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Formal Enforcement Actions Issued Against Institutions — What Do Today's Numbers Say?

by William J. Brown, Senior Enforcement Specialist

A number of financial institutions throughout the country have been subject to some level of enforcement action over the years. Most recently, the banking industry has been affected by the weak economy and deteriorating asset quality related to commercial and residential loans, and, as a result, enforcement actions have risen sharply over the past several months. For the purpose of this article, we will examine formal enforcement actions, which are publicly disclosed by the federal banking agencies and are easily accessible via the Internet. We will examine actions issued since 2007, just prior to when the credit and liquidity problems began affecting our economy and, ultimately, the banking industry. We will also focus our attention on actions issued against financial institutions, rather than individuals (e.g., civil money penalties, prohibition orders, section 19 letters, and other types of formal actions will not be addressed in this article). Finally, we will discuss the provisions that comprise System-related actions and the underlying reasons for the provisions.

General Overview of Enforcement Actions

Enforcement actions have been a key supervisory tool for over 40 years, and they complement traditional supervisory policies and procedures.[1] The federal banking agencies have supervisory

[1] See *Enforcement Unit Purposes and Practices*, FRB-Philadelphia Supervision, Regulation and Credit, October 2007, available online at: <www.philadelphiafed.org/bank-resources/publications/purpose_and_practices.pdf>.

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FEDERAL RESERVE BANK OF PHILADELPHIA

Supervision Spotlight

The Root Causes of Bank Failures

by Michael E. Collins, Executive Vice President

The unprecedented financial market conditions and prolonged recession placed exceptional stress on the entire banking industry. Nearly 100 banks failed during the first nine months of 2009—the most in 17 years. People often presume that the challenging economy and sluggish housing market were the key drivers behind these failures, particularly since many tended to be geographically clustered in distressed regions. While the external economic environment certainly was influential, it was rarely a standalone factor in a bank's demise. The root causes of problems are often traced to inherent risk exposures or management weaknesses that become more pronounced under stressful conditions and ultimately impair an institution's ability to weather adverse conditions.

Many important lessons are still to be learned from the recent crisis. One exercise is to analyze each individual bank failure, isolate the key factors that led to their demise, look for commonalities that exist among the banks collectively, and apply that information to prevent or mitigate future problems. For example, considerable insight is gleaned from the "material loss reviews" that are performed by the primary regulator's inspector general whenever a failure results in a loss to the depository insurance fund that exceeds the greater of $25 million or 2 percent of the bank's total assets at the time of receivership. In addition, recent examination reports and other supplemental data sources can be referenced for the remaining institutions that are not subject to this mandate.

Historical Research

Regulators and government agencies conducted similar analysis after past downturns. The small body of empirical research that has been compiled on the topic allows us to put the perceived causes of bank failures into a historical context spanning the past 30 years.

While the influence of consolidation trends, legislative changes, sectoral downturns, and regulatory oversight cannot be dismissed, and though fraud or other extenuating factors play an occasional role, it is generally accepted that most bank failures ultimately stem from the default of a significant portion of the bank's asset portfolio. A deeper dive into the cause of asset deterioration reveals some prevalent themes in management's behavior and the risk culture of these institutions.

A report written by the Office of the Comptroller of the Currency (OCC) summarized observations about national bank failures that occurred during the period 1979–1987. The OCC found that "management-driven weaknesses played a significant role in the decline of 90 percent of the failed and problem banks the OCC evaluated."[1] Interestingly, the two main internal problems noted were "overly aggressive activity" and "uninformed or inattentive board of directors or management."

The banking industry endured one of its most challenging periods from 1988–1992. During this interval, an extraordinary number of banks failed over a short period of time, more than any time since the 1930s. A congressional budget office report found that:

"Although many of the problems that beset banks were externally induced, the primary responsibility for bank failures rests squarely on the shoulders of bank managers and boards of directors. This responsibility does not negate ineffective regulation or unforeseen economic developments as causes of failure, but the bank manager is the agent who reacts to economic conditions and the regulatory environment. Some managers made mistakes because they reacted incorrectly to a barrage of unusual factors. In some cases, managers simply failed to diversify asset portfolios, and boards of directors did not insist on reasonable loan practices. Managers of failed banks often pursued aggressive loan policies without reasonable precautions against default. As a result, many bank managers who failed to deal effectively with increased competition and adverse economic shocks presided over the demise of their institutions."[2]

It is possible to infer that those banks that survived this period did so by holding more liquid assets, managing modest growth in diversified assets, maintaining a suitable buffer of capital, and complying with regulatory requirements.

The FDIC analyzed bank failures during the timeframe 1993–2003 and summarized observations from material loss reviews. Key findings in the report included the fact that "failed banks frequently assume more risk than bank management is capable of handling."[3] It also noted that "an inattentive or passive board of directors is a precursor to problems."

The relatively benign 2004–2007 period did not have sufficient observations to warrant a comprehensive study, since only seven bank failures occurred in the period.

Common Causes of Recent Failures

The 2008–2009 period witnessed a prolonged economic recession, unprecedented credit market disruption, high unemployment, falling house prices, and the failure of numerous banks. Some of the earliest bank failures were large institutions felled by complex securities investments and alternative loan types. By contrast, more recent failures have been smaller banks suffering insurmountable losses on more traditional loan types. In both instances, management's practices and aggressive risk tolerance are again called into question.

