



DIRECTORS BRIEFING

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Known Risk Indicators Enrich Quality of AML Board Reports

How can bank directors equip themselves to do the best job possible when it comes to approving compliance programs and policies for anti-money laundering and other financial crimes?

Part of the answer is to insist on incisive, reliable and understandable information. Because of the complexity and potential risks of AML violations, boards and their risk committees require clear and effective reporting built on a foundation of excellent metrics of known risk indicators, or KRIs.

“Many mid-size and community banks could do a better job of raising the level of reporting to an executive-summary level,” said Clayton Mitchell, a principal in the financial services practice of Crowe, LLP in Indianapolis. And more, of course, is not necessarily better. “The goal is to tell the board what is important and why it matters. If you are relying on your risk assessment to inform your board with tens or even hundreds of pages, chances are high that the board won’t get the message.”

If directors are looking at the review of AML board reporting and the underlying data as a compliance exercise where they have to review and approve a report and move on, they risk missing the boat, Mitchell added. “They need to credibly challenge the

data to understand what the risks are, determine how they align to business strategy, and how the management is mitigating these risks, within the confines of the defined risk appetite,” he said.

In a recent briefing for ABA members, two banking industry compliance executives outlined how to ensure the quality of KRIs and other metrics for senior management and the board. This includes knowing the source of the data, knowing how often it is updated, validating it, and expecting scrutiny.

“KRI reporting is absolutely critical for conveying the complexities around the AML program succinctly and well to management to get the support you need,” said Megan Hodge, executive compliance director at Ally Financial. “It’s not just about filling out a template when it’s due. Strong reporting facilitates governance to communicate with leadership.” The goal is to “make sure AML is well understood within the organization and that you have the right level of support to execute on the AML program.”

The compliance team that is responsible for developing reporting should envision its audience as occupying three distinct levels of a pyramid.

Risk Indicators (Continued on page 2)

SPECIAL REPORT

Regulatory Relief: What Directors Should Ask Next

Culminating an eight-year effort to right-size banking regulation, Congress has adopted an important regulatory relief bill sought by ABA.

The Economic Growth, Regulatory Relief, and Consumer Protection Act (S. 2155) was signed into law by President Trump on May 24 following bipartisan votes of 67–31 in the Senate and 258–159 in the House.

Directors Briefing expands coverage in this issue to examine the legislation from the perspective of bank directors. We look at reciprocal deposits (page 5), growth strategies and mortgage opportunities (page 6), and other topics, especially for community banks. While the report beginning on page 4 is not comprehensive, we hope it will help directors begin to unfold the implications of this important legislation. 

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OCC Cites Risk in Rate-Hike Ripples

How will bank deposits react to rising interest rates? Uncertainty over the answer to this question makes rising rates a growing risk for banks, the OCC said in its Semiannual Risk Perspective Report, issued May 24.

“Banks may experience unexpected adverse shifts in liability mix or increasing costs that may adversely affect earnings or increase liquidity risk,” the OCC said. The agency noted that banks have acquired historically high levels of non-maturity deposits amid low interest rates in the past decade, and that competitive pressures could further drive up costs of deposits as interest rates climb.

Overall, the health of the financial system remains strong, the OCC said, citing sound asset quality, capital near historical levels, and improving earnings as positive indicators. However, credit risk remains a top concern. The report noted that banks and nonbanks continue to ease underwriting standards as they compete for quality loans. Also, concentrations continue to grow, particularly in commercial real estate.

The OCC said it remains concerned about operational risks, particularly as banks transition to new technology systems and processes and as cyber threats evolve. The OCC highlighted the importance of having effective cyber controls in place and a strong vendor risk management framework to ensure banks conduct due diligence when engaging with third-party service providers.

