Supervisory Spotlight

A Regulator's Perspective on Issues Facing Western Banks

Banking Supervision & Regulation
Federal Reserve Bank of San Francisco

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Greetings! I am taking advantage of the New Year to try a new approach to the Supervisory Spotlight. We began publishing the Spotlight when the financial crisis started heating up. At that time, we thought it was important to share emerging issues, trends, and supervisory concerns with our institutions on a more frequent, or real-time, basis than we had in the past. Based on feedback from our readers, I think we accomplished that goal.

Today, banking industry conditions, even in the 12th District, have stabilized, and the nascent improving trends are enduring. Yes, we still have supervisory concerns; we are, after all, bank supervisors and regulators! But, we have enhanced our ability to communicate with the industry through numerous channels, including our Reserve Bank's web site, the Federal Reserve System's and our local webinars, and System and local publications.

Rather than echo what is discussed so succinctly through many of these sources, I would like to use this publication to highlight speeches, articles, webinars, and other resources that I think would be of particular interest to 12th District financial institutions. As always, I appreciate feedback and suggestions for topics that are of particular concern to your institutions.

First, as bank supervisors in a time when we have extremely low interest rates, we remain concerned about interest rate risk. As we discuss in our quarterly publication, First Glance 12L, over a quarter of District bank assets are in loans and securities maturing or repricing in more than 5 years. With the recent rise in longer-term rates, District banks that collectively reported unrealized gains on their securities portfolios in March 2013 collectively reported unrealized losses just one quarter later. Those collective unrealized losses deepened through December 2013. This is tangible evidence of the impact of a rising interest rate environment on our District's institutions. For local perspectives on interest rate risk, I encourage you to listen to the video archive of our December 5, 2013, Call the Fed webinar, Managing Interest Rate Risk in a Rising Rate Environment. You may also find useful the article, Reaching for Yield: Short-Term Gains, Longer-Term Pains?, in the fourth quarter 2013 issue of *Community Banking Connections*.

Operational risk is another broad risk area that is keeping some bank supervisors up at night. In a challenging earnings environment, our examiners have seen some community banks explore alternative income sources and/or cost cutting to augment the bottom line. Both of these activities can increase operational risk, if not done thoughtfully. Last year, I shared my thoughts on introducing a new product or service at a community bank, which can increase certain aspects of operational risk. The recent cyberattacks on retail stores have highlighted other aspects of operational risk related to the use of technology, outsourcing operations, and payment fraud. Recent *Community Banking Connections* articles have addressed topics such as the end of support for Microsoft Windows XP, which will introduce new elements of risk to bank ATMs in particular, and payments fraud. It is also important to remember that changes in products, services, or delivery channels do not just introduce new aspects of operational risk; the *Consumer Compliance Outlook* article Overview of E-Banking Compliance Considerations views this emerging delivery channel through a compliance lens.

One final topic I'd like to mention affects banks in seven of our nine District states: providing banking services to legal marijuana dispensaries. This has been a challenging issue for banks as they strive to serve their customers and comply with both state and federal law. On February 14, 2014, the Financial Crimes Enforcement Network (FinCEN) issued guidance to clarify BSA expectations for financial institutions seeking to provide services to marijuana-related businesses. On the same day, the U.S. Justice Department issued a memo to the U.S. Attorneys providing further guidance on marijuana-related financial crimes. For those Washington-based financial institutions, the State of Washington Department of Financial Institutions also issued a separate statement that day. Together, the FinCEN and Justice Department documents provide additional clarity for banks that do business with marijuana-related businesses; however, there are still certain requirements and risks that banks need to consider. Accordingly, institutions that now do (or plan to do) business with these entities should review this latest information to ensure that their BSA compliance programs appropriately adhere to the new guidelines.

Best regards,

Teresa Curran

Teresa.Curran@sf.frb.org

Resources

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