

AuditOne Advisory

From Bud Genovese, CEO

We at AuditOne are spending quite a bit of time monitoring and reporting on the hot spots of regulatory focus in order to help banks improve the efficiency and effectiveness of their internal audit programs. We keep a close watch on our clients' examination experiences, and have recently partnered with Western Independent Bankers (WIB) to conduct a survey of banks on this subject. Along these lines, below is a recent article written by AuditOne President Kevin K. Watson that first appeared in WIB's March 2008 Directors Digest.

Top Ten Regulatory Hot Spots Bank Directors Must Watch

By Kevin K. Watson

Today's bank director is faced with an increasingly tough job. Not only have the standards of responsibility and liability been raised, but there's also a seemingly endless flow of information on shifting regulatory requirements and nuance to wade through. What bank directors need is a way to zero in on what really matters, and the place where the regulatory rubber meets the road is the examination report.

Based on our reviews of numerous examination reports, we have determined what we believe to be today's top ten examination hot spots. Since risk management dollars are limited, a sensible approach is to work your way down the top ten list, ensuring that risk management resources are in place. The goal is to increase the bang for your buck. Of course, bank directors should maintain due diligence on all areas of regulatory compliance, but paying attention to this list will improve the cost effectiveness of the risk management function and reduce the risk of regulatory madness.

1. Bank Secrecy Act (BSA)

BSA isn't going away. Examiners are especially noting shortcomings in customer due diligence/enhanced due diligence policy and practices. In addition, other BSA program elements are still garnering attention, including BSA training, independent testing, Suspicious Activity Reports, official designation and qualifications of the BSA Officer, and finally, the BSA risk assessment.

2. FFIEC Interagency Guidelines on Commercial Real Estate Concentrations

Since real estate concentrations will tend to magnify the negative impact of an economic downturn, examiners are holding banks accountable for compliance with the 2006 Interagency Guidelines on Commercial Real Estate Concentrations. Those institutions with real estate portfolios greater than 300% of capital are expected to perform a number of additional risk management procedures including increasing the frequency and type of stress tests to include not only interest rate, but also other indicators such as appraisals and vacancy rates.

3. ALLL Adequacy

As a result of loan portfolio deterioration from subprime meltdown and spill over, examiners are looking at banks closely to determine the potential for serious loan quality problems. Loan problems inevitably manifest in provisions to the ALLL. The focus for examiners is to ensure the problems are identified now instead of in the future. Examiners are directing more resources toward the reasonableness of loan grades as well as compliance with the 2006 Interagency guidance on the ALLL. One of the guidelines requires a periodic independent validation of the ALLL methodology. Examiners will also look closely at the scope, frequency and quality of loan review engagements.

4. Liquidity

The economic downturn catalyzed by the subprime meltdown has exposed some liquidity concerns for some institutions. Examiners have been pointing out shortcomings in the liquidity management and reporting process as well as the over reliance on wholesale funding. Banks with tight liquidity ratios should ensure that liquidity policies are appropriate, liquidity measures are relevant and accurately calculated, and that management and board reporting is adequate.

5. Investments

We have noticed increased examiner attention to investment portfolio management practices manifested in a variety of criticisms, generally related to approval and oversight. Directors are expected to establish strategic direction and risk tolerance limits, review portfolio activity, and monitor compliance with policy limits.

6. Interest Rate Risk

IRR management practices need to be comprehensive, including sensitivity testing of the impact on net interest income and the economic value of equity. Exceptions need to be reported in Board minutes.

7. Call Reports

Examiners have been reviewing call reports thoroughly and pointing out classification errors as well as the need for improved supporting workpapers.

8. Audit Committee independence

At a minimum, Audit Committee meetings should have a closed session portion conducted without the presence of management, particularly when hearing from third party auditors. This session should be documented in the minutes.

9. Business Continuity/Disaster Recovery Plans

Examiners are taking a close look at Business Continuity Plans. BCPs are time-consuming to develop, especially for de novo institutions, but Hurricane Katrina illustrated the importance of having one in place and tested annually.

10. Other Hot Spots

There are a number of other areas receiving examiner attention that share the number ten ranking. These include Community Reinvestment Act, Wire Transfer systems, Information Security compliance, and adequacy of internal audit scope and plans. We also anticipate a search by examiners for the existence of unfair practices, especially at mortgage and credit card lenders.

Bud Genovese is founder and CEO of AuditOne LLC, a California-based internal audit firm that focuses only on banks and their service providers. Mr. Genovese pioneered the concept of providing comprehensive, affordable, independent internal audit services by gathering wide-ranging, extraordinary expertise within one firm. AuditOne now serves over 140 clients throughout the Western United States, and nationally. Contact Bud Genovese at 408-980-8099 or bud.genovese@audit-one.com