Our analysis of common factors in recent failures reveals that management deficiencies and ineffective board oversight were noted in the majority of material loss reviews. The other contributing factors most frequently cited are construction and land development loan concentrations, rapid loan growth, overreliance on volatile noncore funding, insufficient allowance for loan and lease losses

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Michael E. Collins, Executive Vice President

[1] "Bank Failure: An Evaluation of the Factors Contributing to the Failure of National Banks," OCC, June 1988, available online at: <www.occ.treas.gov/bankfailure.pdf>.

[2] "The Changing Business of Banking: A Study of Failed Banks from 1987 to 1992," Congressional Budget Office, June 1994, available online at: <www.cbo.gov/ftpdocs/49xx/doc4915/doc30.pdf>.

[3] "Observations from FDIC OIG: Material Loss Reviews Conducted 1993 Through 2003," FDIC Office of Inspector General, January 22, 2004, available online at: <www.fdicig.gov/reports04/04-004.pdf>.

Regulation R: Is Your Bank in Compliance?

by Linda M. Rojas, Fiduciary Specialist

Overview

In 2007, the Board of Governors of the Federal Reserve System (Board) and the Securities and Exchange Commission (SEC) issued final rules, known as Regulation R.[1] Regulation R implements certain of the broker exceptions for banks from the definition of the term "broker" under the Securities Exchange Act of 1934, as amended by the Gramm-Leach-Bliley Act (GLBA), Title II, and implements the GLBA removal of the blanket exemption from SEC registration for banks that effect securities transactions.[2] The regulation is intended to provide a flexible framework for banks to continue to meet their customers' demands for banking services that include securities products while ensuring consumer protection. It is important to note that the compliance date for Regulation R for most banks was January 1, 2009.[3] The regulation applies to banks, which are defined to include commercial banks, thrifts, trust companies, and U.S. branches and agencies of foreign banks.

As a result of GLBA and Regulation R, if a bank effects securities transactions in trust and fiduciary, custody, or "sweep" accounts, it would need to qualify for an exception or exemption under GLBA or Regulation R or push out these activities to a registered broker-dealer affiliate or third-party broker-dealer.

A banking organization that does not comply with Regulation R may be exposed to the legal and reputational risk of acting illegally as a securities broker.

This article will summarize some key aspects of the Regulation's bank-broker exceptions relating to: 1) third-party networking arrangements, 2) trust and fiduciary activities, 3) deposit "sweep" activities, and 4) custody and safekeeping activities. The GLBA also includes other broker exceptions that are still available for banks to use; however, these exceptions are beyond the scope of this article. The summary is not a substitute for the rule itself and does not constitute legal advice.

Networking Exception

The networking exception permits banks to pay their unregistered employees, such as tellers, loan officers, and private bankers, a one-time, "nominal" cash referral fee for referring bank customers to their broker-dealer affiliates or partners. Regulation R provides several options for determining whether a referral fee is "nominal." One option considers a fee nominal if it does not exceed $25. This dollar amount will be adjusted for inflation on April 1, 2012, and every five years thereafter. Regulation R also provides an exemption to allow banks to pay higher fees for referrals of institutional and high net worth customers as defined by Regulation R.

Trust and Fiduciary Exception

This exception permits a bank to effect securities transactions for its trust or fiduciary customers as long as the bank is chiefly compensated for those transactions by certain types of fees, referred to as "relationship compensation:"[4]

1. Administration or annual fees
2. A percentage of assets under management
3. Flat or capped per-order processing fees that do not exceed the cost the bank incurs in executing such securities transactions
4. Any combination of such fees

Relationship compensation includes 12b-1 fees, service fees, and sub-transfer and sub-accounting fees

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[1] 12 CFR Part 218 for the Board and 17 CFR Part 247 for the SEC. The full text of Regulation R's compliance date is available on the Board's website at: <www.federalreserve.gov/bankinforeg/reglisting.htm#R>.

[2] "Effecting securities transactions" is an SEC term that may include, for example: a bank soliciting a customer's securities purchase or sales order and placing it with a broker-dealer for execution and certain compensation programs designed to encourage employees to refer customers to a broker-dealer.

[3] Regulation R's compliance date is effective the first day of the bank's fiscal year that commences after September 30, 2008, which for most banks was January 1, 2009.

[4] Securities Exchange Act Section 3(a)(4)(B)(ii).

that banks receive from mutual funds or their service providers, and Regulation R provides a number of other examples of the types of fees that qualify as relationship compensation.

Regulation R also provides for two alternative approaches to satisfy compliance with the chiefly compensated test: an account-by-account approach or bankwide approach. Under the account-by-account approach, Regulation R provides that a bank meets the chiefly compensated test if the relationship/total compensation percentage for each trust or fiduciary account of the bank is greater than 50 percent.

The second alternative is the bankwide approach. Under the bankwide approach, Regulation R requires the aggregate relationship/total compensation percentage for the bank's trust and fiduciary business as a whole to be at least 70 percent. The bankwide approach is calculated as follows:

1. Divide the relationship compensation (RC) attributable to the bank's trust and fiduciary business as a whole during each of the immediately preceding two years by the total compensation (TC) attributable to the bank's trust and fiduciary business as a whole during the relevant year
2. Translate the quotient obtained for each of the two years into a percentage
3. Average the percentages obtained for each of the two immediately preceding years

Ex: $$\frac{((RCy\text{-}1/TCy\text{-}1) + (RCy\text{-}2/TCy\text{-}2)) \times 100 = \text{Relationship/Total Compensation \%}}{2}$$

In order to meet the bankwide approach, the relationship total compensation percentage must be greater than or equal to 70 percent. In the example above, y-1 would be the first year of 2009, and y-2 would be 2010, for a bank determining its compliance with the bankwide approach for 2011 (the first year the test will apply).

