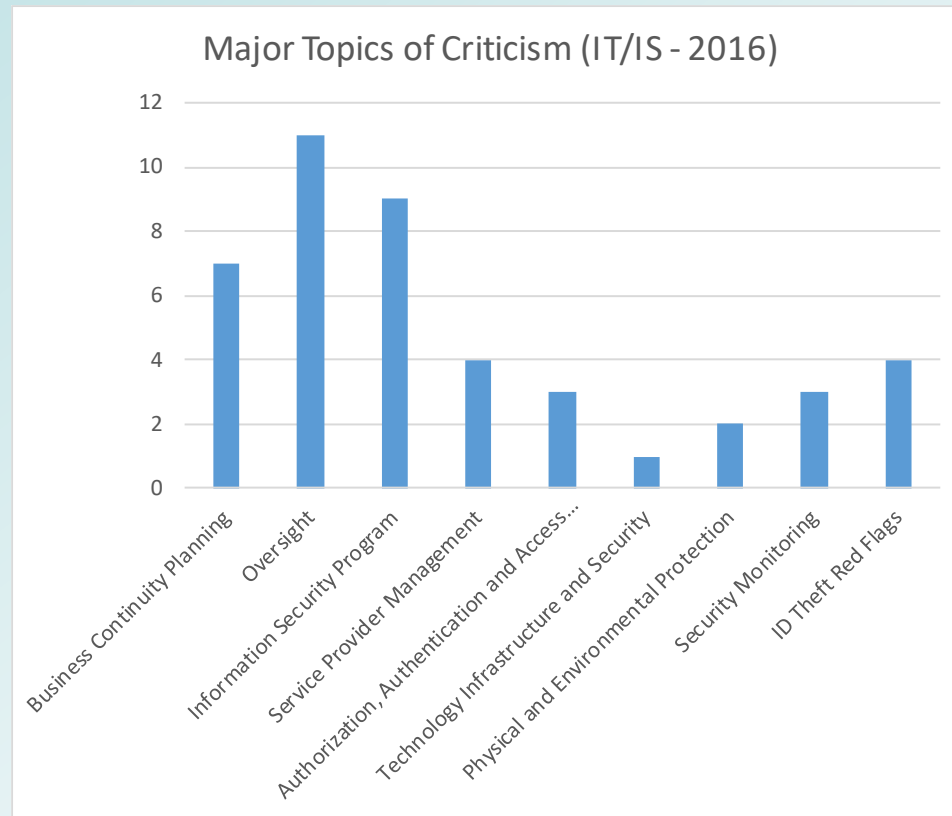
BSA/AML – High Risk Areas

- Documentation of EDD reviews
- Particular attention to MSBs, NRAs, TPPPs, MRBs, et al. – all requiring extra due diligence and monitoring
- Include all potentially high-risk areas in the BSA Risk Assessment
- Support the risk ratings, quantitatively where possible
- Overall rating for inherent and residual risk

BSA/AML – Suspicious Activity Monitoring

- Managing alerts, responding in timely and appropriate fashion
- Documenting decision not to file a SAR
- International activity monitoring
- Validation of automated monitoring system data integrity
- Internal review of the effectiveness of filter criteria

IT / IS / Cybersecurity: Sampled S&S ROE Criticisms



IT / IS Governance

- Documenting in Board meeting minutes: discussion points; annual approval of policies, risk assessments; review of critical service providers
- Monitor corrective action status of prior (exam, audit, pen test) findings, with annual reevaluation and reaffirmation of accepted risks
- Board-appointed IT Steering Committee, with at least quarterly meetings
- IT Manager separate from ISO: for > \$1B
- Annual ISO Report to the Board (e.g., security incidents, handling of sensitive data), per FDIC

IT Risk Assessment

- Address all information assets (incl. hardware, software, data, connections, cloud services)
- Tie in with end-of-life management
- Identify source of threats (internal, external, service provider)
- Bring in controls and their effectiveness (to link inherent and residual risk)
- Provide overall (H/M/L) rating

Cybersecurity

- FDIC expects cybersecurity to be integrated into the IS Program and the IT/IS audit plan
- Preparation of Cybersecurity Assessment Tool
- Multi-layer controls to prevent hackers from destroying your data, your replicated environment, and your back-up
- For critical vendors, you need to understand their cybersecurity resilience, safeguards, etc.
- Info sharing (e.g., FS-ISAC, US-CERT), educating employees

BCP/DRP

- Plan components:
 - Plan may contain out of date information
 - Ensure recovery procedures are in place for critical business functions, incl. back-up power and staff
 - Alternate site not too close to head office
- Importance of regular and comprehensive tests:
 - Run cyber-threats, including key vendor contract obligations (per FDIC testing guidance)
 - Include transactional testing for alternate site test
 - Tabletop testing on pandemic outbreak
 - Define DR test success criteria – e.g., compare actual recovery times with RTOs

Vendor Management

- Risk assessment for each vendor
- Robust due diligence (with contract checklist), plus timely, ongoing, risk-based monitoring
- It's not just IT service providers, and it's not just high risk vendors
- Ask for regulatory reports on critical vendors (e.g., core providers, BSA-related services)
- Other reviews: CS awareness, audit results, BCP test results, SLA compliance
- Not just a check-the-box review
- Vendor contracts: IS breaches, confidentiality

ID Theft / Red Flags

- Training, especially for new hires
- Annual update of ID Theft risk assessment and policy
- Annual ID Theft/Red Flags report to the Board
- Review of core processor's compliance with ID Theft/Red Flags requirements