Compliance risk also continued to be a key supervisory priority. The OCC encouraged banks to focus on ensuring that their Bank Secrecy Act/anti-money laundering compliance programs are up to date. ∞

RISK INDICATORS

(Continued from page 1)

Hands-on professionals—line-of-business managers and risk managers who make up the first and second lines of defense—form the bottom layer, with management committees in the middle, and the board and its committee at the top. The same core data should be used to drive reporting to all three audiences, said Tyler Reynolds, senior director for enterprise finance crimes compliance policy and risk management at U.S. Bank.

Most boards recognize that “they are accountable for the whole program,” Reynolds said. But with so many issues vying for board attention, directors depend on management to deliver succinct reports tailored to their specific concerns, he added.

Effective board reporting on BSA/AML risks focuses on the overall health of the program by highlighting trends and summaries, Reynolds said. The bullet points or one-page summary that makes it to the board of directors are typically derived from 20 pages or more of core.

How much information the board needs depends on “where you are in your AML journey,” Reynolds said. An institution that is working through adverse examination findings or enforcement actions related to AML generally requires more reporting than one without such worries.

Both the risk committee and the full board should come away from any AML briefing with a grasp of how management is executing and maintaining the program, what training is occurring, and what issues are being addressed at the moment, Reynolds said.

Every board has a different philosophy, Hodge said. One board may want to see a green/yellow/red stoplight report, while another may want one-page narratives. “With some boards, you’d better

come in with no more than five bullet points,” she added. The most important thing is to substantiate the overall rating of the program, Hodge said. “You really need to pin down what is causing risks and issues.”

Directors should probe to understand what constitutes acceptable performance, because the answer isn’t always intuitive, Hodge said. For example, Suspicious Activity Reports must be filed within 30 days of determining the need to do so. “An untrained person might see a 95 percent on-time filing rate and say, ‘95 percent—that’s an A!’” But regulators may not be tolerant of late-filing rates of more than zero to 2 percent, she added. ∞



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View from the Top —

A Conversation with OCC's Beth Knickerbocker

Beth Knickerbocker brings a rare blend of skills, knowledge and insight to her role as the OCC's chief innovation officer. For more than 25 years, she has been a lawyer, a regulator, a bank chief risk officer, and an association official. She is familiar to ABA members as vice president and senior counsel in the ABA's office of regulatory policy from 2012 to 2014.

Knickerbocker began her career in 1992 as an OCC attorney. In 2000, she became a senior associate in the law firm Sutherland Asbill & Brennan LLP. She joined Marshall & Ilsley Corp. in 2004, becoming its chief risk officer before joining ABA in 2012. She returned to the OCC as special counsel in 2014 and was named acting chief innovation officer in 2016 before officially taking on the role in 2017. Directors Briefing recently chatted with Knickerbocker about the Office of Innovation and its mission.

What is the role of the OCC Office of Innovation?

We're a clearing house for issues related to innovation in financial services and emerging trends, and a central point of contact on these topics. We engage with the industry and all stakeholders to improve understanding of developments such as financial technology. We also work with examiners and supervisors, providing materials, sharing research, and performing training. Last year, we helped recast the OCC's FAQs on third-party risk management.

We often spend time with bank directors, and we also host outreach events called "office hours." Participants can sit down with OCC officials for an hour to discuss fintech and new products and services, and

we talk about responsible innovation. We'll host these listening sessions in San Francisco during July and in Denver during August.

What does innovation mean in a banking context?

People tend to view financial services as not cutting edge, but I would challenge that. Innovation has been vital to banking's evolution for 150 years. The advent of ATMs and internet banking are clear examples of revolutionary changes.

What's different now is the speed at which technology can help the industry evolve. Innovation is driven by demographic changes and customers' shifting expectations for how they want to manage money. Mobile banking is a prime example.

Community banks are a part of this trend, and if they are not yet focused on innovation strategies, they probably should be. Their customers increasingly expect to be able to engage in transactions and make financial decisions 24/7.

What kinds of products and services are ripe for innovation?