Regulation R states that a bank may exclude trust and fiduciary accounts that were opened for fewer than three months during the relevant year or that were acquired during the previous 12 months as part of a merger and acquisition transaction. This exclusion applies to both the bankwide approach and the account-by-account approach.

In addition to the above requirements, for a bank to use the trust and fiduciary exception, it must adhere to specific advertising restrictions. Advertisement is defined by Regulation R as any material that is distributed through public media, such as newspapers, radio, television, and websites. A bank may not advertise its securities brokerage services for trust and fiduciary accounts except as part of advertising its broader trust and fiduciary services. Also, a bank may not advertise its securities brokerage services for trust and fiduciary accounts more prominently than other aspects of the trust and fiduciary services provided to these accounts. Regulation R also requires a bank to direct all transactions in publicly-traded securities for trust and fiduciary customers to a registered broker-dealer for execution.

Sweep Exception

This exception allows a bank to sweep funds from bank accounts into "no-load" money market funds without registering as a broker-dealer. To qualify as a "no-load" fund, a fund must have no front-end or back-end loads and no more than 25 basis points in asset-based sales charges and service fees.

Banks are also permitted to sweep deposits into a "load" money market fund if, among other things, it does not characterize the fund as being "no-load" and provides the fund's prospectus to the customer before the sweep transactions are authorized. Furthermore, a bank is allowed to invest customer funds into a money market mutual fund if it provides the customer with some other product or service that would not require broker-dealer registration, such as an escrow, trust, or fiduciary or custody account.

Custody and Safekeeping Exception

Under Regulation R, banks can continue to accept securities orders in a custodial capacity if the transactions constitute customary banking activities, subject to certain conditions. If a bank does not accept orders for securities transactions from a custody account, then it is not necessary to adhere to the conditions in Regulation R with respect to that account. Furthermore, a bank does not need to rely on the custody exception under the regulation to conduct certain other permitted custodial activities (e.g., facilitating the movement of cash and securities associated with clearing and settling a customer securities transaction).

Regulation R allows a bank to accept orders for securities transactions for an employee benefit plan account or an individual retirement account or similar account for which the bank acts as a custodian. However, this exemption is not available if the bank acts as a trustee or fiduciary for the account, other than as a directed trustee.

A directed trustee is defined in the regulation as a trustee that does not exercise investment discretion with respect to the account. A bank that acts as a directed trustee for these types of accounts may rely on the custody exemption. However, the bank's trustee relationship with the account remains a trust and fiduciary relationship, and, as such, the bank must continue to comply with applicable fiduciary principles and standards in its relationships with the account.

The banking agencies are currently developing recordkeeping rules for banks that rely on the exceptions and exemptions in Regulation R and the GLBA broker push-out provisions.

The advertisement restrictions applicable to employment benefit and individual retirement and similar accounts are very similar to the restrictions imposed in the fiduciary exception. For example, a bank may not advertise that it accepts securities transaction orders for employee benefit plan accounts or individual retirement accounts (or similar accounts), except as part of advertising the other custodial or safekeeping services the bank provides to these accounts. Certain additional advertising restrictions apply to individual retirement accounts.

The regulation allows a bank custodian to accept trades for other types of custody accounts on an "accommodation" basis. Regulation R restricts fees that a bank may accept for initiating an accommodation order for a custody account and employee compensation related to these accounts. For "accommodation" accounts, the bank is restricted from providing investment advice, research, or recommendations to the account. Stricter advertising and sales literature requirements also apply to custody accounts for which accommodation orders are accepted.

Compliance

The banking agencies are currently developing recordkeeping rules for banks that rely on the exceptions and exemptions in Regulation R and the GLBA broker push-out provisions. Items that examiners may find useful in determining a bank holding company, state member bank, or U.S. branch/agency of a foreign bank's compliance with Regulation R and GLBA include the following:

1. Whether the institution's employee training is adequate
2. Whether the institution has performed an appropriate analysis to identify the specific exceptions and exemptions it will rely on for continuing to effect securities transactions
3. Whether the institution has written policies and procedures to ensure compliance
4. Whether the institution has processes in place to document its approach for calculating the chiefly compensated test (account-by-account or bank-wide method)
5. Whether the institution has processes in place to ensure that the advertising restrictions are being followed
6. Whether the institution's board and/or the board committee has been informed of the institution's approach for and progress in complying with the GLBA broker push-out provisions and Regulation R
7. Whether the institution has appropriate record retention policies and procedures in place to ensure retention of records to document its calculation of the chiefly compensated test, compliance with advertisement restrictions, and with safekeeping and custody provisions
8. Whether the software programs used by the institution's service providers for trust recordkeeping and accounting are adequate to ensure compli-

ance with the statute and Regulation R

9. Whether the institution has reviewed its networking arrangements with broker-dealers and its compensation and bonus programs that may involve effecting securities transactions to ensure compliance with the rules
10. Whether the institution has decided to push out any of its securities activities or accounts to a registered brokerage firm/affiliate to comply with the rules

This article highlights only some of the key terms and conditions of Regulation R. If your institution has questions regarding Regulation R, you are encouraged to contact Barbara Cornyn (barbara.cornyn@frb.org) of the Board's Division of Banking Supervision and Regulation at (202) 452-2434 or Michael Waldron (michael.w.waldran@frb.org) of the Board's Legal Division at (202) 452-2798.[5] ☐

[5] Barbara Cornyn of the Board's Divison of Banking Supervision and Regulation and Kieran Fallon of the Board's Legal Divison contributed to this article.