Access Issues

- Annual review of user access rights on all critical systems
- Isolate security cameras, ATMs, VOIP devices to a separate network
- Independent administrator activity review for critical systems
- Shared system administrator credentials
- Delete access for terminated users

Other IT Issues

- Periodic review of firewall rules
- Social engineering should test all employees
- Pen test frequency driven by IT Risk Assessment, but moving towards quarterly scans
- Corrective action tracking of pen tests results, with Board sign-off for risk acceptance
- Develop formal document imaging policy
- Expand patch management policy to outline timeframes based on criticality of the patch

Other IT Issues – Cont'd

- Hardening policy:
 - Change default credentials and default configurations
 - Unauthorized software installs
 - Remove unnecessary programs
- Background checks on contractors as well as employees
- Mobile devices not configured with standard security controls
- External hard drives used for back-up rotation not encrypted

EFT – General Issues

- Risk assessments for all EFT services and E-Banking applications: cash management (RDC, ACH, wires), online banking, mobile banking, merchant card services, etc.
- New risk assessment required for new service offering or converting to a new service provider
- Ensure policies reflect current practices (e.g., uncollected funds, suspicious activity reporting to BSA department)

EFT – General Issues (Cont'd)

- Ensure customer due diligence is completed and well documented
- Common examiner findings include:
 - Missing date of execution in cash management agreements
 - No record for new RDC customer training
 - Lack of wire transfer agreement for not-in-person wire transfers

Wires: Fraud Risk Concerns

- Wire Transfer Policy should be comprehensive, should reflect actual practice (e.g., current system used), should be supported by written procedures for processing wires
- Separation of duties:
 - Incoming wires: between receipt of wire vs. posting to customer account
 - Outgoing wires: between enterer vs. verifier, between oversight vs. reconciliation functions, between balancing vs. servicing of FRB and correspondent accounts

Wire Transfers – Cont'd

- Outgoing wires:
 - Only allow e-banking or fax as a submission channel; avoid e-mail and telephone (high fraud risk)
 - Perform callback on a different communication channel (e.g., telephone callback for e-banking wires)
 - Enable call-back feature when processing manual wire transfer telephone request from correspondent
- Ensure client wire transfer agreement is in place
- Have dual (back-up) wire system/channel – e.g., Fedline plus PCBB or Wells Fargo
- Remove unnecessary wire users
- At least annual testing on DR wire system

Remote Deposit Capture

- Daily limits
- Educate customers re handling/disposition of remotely deposited checks
- Periodic monitoring of high risk customers (once or twice a year is acceptable), duly documented
- BSA department review before accepting new RDC customer

EFT – Other Concerns

- Online Banking, Mobile Banking:
 - Implement MFA controls
 - Ensure completed cash management agreements
 - Address “jail-broken” phones (= privilege escalation to get around software restrictions imposed by Apple and Android)
- Automated Clearing House (ACH):
 - Doesn’t get much examiner attention – rely on annual WesPay self-audit
 - Watch controls over IATs (international ACH transactions)

Operations, Administration

- Generally low risk profile (e.g., infrequent S&S exam report attention)
- Certifications program does get attention: it provides ongoing assurance to management and Board re effectiveness of internal controls
- Audit to ensure key G/L accounts and functions get certified (accurately, regularly)
- Segregate certifications from accounting and operational duties
- Segregation of duties always a challenge for small FIs (sharing, cross-training)
- Dormant controls, incl. timely escheatment

Other Ops/Admin Concerns

- Controls over garnishment processing
- Multi-branch FIs: Does Central Ops set branch procedures (see below) and perform oversight function (e.g., exception monitoring, loss monitoring, large item review)?
- New account opening: CIP/KYC
- Also: branch staff knowledge of BSA/AML
- Branch security
- Two-week vacation for sensitive positions
- Call Report errors
- Timely charge-off of suspense items, O/Ds

And Finally ... Written Procedures

- Having comprehensive and up-to-date written procedures is an important discipline:
 - Responsibility
 - Accountability
 - Continuity
 - Consistency
 - Education/training
- Should be reviewed and approved by senior manager – but (unlike policies) Board approval not necessary

Appendix:

***Overview of
AuditOne LLC***

AuditOne: Who We Are

- A high-quality, cost-effective provider of outsourced internal audit and credit review services, plus related advisory work
- Around 300 clients nationally, most of them community banks or credit unions and based mainly in the Western states
- We are the largest firm in the Western US focused on internal audit services for FIs
- Close to 40 professional employees, with a broad and deep range of banking expertise; our staff averages 25+ years of relevant experience

A Full-Service Menu

- Credit/ALLL
- Compliance/BSA
- IT/IS
- Operations/Administration
- Asset/Liability Management
- We also offer advisory services (via our affiliate, Insight Risk Consulting), as well as set-up and testing for both Sarbanes-Oxley Section 404 and FDICIA 36

Our Management Team

- Bud Genovese, Chairman
- Jeremy Taylor, Co-CEO (Northern clients)
- Kevin Watson, Co-CEO (Southern clients)
- Ling Genovese, CFO
- Angela Canda, Office Manager
- Practice Directors:
 - Celeste Burton, Compliance
 - Kevin Tsuei, Technology
 - Brock Williamson, Credit
 - Gary Andreini, Operations
 - David Kellerman, ALM
 - Genelle Wrzesinski, EFT

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