Consumers are embracing the ability to perform person-to-person financial transactions using digital wallets like Venmo and Zelle. And the surge in small business has created many sole proprietorships and companies with one or two employees that want to perform transactions and get capital and liquidity funding almost



Beth Knickerbocker

instantaneously. We monitor all these developments and offer technical assistance to help banks ensure that no matter what technology they pursue, they implement it in a safe and sound way.

What can bank directors do to help their institutions innovate safely and soundly?

A fundamental step in the bank's journey to innovation is to look at its business model and strategy to decide where the bank is and where it's going. Board members can ask, Who are

today's bank's customers, and who will they be in five to 10 years? What services will they need? Directors have insight into their communities and have a lot to offer regarding these questions.

It's been said that it's natural to overestimate what can be done in a year and underestimate what can be done in five to 10 years. Technology is moving so fast, and not every new product or service can be ready for prime time in a year or

two. Implementation takes time, particularly if the bank's core processing system is involved.

We encourage banks that are developing new products and services to reach out to us, because waiting to see how an innovation works out can be disruptive. We saw during the financial crisis how some products and services that were considered innovative ended up creating significant risk and causing consumer harm, and nobody wants that to happen again. 



'People tend to view financial services as not cutting edge, but I would challenge that. Innovation has been vital to banking's evolution for 150 years.'

Inquisitive Directors Needed as Reg Relief Arrives

Now that the regulatory relief bill has become law, banks, their customers and their communities stand to reap significant benefits. Directors can expect to hear more about the law's implications at board meetings in the weeks and months to come, as managers analyze business opportunities and regulators draft rules to implement many of the changes.

"At our next board meetings, we will be talking about the regulatory relief law in a macro sense. As details flow out, we will discuss it in a more micro sense," said Jeff Plagge, president and CEO of Northwest Financial Corp., Arnolds Park, Iowa.

Northwest Financial Corp. owns banks that are \$250 million and \$1.6 billion in assets, and the larger bank will benefit from a provision that institutes longer exam cycles for community banks, Plagge said. One immediate implication may be that Northwest will sync up its third-party loan review process to take place in the middle of this new cycle, he added.

Bank directors should be inquisitive, probing how the bank benefits and what it can be doing to take advantage of changes. One area of immediate interest is capital, said John Bowman, a partner in the law firm Dinsmore in Washington, D.C., and former director of the Office of Thrift Supervision. He noted that the law includes a simple leverage ratio that could reduce reporting burdens for thousands of community banks.

"If I were on the board of a

community bank with assets of \$10 billion or less, I'd look at those capital simplification provisions," Bowman



Bank directors should be probing how the bank benefits and what it can be doing to take advantage of changes.

said. "It means you don't have to fool around with Basel III calculations, which have been a thorn in the side of community banks for some time. A caveat is how long it is going to take the regulators to develop the regulations to implement this provision."

ABA President and CEO Rob Nichols described the legislation as both an important victory and a first step in a more favorable era for

banking regulation. The bill became law as several new banking regulators were taking office, he noted. "They will work collaboratively with us on other regulatory changes to properly tailor the rules over the nation's banking system," Nichols said in a May 29 webinar for ABA members.

"Moving fast to take advantage of regulatory relief should be top of mind for boards," said Onker Basu, a senior director with Cornerstone Advisors, Scottsdale, Ariz. "I believe there will be first-mover advantage for banks that are able to assess and take

advantage of the provisions that best apply to their individual institution."

Basu said the most important element of the bill is Section 401, which raises the threshold for applying enhanced prudential standards from \$50 billion to \$250 billion. While regional to large banking companies are the target of this relief measure, any regulatory burden relief provides oxygen to the industry as a whole, Basu said. Additionally, the relaxation of some of the provisions from Dodd-Frank, the Volcker Rule and other relief measures for small banks under the \$10 billion threshold will provide opportunity for redeployment of capital.

