Supervisory Spotlight

A Regulator's Perspective on Issues Facing Western Banks

Banking Supervision & Regulation
Federal Reserve Bank of San Francisco

June 2014

Greetings!

We recently held our Division's semiannual Risk Assessment Session, where we discussed a variety of risks that challenge our Twelfth District bankers. It probably isn't a surprise to you that the top three risks facing community bankers in our district are the Bank Secrecy Act and anti-money laundering (BSA/AML), information security (and particularly cybersecurity), and interest rate risk. I shared some interest rate risk resources with you in the last Supervisory Spotlight and I recently covered cybersecurity in a special issue of Supervisory Spotlight. So, I'd like to focus in this issue on the other top risk, BSA/AML, as well as share some thoughts on mergers and acquisitions and the ALLL.

Over the past year, our examiners have observed that many community bankers are devoting more attention to BSA/AML compliance. But we are still identifying an array of BSA/AML internal control weaknesses in community banks, which indicates that continued diligence is needed. Some areas that may require additional attention include considering the BSA/AML risk of new products and services; better identifying potentially high-risk customer activities, such as operating private ATMs, money service businesses, and marijuana-related businesses; ensuring job-specific BSA/AML training for staff; and providing meaningful reporting to the board of directors or its appointed committee. The *Community Banking Connections* article, Assessing Inherent BSA/AML Risk at Community Banks, provides some valuable insight on this topic, and the last issue of Supervisory Spotlight provided resources about servicing marijuana-related businesses. More recently, on April 30, 2014, the Federal Reserve offered an Ask the Fed webinar, *General Themes and Observations from Bank Secrecy Act/Anti-Money Laundering (BSA/AML) Examinations*. If you were not able to participate in this webinar, you can view the archived presentation on the Ask the Fed website. Community bankers would be wise to ensure that all pillars of the bank's BSA/AML program are effective, particularly as weaknesses in the program will make it difficult for the institution to pursue expansionary activities.

Speaking of applications, I'd like to share some thoughts on recent merger activity and the applications process. Like other areas across the nation, we are seeing an increase in merger activity between banks of all sizes. We carefully review every merger application to ensure that the resulting institution will be positioned to operate in a safe and sound manner and that the application meets various statutory factors. SR letter 14-2/CA letter 14-1, Enhancing Transparency in the Federal Reserve's Applications Process, discusses common issues that have precluded the approval of various applications nationwide. In addition to familiarizing yourself with these common issues, I encourage you to review the applications information on our public website and to reach out to Applications Director Gerry Tsai or Applications Manager Elisa Johnson to discuss your proposal before filing an application. Also, SR letter 12-12/CA letter 12-11, Implementation of a New Process for Requesting Guidance from the Federal Reserve Regarding Bank and Nonbank Acquisitions and Other Proposals, describes our more formal application pre-filing process in more detail.

I'd like to close with some thoughts on a topic of perennial interest: the allowance for loan and lease losses (ALLL). Over the past year or so, we've noticed that many Twelfth District financial indicators are returning to "normal" levels, as discussed in the First Quarter 2014 First Glance 12L. As credit conditions improve, many bankers are reassessing the level of the ALLL, and the appropriateness of zero and negative provisions was a topic of much discussion at our recent roundtables with Twelfth District CFOs and their external auditors. The First Quarter 2013 *Community Banking Connections* article, Reversing the Trend: An Examiner's Thoughts About Negative Provisions and the ALLL, provides a good overview of how Federal Reserve examiners will evaluate the appropriateness of negative ALLL provisions. Clearly, each institution's decision on provisioning must be based on its unique circumstances, and I encourage you to discuss any questions on zero or negative provisioning with your primary supervisor and your external auditor.

As always, I appreciate feedback and suggestions for topics that are of particular concern to your institutions.

Best regards,

Teresa Curran

Teresa.Curran@sf.frb.org

Resources

You can view additional *Community Banking Connections* articles and subscribe to an electronic or hard copy of the publication at http://www.communitybankingconnections.org/. You can also view additional *Consumer Compliance Outlook* articles and subscribe to that publication at http://www.philadelphiafed.org/bank-resources/publications/consumer-compliance-outlook/. Please also consider subscribing to receive notifications of our Reserve Bank's Banking Supervision publications and programs at http://www.frbsf.org/our-district/subscriptions/banking-supervision-regulation-subscriptions/.