Formal Enforcement Actions Issued Against Institutions — What Do Today's Numbers Say?

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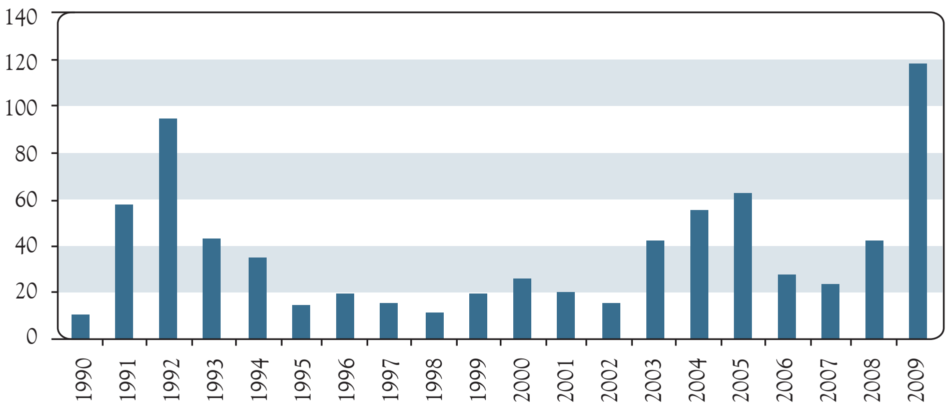
Formal Enforcement Actions Issued by the Federal Reserve Since 1990



tools to limit potentially risky behavior by financial institutions and have a broad range of enforcement powers over the institutions they supervise. The agencies have the power to improve capital, restrict asset growth and riskier lending, restrict dividends, levy fines, and remove management.

Enforcement actions can be either formal or informal, depending on the severity of the situation. The objective of a formal action generally is to correct practices that the agency believes to be unlawful, unsafe, or unsound. As mentioned earlier, formal supervisory actions may be taken against a financial institution or any institution-affiliated party and are legally enforceable and publically available.[2]

Recent History

During the banking crisis of the 1980s and early 1990s, federal banking agencies widely used formal actions. During the mid-1980s, as the number of problem banks increased dramatically, so did the number of formal actions. A typical 1980s formal action required banks to take corrective actions in various areas: compliance with regulations, improvement in operating procedures, the raising of new capital, the replacement of managers, and so forth. As the number of problem banks declined in the late 1980s, the issuance of formal actions also declined.

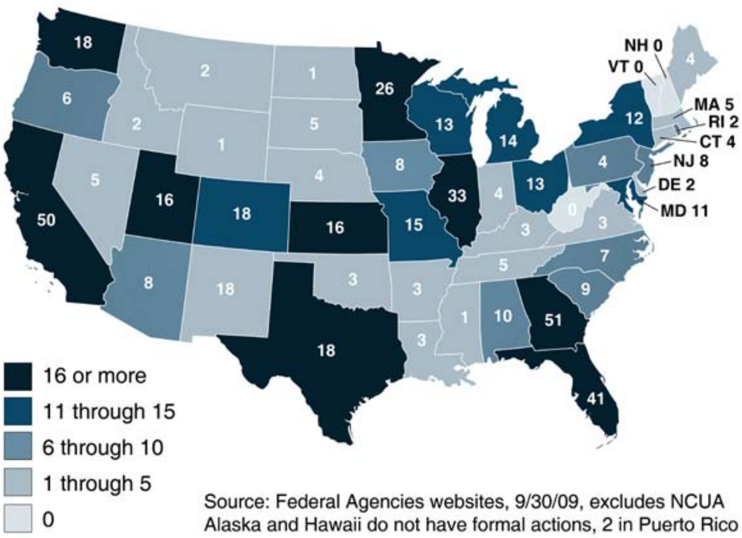
[2] Formal actions for the Federal Reserve include the following: Written Agreements, Cease and Desist Orders, Prompt Corrective Action Directives, Section 4(m) Agreements, and Civil Money Penalties. In addition, 4(m) Agreements are considered formal actions, but are not posted on the Board's public website.

