Conducting Consumer Compliance Risk Assessments – Examiner Insights

Outlook Live Webinar – August 20, 2013

Dorothy Stefanyszyn & Joe Detchemendy
Examiners – Federal Reserve Bank of St. Louis

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Agenda

- Defining a Risk Assessment
  - Benefits
  - Inherent vs. Residual Risk
  - Measuring Risk
- Controlling risk
  - Effective Control Characteristics
  - Control Considerations
- Post Risk Assessment
- Fair Lending and CRA Considerations

What is a Compliance Risk Assessment?

- A compliance risk assessment is a procedure that identifies the major inherent risks within a business line, factors in any processes and procedures that are practiced by the institution to control and/or mitigate those risks, resulting in a measurement of the residual risk the business line poses to the institution

Why Prepare a Compliance Risk Assessment?

- Proactive, rather than reactive
  - To identify areas of significant risk to the bank
  - To assess the bank's likelihood of violating laws and regulations
  - To identify areas where controls are needed to mitigate risk
  - To evaluate the institution's level of compliance risk in order to make effective and sound decisions
  - To best utilize the limited time and resources allotted to compliance

What are the Components of a Risk Assessment?

- Include an assessment of:
  - Inherent Risk
    - What activities does the bank participate in and what level of risk do they pose to the institution?
  - Risk Controls
    - What does the institution have in place to mitigate and control the risk?
  - Residual Risk
    - Where should compliance efforts be focused?

Inherent vs. Residual Risk

- What is inherent risk?
  - The risk of error if there were absolutely no controls in place
  - Requires detailed knowledge of business processes and regulatory requirements to assess
- What is residual risk?
  - The level of risk present after effective controls are accounted for, such as policies, secondary reviews, etc.
  - Identifies areas to focus time and resources

Example: Inherent vs. Residual Risk

- Residential Real Estate Lending
  - Small, rural institution
  - Fairly homogeneous market
  - Non-complex product offerings
- What are the inherent risks?
  - Assess applicable rules and regulations
  - Take into consideration product complexity and bank characteristics

Example: Inherent vs. Residual Risk *(continued)*

- What controls are in place?
  - Functions that work to prevent violations
- What is the residual risk?
  - Where does the institution stand after controls are applied?

Inherent Risk: Other Considerations

- Product characteristics
  - Complexity, volume, and recent or upcoming changes
- Organizational structure
  - Recent changes
- Third party use
  - Responsibility for compliance can't be delegated
- UDAP considerations
  - Clear and understandable terms and conditions

Ratings Systems

- There are no regulatory requirements to use a particular rating system.
- Ensure rating system enables conclusions to be consistent and based on logical rationale
- Different degrees of complexity based on the needs of the institution
  - Low-Moderate-High
  - One-to-Five

Rating System Example: One-to-Five

- Low Risk (1)
  - No major change, minimal growth, non-complex
- Limited Risk (2)
- Moderate Risk (3)
- Considerable Risk (4)
- High Risk (5)
  - New offering, high growth, complex products

Mitigating Inherent Risk: Controls

- Controls should
  - Perform a function that mitigates or reduces inherent risks that have been identified
  - Be automated or manual
  - Be preventative, not detective
  - Be designed to operate in an effective manner
  - Be integrated within the business lines

Evaluating Controls

- Designed effectively
  - How reliable is the control?
  - Will the control identify exceptions in every necessary instance?
  - What business lines or systems are covered by the control?
  - Can the control be easily circumvented?
- Operate effectively
  - How well does the control perform in practice?
  - Does it function as intended?
  - Are there periodic assessments of controls?

Example: Compliance Risk Matrix

Line of Business, Product or Service	Inherent Risk	Risk Controls	Residual Risk
Commercial Loans	Moderate	Satisfactory	Limited
Agricultural Loans	Limited	Satisfactory	Low
Consumer – Closed-End	Moderate	Satisfactory	Limited
Consumer – Open-End	Moderate	Satisfactory	Limited
RE – Portfolio	Moderate	Fair	Moderate
RE – Sec Mkt	Moderate	Fair	Moderate
Loans in SFHAs	Moderate	Satisfactory	Moderate
HMDA LAR	Moderate	Fair	Moderate
Deposit Operations	Limited	Satisfactory	Low
E-Banking	Limited	Satisfactory	Low
Aggregate Risk and Risk Control Assessment	Moderate	Satisfactory	Limited
Inherent and residual risks are categorized as Low, Limited, Moderate, Considerable or High; Controls are characterized as Strong, Satisfactory, Fair, Marginal, or Unsatisfactory			

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Example: Effective Controls

- Residential Real Estate Lending
  - $250M institution
  - Non-MSA, fairly homogenous market area, large portions reside in designated flood zones
  - Some variable rate product offerings
  - Moderate inherent risk to institution
- Controls: Effective?
  - Automated loan documentation software
  - Secondary reviews
  - Written procedures for flood determination and insurance minimums
  - No worksheet to assist in calculation of insurance minimums
- What is the residual risk?

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Controls: Other Considerations

- Trend of Risk
  - Increasing/Stable/Decreasing
- Compliance culture at bank
  - *Check the box* or *a part of the way business is done*
- Formality
  - Policies and procedures formal enough for bank size/structure
- Monitoring Systems
  - Do information systems enable the proper tracking

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Post Risk Assessment

- What should the institution do after its compliance risk assessment is established?
  - Prioritize compliance resource allocation based on findings
  - Maintain and update, as necessary, a summary of the institution's identified risks
  - Calculate the institution's consolidated risk profile
  - Integrate changes from new or changed products, services, regulations, and from new exam or audit findings
  - Re-evaluate risk measurements, controls, and levels on a periodic basis

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Understand Your Market: Fair Lending and CRA Considerations

- Level of controls necessary to mitigate reputational and monetary loss risks associated with ECOA, FHA, and CRA laws largely depend on the characteristics of the institutions market area and level of real estate lending
  - Presence of low- and moderate-income census tracts
  - High minority populations and/or majority-minority areas within market area

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Example: Fair Lending and CRA Considerations

- Residential Real Estate Mortgage Department
  - $2B institution
  - Diverse multistate MSA, many majority-minority and LMI census tracts
  - Complex product offerings, including variable rate and government insured lending products
  - Secondary market lending channels, broker arrangements with local realtors
- What is the inherent risk?

Example: Fair Lending and CRA Considerations

- What controls are in place?
  - Automated underwriting and documentation systems
  - Secondary reviews of loan documentation before close
  - Detailed written loan policy and pricing guidelines
  - Documentation of exceptions
- What is the residual risk?
  - What controls, if added, would mitigate more risk?

Final Thoughts

- Risk Assessments tend to be more effective when they are:
  - Objective and honest
  - Supported by the board and senior management
  - Conducted by and potentially across business units
  - Dynamic (vs. static)
  - Less driven by checklists
  - Structured to consider the lifecycle of a product/service

Questions

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