In other key provisions, the law:

- Provides qualified mortgage designation for most mortgages held in portfolio by banks with less than \$10 billion in assets.
- Applies principles of tailored supervision to larger banks.
- Ends mandated stress tests for banks with under \$100 billion in assets.
- Provides relief from appraisal requirements for smaller mortgages.
- Provides charter flexibility for federal thrifts with less than \$20 billion in assets.
- Provides relief from the Volcker Rule for most community banks. 

Directors Briefing Newsletter Seeking Your Input

Directors Briefing is looking for a several bankers who would like to participate in two or three teleconferences a year as an advisory committee. The *Directors Briefing* team and editor Debra Cope are seeking your ideas on content for future issues. *What would your directors like to read? How else can ABA support your bank board?* If interested, please contact ABA's Carrie Clark (cclark@aba.com).

Law Improves Treatment of Reciprocal Deposits

One key provision of S. 2155 that has received little publicity so far is Section 202. Under Section 202, which became effective when the president signed S. 2155, most reciprocal deposits are no longer considered brokered. ABA officially supported the legislation that became Section 202.

ABA endorses two reciprocal deposit services—CDARS and Insured Cash Sweep, or ICS—offered by Promontory Interfinancial Network, LLC.

The new law permits a well-capitalized bank with a CAMELS rating of 1 or 2 to hold reciprocal deposits up to the lesser of 20 percent of its total liabilities or \$5 billion without those deposits being treated as brokered. (Reciprocal deposits at a bank above these amounts are also permitted, but remain brokered.)

In addition, a bank that drops below well-capitalized is no longer required to obtain a waiver from the FDIC to continue accepting reciprocal deposits, as long as it does not accept an amount that would cause its total reciprocal deposits to exceed a previous four-quarter average.

For banks that hesitated to offer or to take full advantage of reciprocal deposits through services such as CDARS and ICS because regulators treated all such deposits as brokered, a big concern is now removed.

Banks—especially community banks—should welcome this legislative change, which comes at a critical time.

Two factors have changed the deposit landscape and are continuing to change it, shaping it into something different from anything seen before.



Under Section 202 most reciprocal deposits are no longer considered brokered.

First, an unintended consequence of recent Basel Committee liquidity rules has been to place far more value on retail deposits for the large banks covered by the rules. Consequently, the largest banks have focused on—and invested in—retail deposit-gathering, creating ferocious competition.

Second, the much-increased competition is heightened by technology that enables any financial institution anywhere to solicit a bank's local retail deposits, which are the deposits that smaller banks have traditionally used to fund their lending.

Community banks are therefore finding it important to expand their efforts in nonretail deposits, where there is less competition. They are also recognizing that they need to change their deposit mix to give more

emphasis to corporate and public-unit deposits.

Reciprocal deposits can help banks succeed in these efforts and keep their local money working locally. And the change in law that makes most reciprocal deposits non-brokered makes their use by banks even more attractive.

Questions for bank directors to ask at the next board meeting are:

- Does our bank have the best tools to target nonretail deposits, and is it using them as well as it could be?
- Is there more that our bank can do with reciprocal deposits, now that most reciprocal deposits are considered nonbrokered?

In addition to pursuing these questions, directors should ensure that the bank carefully reviews its liability policies to ensure that they enable management—and especially the management level ALCO committee—to give reciprocal deposits the consideration they deserve. 

Doing Regulation Requires Adjustments

Regulatory relief is welcome news for banks, but that doesn't mean there are no adjustments to make. For the past decade, banks have been adopting structural changes to comply with a raft of new regulatory requirements under the Dodd-Frank Act.

Now, as regulatory requirements unwind, banks may want to reconsider some decisions, said Alma Angotti, managing director and co-lead of the Global Investigations & Compliance practice at Navigant. Or she said, “they may decide to take the very conservative approach of continuing to comply, even in the face of regulatory relief.” The recently withdrawn

fiduciary rule, which applies to retirement accounts, is an example. Some banks will continue to comply “because they think regulatory relief might be temporary, or because it might be in the best interest of the bank or a better fit with the institution's risk appetite,” Angotti said.