Formal Actions: 2007–2009*

YEAR	FDIC	FRB	OCC	OTS	TOTAL
2007	54	3	27	28	122
2008	102	37	94	45	278
2009	185	118	87	98	488

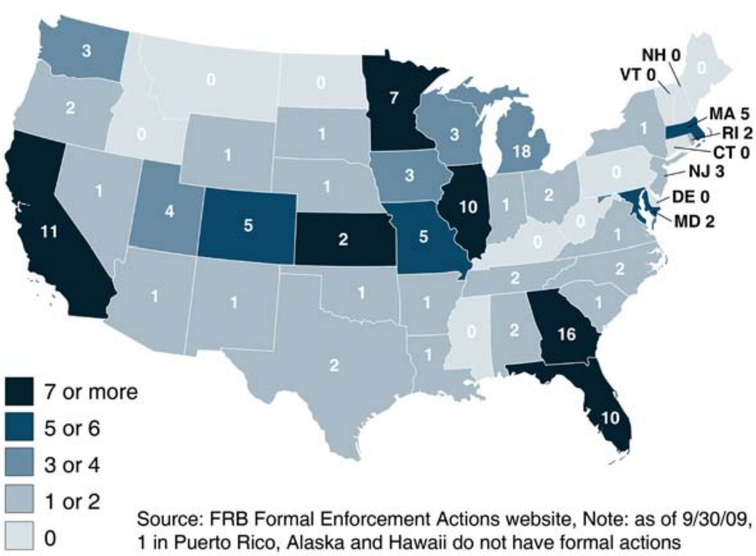
*Based on data from federal banking agency websites as of 9/30/2009. Excludes actions issued against both individuals and companies, such as prohibition orders and civil money penalties.

Listing by state of the 488 formal actions issued by the federal banking agencies so far in 2009



Source: Federal Agencies websites, 9/30/09, excludes NCUA
Alaska and Hawaii do not have formal actions, 2 in Puerto Rico

118 Formal Enforcement Actions have been issued by the FRS so far in 2009



Source: FRB Formal Enforcement Actions website, Note: as of 9/30/09,
1 in Puerto Rico, Alaska and Hawaii do not have formal actions

But then came 1991 and 1992 and a growing number of problem banks, particularly in New England, which brought another increase in the number of formal actions. During the later part of the decade, the number of actions declined as the economy improved and financial institutions' earnings rebounded. This trend continued during the economic expansion through early 2003. However, there was a spike in formal enforcement actions in 2004 and 2005 that focused on compliance with the Bank Secrecy Act and other anti-money laundering standards.

2009—Unprecedented Growth in Actions

During the past several months of the financial markets being in turmoil, lax credit extensions, breakdowns in underwriting practices, and the decline in housing prices have all triggered increases in the issuance of formal enforcement actions by the federal banking agencies. All of the federal banking agencies are issuing enforcement actions against companies at a record pace; the first nine months of 2009 have seen an unprecedented growth in actions.

For the first nine months of 2009, the federal banking agencies have already issued 488 formal enforcement actions—a 76% increase from 2008 and a 400% increase from 2007. So far this year, the actions have been issued to institutions located in every state, except five: Alaska, Hawaii, West Virginia, New Hampshire, and Vermont. Currently, the hardest hit states are Georgia (51), California (50), Florida (41), and Illinois (33). In these four states alone, the aggregate number of actions issued (175) constitute approximately 36% of the total number issued (488) so far this year. Banks in these states were greatly affected by housing-related loans and a weakening economy, resulting in severe asset-quality deterioration. The geographic pattern may be expressed in a number of different ways, but the message is clear: given the current regulatory and economic climate, the number of enforcement actions is rising and likely to increase more in the months ahead.

2009 Formal Enforcement Actions — Federal Reserve

Dividend Restrictions	108	92%
Debt and Stock Redemption Restrictions	95	81%
Capital Plan Submission Requirement	69	58%
ALLL Reserves and Methodology	39	33%
Asset Improvement Plans	34	29%
Board Oversight	33	28%
Liquidity/Funds Management	32	27%
Contingency Funding Planning	27	23%
Cash Flow Projections	25	21%
Tie: Lending/Credit Administration Plans, Credit Risk Management Policies, and Loan Review Plans	22	19%
Strategic Planning and Budgeting	19	16%
Tie: Earnings Plans, Management Reviews, and Affiliate Transactions Restrictions	16	14%
Concentrations of Credit	11	9%
BSA/AML Programs	8	7%
Tie: Source of Strength, Interest Rate Risk	7	6%
Tie: Brokered Deposits, Internal Audit	6	5%

At the time of this writing, the Federal Reserve issued 106 Written Agreements, 6 Cease and Desist Orders, and 6 Prompt Corrective Action (PCA) directives for institutions so far this year. This is a far cry from 2007 and 2008, when the Federal Reserve issued a total of 50 formal enforcement actions against financial institutions. A majority of these actions were issued against bank holding companies whose subsidiary banks were designated as problem banks (composite 4 or 5 rating) at their most recent examination. A long-standing Federal Reserve Bank policy states that the bank holding company (BHC) should act as a source of strength for its depository institution subsidiaries.

Because of the credit crunch, the Federal Reserve, along with the other federal regulatory agencies, has focused its attention on basic safety and soundness issues like capital retention, asset quality, liquidity and funds management, and board oversight, and the recent actions support these issues. Some of the common issues found in today's examinations are: weak board oversight, rapid loan growth, commercial real estate concentrations, inadequate ALLL, and weak credit risk management controls and practices.

The following is a list of the corrective actions, ranked by frequency, that have been included in the 118 formal actions issued by the Federal Reserve for bank holding companies and state member banks so far this year:

As mentioned earlier, one fundamental principle is that a BHC should serve as a source of managerial and financial strength to its subsidiary banks.[3] Therefore, the Federal Reserve expects organizations to hold capital commensurate with its overall risk profile. During tough economic times, capital preservation takes on added importance. As such, it is not surprising that the Federal Reserve included

[3] SR Letter 09-4, *Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies*, February 24, 2009, available online at: <www.federalreserve.gov/boarddocs/srletters/2009/SR0904.htm#access>.

