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Re: Federal Reserve Bank of New York Observations about Recent Examinations

Today I attended a seminar where a Senior Examiner from the Federal Reserve Bank of New York gave a talk on some of the things that the Fed is seeing in recent examinations and some of the things they want to stress to banks that are preparing for examinations.

Enforcement Actions. The Fed has 113 public enforcement actions pending and many more private actions ongoing. Many banks with such actions ongoing want to have the actions lifted as soon as possible. The Fed notes that many banks may address the issues that are the subject of the action, but slip up in other areas. Surprisingly, the Fed has seen a number of banks fail to comply with the conditions of the enforcement actions. This may be due to a number of factors, but often it has to do with loss of key staff, especially in the compliance area. The Fed is generally unwilling to lift an action until a bank is running smoothly in all areas not just where the action applied. In addition, before lifting an action, the Fed wants to see sustained performance under the enforcement action over a realistic period of time.

Senior Management. The Fed has been overall pleased with the involvement of senior management with compliance. The Examiner noted that multi-million dollar fines and the threat of criminal penalties reach the attention of senior management. While the Fed notes that senior management is saying the right things, the Fed wants to see that this tone trickles down to the staff at the Bank. Examinations will review whether the message from top management is being effectively implemented at the staff level.

Derisking. While this may not be a word, the Fed examiner used it to describe a recent phenomenon whereby banks exit so-called “high risk” businesses. The Examiner cited dollar clearing as one such activity. Many banks blame the Fed for chasing them out of these businesses. The Examiner stated that the Fed has no policy or practice to discourage banks from engaging in certain activities. It is the responsibility of the banks to insure they conduct their activities in accordance with law and safe operational standards.

Examination Red Flags. The Examiner cited a few items that cause examiners to look more closely at a bank:

Loss of key staff members or reductions in staff—the Fed is aware that compliance is a hot employment area—he termed it a "merry-go-round."

Failure to follow the advice of consultants or lawyers—the Fed sees many instances of banks obtaining expert help and then ignoring it.

Adoption of new systems—banks often fail to integrate properly new systems.

Use of outside independent testing firms—Examiners will review whether the contracts are properly concluded and that the bank internally has done a complete job on setting parameters for the outside firm.

Assuming that "low risk" activities are so riskless that monitoring can be patchwork.

Using too many spreadsheets for compliance may be an issue depending on the scope and frequency of transactions.

Internal Audit. As part of an examination, the first thing the examiners look at are internal audit reports. If a bank is not doing a yearly audit, that decision must be carefully risk-weighted and defined. The Examiner suggested that doing some targeted audits between comprehensive internal audits might give a bank some leeway on audit frequency. It is important that any comprehensive internal audit report contain an assessment of a bank's whole program—a so-called "roll-up." This insures that the individual audits of particular areas do not result in missing the big picture.

Customer Due Diligence. Almost all banks have some sort of system for this purpose, but the Fed is concerned that not enough effort is spent on reevaluating customers—a so-called "refresher." Some banks do this on schedules for example every year for high-risk customers, but many banks do not do it at all. The Fed wants to see this done regularly and also have trigger events that signal even more frequent refreshers.

Automated Transaction Monitoring. The Fed wants to know if a bank is using the most recent version of the system, and if not, why not. Has the bank determined that its system is working with all of the bank's systems. Does the monitoring cover all the transactions conducted by the bank. The Fed finds many banks are using systems that are not tailored for those banks and do not properly cover the applicable business areas.

Look-backs. The Examiner was amazed to learn that one of the hardest parts of doing a look-back for some banks was to insure that all the relevant transactions were captured. This demonstrated that certain banks could not possibly be evaluating all their transactions. A look-back is only as good as the data that is being evaluated. A comprehensive IT audit is usually necessary to insure that all systems are properly reporting and working together.

Training. Examiners always look at training plans and programs. All new staff needs to be trained. Compliance needs specialized training and a lot of it. Training needs to be done using a bank's own forms and using a bank's own procedures. A bank needs to review constantly whether training needs to be "refreshed" for its staff.

OFAC. The Examiner said that the Fed is being more critical of pithy and blunt assessments of alerts—they want to see more of a narrative on why something is not a problem. A statement such as “no issue” will not be sufficient. The examiners will make sure that banks are reviewing their “good guy” lists not only in terms of how they add to the list, but how people who are on the list can stay there.

R.C.A.