The board should ask how the bank management intends to respond to the ramp-down in regulatory requirements. Will products and services or the customer base change? What happens if the answer is yes? Are there any compliance-related changes that can now be reversed, either because of cost or risk? 

Obstacles to Growth Diminish for Most Banks

For growth-minded bank holding companies, mergers and acquisitions could get a boost from the enactment of the regulatory reform law, according to Onker Basu, a senior director with Cornerstone Advisors, a financial services consulting and research firm based in Scottsdale, Ariz.

The Dodd-Frank Act has exerted a drag on bank M&A since its enactment in 2010 because it imposed progressively more intense compliance requirements on bank holding companies that crossed the \$10 billion or \$50 billion asset threshold, Basu said. Under the new law, moving up an asset tier



The law should enable many banks to redirect compliance spending to growth.

will be a less complicated decision for most bank holding companies, he continued, adding that the law should enable many banks to redirect compliance spending to growth.

“The passage of this bill, coupled with tax reform and the overall positive sentiment on the economy, provides a significant platform for profitable growth that should be taken advantage

of in the next 12 to 18 months,” Basu said, adding that banks under \$10 billion in assets should see more M&A opportunities.

Basu described Section 401—titled “Tailoring Regulations for

Certain Bank Holding Companies”—as the most significant piece of the bill. The legislation “signals a step towards allowing the smaller banks to compete more effectively with large banks and fintech disruptors” by reducing both the explicit and hidden costs of compliance for those institutions, he said.

Since 2010, Basu noted, the focus on managing to a constantly changing regulatory landscape “has consumed board attention because of the reputation risk and potential fines that could be levied by the regulators.” He called this an “over-emphasis on regulatory compliance activities both from a process and technology standpoint,” and said it had made it increasingly difficult for bank holding companies to operate in the \$10 billion to \$50 billion-asset range, as well as at the next threshold of \$50 billion and up.

Boards should direct their attention to how to best resize their risk activities to invest in revenue generation and growth, given that regulatory compliance activities should be reduced, Basu advised. Boards should also direct the management team to develop an action plan detailing how they would take advantage of the various provisions in the bill.

Some important questions to ask include:

- How does management view the impact of the bill in terms of the current risk related activities?
- How would they reduce the cost of compliance activities without increasing operational risk?
- How would they plan to drive growth in the mortgage business given the provisions in the bill?
- How would they use digital banking to increase the level of customer acquisition and the deposit base? ∞

More Portfolio Loans Will Meet QM Rule

As community bank boards absorb the regulatory relief legislation, one of their first challenges will be to get a handle on new business opportunities in mortgage lending, experts said.

Most mortgages held in portfolio by banks with less than \$10 billion in assets would be designated as “Qualified Mortgages” under the regulatory relief law. The distinction is important to banks because QM loans enjoy more liability protection.

ABA Chairman Kenneth L. Burgess said he is optimistic that his bank—FirstCapital Bank of Texas—will be able to expand mortgage lending. “One of the biggest concerns our bank has had since Dodd-Frank passed was that we had much less ability to make mortgage loans to people who are retired or to small business owners,” Burgess explained.

Regulatory action may be

required to implement the expansion of safe-harbor rules for Qualified Mortgages made by banks with less than \$10 billion in assets.

“What this does is it opens things up. It makes more loans available to people in new jobs or with variable income, and gives banks more flexibility to make mortgages,” said ABA EVP Bob Davis. What has not changed is that qualified mortgages may not carry features such as prepayment penalties, negative amortization, and interest-only payment terms, he added.

Davis noted that several other mortgage provisions should be welcomed by bankers. For example, banks that make fewer than 500 mortgages will be able to meet Home Mortgage Disclosure Act requirements using smaller data sets and at lower costs than more active mortgage lenders. ∞

Fed Spotlights Financial Fitness of U.S. Households

Understanding a bank's customers and the economic environment is a constant priority for boards of directors. A recent publication from Federal Reserve staff offers information and insights that can help directors to stay informed about trends that are shaping household finances.