2009 Federal Reserve Formal Enforcement Actions by Type

STRUCTURE	TOTAL
Bank Holding Companies (BHCs)	74 (63%)
State Member Banks (SMBs)	19 (16%)
Both BHCs and SMBs	25 (21%)

2009 Federal Reserve Formal Enforcement Actions by Type

STRUCTURE	TOTAL
Written Agreements	106 (90%)
Cease and Desist Orders	6 (5%)
PCA Directives	6 (5%)

in over 80% of its actions this year requirements that BHCs must inform the Federal Reserve in advance of declaring or paying dividends or redeeming or repurchasing stock. In addition, over 50% of actions issued provisions requiring plans for the institution's capital needs.

Over 30% of the actions include provisions that require organizations to address asset quality deterioration — replenishing low ALLL levels and planning how institutions will improve their classified assets. Addressing lax board oversight and developing stronger liquidity and contingency funding plans were other provisions that appeared in over 20% of the actions issued so far this year.

Conclusion

The 1980s and early 1990s saw high interest rates and high inflation compared to today, with low interest rates and possible deflation. Corporate governance must keep pace with the challenges in the present economic and financial environment, or a financial institution's board and senior management risk receiving enforcement actions resulting from breakdowns in business practices and noncompliance with laws and regulations. Economists and financial experts have been saying that we may have reached the bottom and can only go up. Whether the trends presented in this article will hold true in the future remains to be seen; unfortunately, given the current economic and regulatory climate, the number of enforcement actions may continue to increase. ☐

Where to Find Information on Enforcement Actions for the Federal Banking Agencies

The following agency websites offer information on enforcement actions against the respective types of institutions and their affiliated parties:

AGENCY	INSTITUTIONS AND PARTIES	WEBSITE
Federal Reserve	State member banks, bank holding companies, and branches and agencies of foreign banking organizations	<www.federalreserve.gov/boarddocs/enforcement/>
Federal Deposit Insurance Corporation	State nonmember banks and insured branches of foreign banks	<www.fdic.gov/bank/individual/enforcement/index.html>
Office of the Comptroller of the Currency	National banks and federally chartered branches and agencies of foreign banks	<apps.occ.gov/EnforcementActions/>
Office of Thrift Supervision	Thrift associations	<ots.treas.gov/?p=Enforcement>

From the

Examiner's Desk

Avoiding the Breakdown: An Effective Internal Control Program

by Becky Goodwin, Examiner, and Catherine Donaghy, Assistant Examiner

The current economic environment and financial pressures to improve margins and earnings performance are challenging many financial institutions, causing them to downsize, employ newer technologies, or offer new products and services in attempts to maintain a competitive edge. As a result, there is the potential that the internal control environment may not always evolve in kind. Failure to maintain an internal control environment commensurate with the size and activities of an institution can open Pandora's Box and create issues, including opportunity for fraud.

This article will provide the characteristics of an effective internal control program and expectations from the examiner's perspective, detail some examples of fraudulent activity and outline potential trends, and discuss how to avoid or limit the likelihood of a fraud event (if possible). In addition, the various responsibilities of the board of directors and senior management will be defined.

Characteristics of an Effective Internal Control Program[1]

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) has defined internal control as a process, which should be developed by the directorate and senior management to provide reasonable assurance regarding the effectiveness and efficiency of an institution's operations, the reliability of financial reporting, and compliance with applicable laws and regulations. According to COSO, the following five components can help to create an effective internal control system:

1. **Control environment**—This sets the tone for an effective internal control system, and factors include the integrity, ethical values, and competence of the institution's staff; management's philosophy and operating style; management's methods for assigning authority and responsibility and for organizing and developing staff; and the attention and direction provided by the board of directors.
2. **Risk assessment**—This is defined as the identification and analysis of relevant risks to achieve the objectives and form a basis for determining how internal and external risks should be managed. As economic, industry, regulatory, and operating conditions continue to evolve, likewise processes must be developed for the purpose of identifying and managing unique risks associated with those changes.
3. **Control activities**—These consist of policies and procedures that help to ensure that management directives are fulfilled, and they also help to ensure that necessary actions are taken to appropriately address risks in order to achieve the entity's objectives. There is a range of control activities, including but not limited to approvals, authorizations, verifications, reconciliations, operational reviews, security of assets, segregation of duties, and dual controls. These occur at various levels throughout an organization.
4. **Information and communication**—These cover system-generated information, as well as effective communication, internally throughout the organization and externally to stakeholders. The board of directors and senior management must clearly communicate to all staff that control responsibilities must be taken seriously. In addition, staff must understand their own role in the internal

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[1] "Internal Control—Integrated Framework" is available at: <www.coso.org/IC-IntegratedFramework-summary.htm>.

control system and how individual activities relate to the work of others within the organization.

5. **Monitoring activities**—These relate to oversight of the internal control structure. The internal control system needs to be monitored through a process that assesses the quality of the system's performance over time. This process is ongoing and occurs throughout the normal course of operations. The scope and frequency of assessments or evaluations will be contingent upon the risk posed to the institution and the level and effectiveness of surrounding controls. In any event, internal control deficiencies should be escalated and the most serious issues reported to the board and senior management. Additional guidance surrounding monitoring activities has been developed by COSO; in February of 2009 COSO released its first volume of "Guidance on Monitoring Internal Control Systems."[2]

What to Expect from Examiners

A financial institution's internal control environment assessment falls under the Management and Risk Management components of a bank examination or bank holding company inspection. Examiners expect that board members and senior management understand their institution's activities and associated level of risk. During an examination or inspection, examiner activities include the following:

- Conduct discussions and fact-finding interviews regarding risk and internal controls
- Request and review internally-generated reports, policies and procedures, and physical controls to ensure that adequate controls exist
- Request and review management information system (MIS)-generated reports for accuracy and appropriateness given the risk undertaken by the institution.
- Evaluate committee and board packages (with minutes) to ensure that appropriate reports and information are disseminated to the board adequately, and that risks are identified and quantified in a timely fashion
- Review internal audit reports and ensure that deficiencies are reported and addressed in a timely manner
- Request and review internal audit workpapers to determine the level and scope of audits conducted by the internal audit function

The board and senior management are responsible for monitoring all significant risk, controls, and the high-risk areas associated with new products, such as electronic banking, stored value cards, remote deposit capture, and ACH. In addition, the board is ultimately responsible for compliance with new laws and regulations; therefore, the board must ensure that the audit function consistently meets legal, regulatory, and supervisory requirements. Moreover, the board must make certain that the audit function monitors and tests the reliability and effectiveness of both the institution's internal controls and its financial statements. Lastly, the independence of the audit function is vital to the overall effectiveness of every audit program.

Fraud: A Result of Broken Internal Controls?

Some would argue that not all fraudulent activity is the result of broken controls. However, there is no doubt that a broken control environment is conducive to fraudulent activity. Even more importantly, fraud can eventually cost an institution enormously in terms of viability and reputation, in addition to any direct financial impact.

Adrian Stern, CPA, Cr.FA, suggests that some effective tools in the battle against fraud include having strong internal controls, performing audits of records, and analyzing key financial trends. Clear policies and zero tolerance toward fraud, along with employee support programs, also help to create the proper control environment. Moreover, Stern provides some clear examples of poor controls, which may be common occurrences, as outlined below:

- Lack of segregation of duties, such as an individual making bank deposits, posting them to the accounts receivable system, and performing monthly bank reconciliations
- Poor physical controls over inventory, marketable

[2]<www.coso.org/documents/COSOMonitoringGuidanceFeb09Release_000.pdf>.

securities, or blank check stock

- Inadequate documentation and support for cash disbursements
- Inadequate or obsolete accounting software
- Failing to perform independent verification, such as spot checks of physical inventory

To help prevent internal control breakdowns, financial institutions should conduct periodic risk assessments, led by either internal or external auditing staff. The assessments should focus on high-risk areas, such as physical controls relating to high dollar fixed assets, cash, marketable securities, payroll, and inventory.[3]

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The Lending Function

Current economic conditions demand that financial institutions strengthen internal controls over the lending process; at a minimum, they should be reviewed for effectiveness. In a case study of a company's internal controls, author Kevin Clancy documented that the validity and collectability of the company's accounts receivable were in question. A subsequent forensic investigation identified fictitious customers, fictitious sales, and forged bills of lading, invoices, and other fraudulent documents. Ultimately, it was determined that certain company officers were involved in a massive fraud, resulting in U.S. and foreign bank losses of between $600 million and $1 billion and, in turn, the arrest of the company's chief executive officer on charges of conspiracy to commit bank fraud, mail fraud, and wire fraud. The company's CFO and former treasurer were also arrested on similar charges.[4] Regardless of a loan department's credibility, internal controls are necessary to ensure professional and legal operations.

Employees

Comprehensive and correct internal controls can prevent many types of fraud, especially those committed by an institution's employees. The Department of Justice noted one such case, where a vault teller responsible for preparing the daily vault cash reconciliation reports and providing the reports to bank officers created false internal bank documents, which purported to show the movement of cash in and out of the branch vault. In doing so, the vault teller defrauded the bank in excess of $3.2 million. Bank management indicated that the teller had used the position of trust and co-opted internal controls by exploiting professional relationships at the institution.[5] Because not all fraud is the result of weak controls, Stern indicates that institutions should seek ways to lessen outside pressures on employees that may lead them to commit fraud. He attests that some institutions have actually introduced programs to help their employees with financial difficulties, thereby reducing the employee's temptation to commit fraud.

Future Considerations and Other Areas

While lessons can be learned from past instances of fraudulent activity related to insufficient internal controls, lessons are also being learned about potential areas of increased fraud now and in the future.

TARP. In the age of Troubled Asset Relief Program (TARP) funds, the appropriate use of funding has often been the topic of discussion. According to Robert S. Mueller, III, director of the Federal Bureau of Investigations (FBI), a potential area for new fraud cases involves TARP funds. The FBI is currently working with other agencies to identify how and for

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[3] Stern, Adrian CPA Cr. FA, "Focus on Fraud: Internal Controls, Audit Policies—and a Tough Stance—Can Help Deter Fraud," California CPA, September 1, 2005, available online at: <www.allbusiness.com/accounting-reporting/fraud/563988-1.html>.

[4] Clancy, Kevin, "Bottom Line: Strong Internal Controls Are the Best Defense Against Financial Fraud," *U.S. Business Review*, available online at: <www.usbusiness-review.com/content/view/817/80/>.