The *Report on the Economic Well-Being of U.S. Households in 2017* surveys individuals' attitudes toward banking and credit, dealing with unexpected expenses, income, employment, and retirement, among other topics. The 56-page report draws on more than 12,000 interviews with a wide range of U.S. adults, ages 18 and older, who are representative of the population as a whole.

In a key finding, the report found that 74 percent of U.S. adults that were surveyed in November and December 2017 said they are "doing okay" or "living comfortably." This figure is up eleven points from 2013, when the survey began. Meanwhile, 19 percent in 2017 said they were "just getting by," and 7 percent said it was difficult to get by financially.

The Fed also reported that four in 10 adults had applied for credit during 2017—similar to the share in 2016—and 32 percent of those households were turned down or given less credit than they applied for. In addition, one in nine adults said they put off applying for at least some form of credit because they thought they would be turned down.

The rate at which individuals were denied or offered less credit than requested varied by the type of credit application. Among credit card applicants, 34 percent had this adverse outcome, versus 16 percent of auto loan applicants.

Denial rates also differed by family income, race, and ethnicity. Lower-income individuals were more likely to experience adverse outcomes on credit applications than those with higher incomes. Among applicants with incomes under \$40,000, 39 percent were denied credit versus 10 percent of applicants with incomes over \$100,000. Within each income

bracket, black and Hispanic individuals were more likely to report an adverse credit outcome.

In a section covering savings practices, seven in 10 respondents said they could cover three months of expenses from savings alone or from a combination of savings, assets and credit if they lost their main source of income. Seventeen percent said their spending in the previous month exceeded their income, down slightly from 2014. The survey found that 25 percent of non-retired respondents had retirement savings or pension, including 13 percent of those over age 60.

One striking finding was that four in 10 American adults said they would be hard-pressed to cover an unexpected expense of \$400. They would either not be able to cover it, or would have to sell something or borrow money to meet the expense. This nevertheless represents an improvement from 2013, when half of adults said it would be difficult or impossible to cover a \$400 expense. 



Four in 10 adults would struggle to cover a \$400 emergency expense.



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This special eight-page issue covers the implications of the S. 2155 legislation.

Mutuality Remains Important Differentiator for One in 12 Banks

Mutual banks are going strong in 2018, totaling nearly 500 institutions that account for 8.7 percent of all FDIC-insured banks. And according to the 2018 ABA Mutual Survey, mutuality plays an important role in their differentiation strategy.

In all, 494 financial institutions, including 160 holding companies, were organized as mutuals as of year-end 2017, with combined assets of \$268.6 billion.

“Mutuals failed at a slower rate and also combined at a slower rate than other institutions,” pushing



‘Mutuals failed at a slower rate and also combined at a slower rate than other institutions.’

their share of total FDIC-insured assets up from 8.2 percent in 2007, said ABA EVP Bob Davis in a presentation on the state of mutual institutions. Davis spoke at the ABA Mutual Community Bank Forum, held in Washington, D.C., on April 23.

The annual survey of mutual financial institutions found that 87 percent believed mutuality was an important differentiator, and 77 percent believed their

regulator understood the concept of mutuality.

Thirty-two percent of the survey

participants were organized as mutual holding companies, a corporate governance structure that affords institutions some flexibility in accessing capital markets.

Mutuals are benefiting from operating in a “better economic environment with less of a regulatory burden,” said Bradford C. Paige, president and CEO of Kennebunk Savings, a \$1.1 billion-asset mutual in Kennebunk, Maine, who spoke alongside Davis at the Mutual Forum.

One trend that appears to be gaining is institutions using the mutual holding company structure to combine with other institutions while maintaining separate identities, Paige noted. 