[5] Available online at: <oklahomacity.fbi.gov/dojpressrel/pressrel08/jan28_08.htm>.

what purpose these funds are being used. Mueller stressed the need for "independent board members, auditors, and outside counsel" to help keep organizations honest. "If this financial crisis has taught us anything," he said, "it may be that it is time for a cultural shift—a 'back to basics' approach that incorporates sound business judgment, risk assessment, and integrity, from the top down."[6]

Investment portfolio. Another area susceptible to fraudulent activity is the investment portfolio process, due to the level of oversight and management. Brent Currey, an audit manager at the accounting firm, Frost PLLC, indicates that the investment portfolios of most financial institutions are often managed by a single individual with little or no oversight by another party, often due to a lack of available staff.[7] In some instances, staff with the required specialized skill set to manage the investment portfolio may be scarce. This highlights a greater need for additional scrutiny.

Currey explains the key controls needed under such circumstances, and they include proper segregation of duties for investment portfolios and processes involving purchasing, disbursement, and reconciliation within the investment cycle. Moreover, Currey indicates that risk analysis of the investment portfolio should be monitored closely by the institution's oversight group or an appropriate committee to ensure that the risk profile of the investment portfolio matches the risk goals for the institution. A key control is to separate the reconciliation of the investment portfolio from the management function. However, and more importantly, the reconciliation process should be performed by a separate individual, and the reconciling individual should be familiar with the investment process and diligently follow up on any significant reconciling items in a timely matter.

Conclusion

The point can again be made that one of the most significant challenges of the current economic environment is combating fraudulent activity. While there may not be a feasible way to eliminate every imaginable type of fraud, board and senior management have an important role in ensuring that the internal control environment and internal audit control function remain effective. Plato was quoted as saying "Good people do not need laws to tell them to act responsibly, while bad people will find a way around the laws." In this case, a strong and effective internal control environment serves as a deterrent to those who seek to circumvent the laws and processes designed to protect an institution. □

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[6] Available online at <www.fbi.gov/pressrel/speeches/mueller060209.htm>.

[7] "FROST, PLLC Shows How Lack of Internal Controls Leads to Fraud with Investment Portfolios," press release, available online at: <www.prlog.org/10381153-frost-pllc-shows-how-lack-of-internal-controls-leads-to-fraud-with-investment-portfolios.html>.

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(ALLL), inappropriate or poorly followed loan policies, and weak internal controls.

One specific area that will receive ongoing attention is commercial real estate (CRE) concentrations. At institutions that failed through the third quarter of 2009, the average CRE concentration, measured as a percentage of total risk-based capital, was well above the supervisory criteria defined in the 2006 interagency CRE guidance. History has shown that the inherent volatility in CRE markets presents considerable risk to the safety and soundness of banks. This risk stems from both the value of the property itself and the way the bank manages the risk. The risk management practices in place should be commensurate with the risk inherent in the portfolio. Common weaknesses include slow adoption of portfoliowide stress testing, lack of formal market analysis, inappropriate interest reserve extensions, and failure to incorporate CRE concentrations into the ALLL methodology.

Challenges Shaping the Regulatory Response

In several material loss reviews, regulators have been criticized for recognizing problems at an early stage, but not acting promptly or forcefully enough. Examiner guidance on this issue can be summarized by the following: "One important aspect of an examiner's job is knowing how to read and react, in a balanced and effective way, to symptoms of problems that may not yet be obvious to bank management and directors. This is sometimes the last point in time when an examiner may make a difference, through effective communications or moral suasion, in whether the bank rights itself or becomes a problem bank."[4]

Since problems can be masked during good times, one future challenge for supervisors is to determine the optimal time to intervene and the strength with which they need to convey their message. During benign times, there is less appetite for change, so greater reliance on leading indicators may be needed in order to react in time to rehabilitate. One response will be to boost the use of stress testing and off-site surveillance to better inform examinations. More attention will be given to reducing cyclical tendencies that tend to exacerbate problems. As Chairman Ben Bernanke stated, "We should revisit capital regulations, accounting rules, and other aspects of the regulatory regime to ensure that they do not induce excessive procyclicality in the financial system and the economy."[5] Greater emphasis will also be placed on incentives to ensure that they are properly aligned with the long-term health considerations of the institution.

Regulators recognize the importance of striking a proper balance. The objective is to ensure the safety and soundness of the institution, but to do so in a way that does not unduly constrict credit, impose excessive regulatory burden on the industry, or stifle innovation.

The Importance of an Actively Engaged Board

Perhaps the most common theme seen consistently throughout the years involves the board of directors and the role it plays in an institution's success or failure.

Effective governance stems from the board's commitment level, clarity about its role, and the extent and nature of its involvement in strategy, management succession, risk management, and compliance.

Conclusion

Bank failures have a significant impact on local communities and at times can create problems for otherwise healthy banks. It is the regulator's responsibility to safeguard the public's trust in banking, while still promoting industry competition and avoiding moral hazards. The risk of bank failures can be mitigated, but not eliminated. ☐

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[4] *An Examiner's Guide to Problem Bank Identification, Rehabilitation, and Resolution*, OCC, January 2001, available online at: <www.occ.treas.gov/prbbnkgd.pdf>.

[5] "The Crisis and the Policy Response," Chairman Ben S. Bernanke, London School of Economics, London, England, January 13, 2009, available online at:<www.federalreserve.gov/newsevents/speech/bernanke20090113a.htm>.

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