

STAYING AHEAD OF EVOLVING COMPLIANCE RISKS

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Personal. Proactive. Progressive...

- Compliance risk assessment
 - Interpretation
 - Staying ahead
 - Steps of risk assessment process
 - Monitoring
- Recent regulatory changes

COMPLIANCE RISK ASSESSMENT

Definition

Compliance risk is the current and prospective risk to earnings or capital arising from violations of, or nonconformance with, laws, rules, regulations, practices, internal policies, and procedures, or ethical standards

Compliance risk can lead to:

- Diminished reputation
- Reduced franchise (branding) value
- Limited business opportunities
- Reduced expansion potential
- Inability to enforce contracts



Compliance Risk – Evolving?

- Compliance risk assessment scopes are expanding to support increased regulatory requirements and government scrutiny
 - Tracking the numerous changes is becoming an ever-increasing burden
- The “checklist approach” for performing compliance risk assessments is not feasible
 - Needs to be more risk based
- Compliance risk management is developing as a distinct specialization

Compliance Risk – Evolving?

- Assessment activity is evolving into a continuous, almost dynamic, process
- Assessments are incorporating more third party risks
 - Risk managers often fail to incorporate legal and regulatory risks created by vendors and outsources in compliance risk assessments

Risk Tolerance

- Determining tolerance for compliance risk is a subjective task; therefore, not an easy one
- With proper controls and risk management strategies, it can be done
 - Compliance risk assessment
 - Risk based
 - Continuous updating

Compliance Risk Assessment

Steps in the risk assessment process:

1. Identify the risk and exposure
2. Measure the risk
3. Prioritize the risk
4. Populate the risk assessment matrix for each “measurement value”
5. Implementation of assessment

Identifying Compliance Risk

- Take inventory of all policies, procedures, rules and regulations applying to the credit union
- Develop a list of compliance risk; list out any recognizable problems, concerns, & perceivable risks regarding compliance

Measure Compliance Risk

Risk's potential impact on achievement of goals and objectives

- Impact of compliance risk indicators
 - Examples: High, Moderate, Low
 - Be consistent
- Probability of risk management indicators
 - Examples: High, Moderate, Low
- Create rating definition to promote consistency
 - Rating: Common denomination
 - System: create one that works best for you using numbering, lettering, or description indicators

Risk Indicator Measurement

- High Impact:
 - Violations or noncompliance expose a credit union to significant impairment of reputation, value, earnings, or business opportunity
 - Seasoned employees: monitor/ validate annually or more often
 - Conduct independent testing of compliance items
 - If risk happens, a credit union will probably not achieve its objective or to do so may require major damage control

Risk Indicator Measurement

- Moderate Impact:
 - Frequency or severity of violations/noncompliance is reasonable
 - Frequent testing of compliance items
 - If risk happens, a credit union will have to do extra work or it will be inefficient; still able to achieve goals and objectives

Risk Indicator Measurement

- Low Impact:
 - Violations or noncompliance issues are insignificant, as measured by their number or seriousness
 - Credit union has good record of compliance
 - Credit union has strong control structure that has proven effective
 - If risk happens, credit union will be aware of it but it will have little or no effect upon operations or objective's achievement

Risk Indicator Measurement

- Probability of Occurrence
 - Analyze probability of a risk becoming a reality
 - High Probability: will happen often
 - Moderate Probability: likely to happen, but not often
 - Low Probability: unlikely to happen at all



- Prioritize the compliance risk
 - Rank each “measured value” group from most to least significant
 - Break down matrix by compliance section, listing out departments and divisions. Example:
 - Lending (commercial, consumer, real estate, credit card)
 - Deposits (overdraft protection, new accounts)
 - IT (GLBA, privacy, red flags)
 - Branch operations
 - HR
 - Financial reporting (Call Report)

- Responsible party
 - Assign sections to “responsible parties” for oversight control and feedback as procedure changes are made
 - Each section can be assigned to the manager or director of that section
 - An acceptable “responsible party” should exhibit the following:
 - Exclusive responsibility for managing the risk
 - Appropriate knowledge to manage the risk
 - Necessary authority to manage the risk
 - List of individuals managing the risk must be reviewed and approved by management and the Board.

Risk Assessment Matrix

- Populate risk assessment matrix
 - List all measured values into a matrix
 - Details should include:
 - Compliance section
 - Sub-section
 - Objective/activity
 - Risk and exposure
 - Potential impact
 - Probability

Monitoring Frequency/ Requirements

Probability \ Impact	High	Moderate	Low
High	Extensive Risk Management Required	Considerable Risk Management Required	Manage & Monitor Risk
Moderate	Manage & Monitor Risk	Manage & Monitor or Only Monitor Risk	Monitor
Low	Monitor	Monitor Or Accept Risk	Accept Risk

Implementation Plan

- Take steps for compliance assessment to be effective
 - Research how it will impact both financially and operationally
- Create an action plan to roll out compliance assessment including testing the plan and training staff
- Incorporate BSA and ACH specialized assessments; both are required to be included in compliance assessment
- **Incorporate a review of risk assessment and areas in the internal audit/Supervisory Committee audit plan based on determined frequency**

What You Should Know

- Supervisory/Audit Committee members/Internal Auditors
 - Regulatory changes - familiarity
 - Training – webinars/seminars
 - Research information
 - Understand risks of noncompliance

RECENT REGULATORY CHANGES

Recent Regulatory Changes

- FCU director duties rule
- Evaluating payment system service providers
- Best practices in real estate appraisals
- Investment due diligence
- Indirect lending and due diligence
- SAFE Act
- Dodd-Frank legislation
- Enterprise risk management
- ACH updates
- New federal garnishment rules
- Overdraft payment supervisory guidance
- BSA reorganization of regulations
- Residential mortgage foreclosure concerns
- Call Report changes in March 2011

FCU Director Duties Rule

- Effective January 27, 2011; compliance required by July 27, 2011
- Only applies to federal credit unions
- State credit unions have similar rule

NCUA LETTER TO FEDERAL CREDIT UNIONS

NATIONAL CREDIT UNION ADMINISTRATION
1775 Duke Street, Alexandria, VA 22314

DATE: February 2011 LETTER NO.: 11-FCU-02
TO: Federal Credit Unions
SUBJ: Duties of Federal Credit Union Boards of Directors
ENCL: NCUA Regulation §701.4

FCU Director Duties Rule

- The rule states:

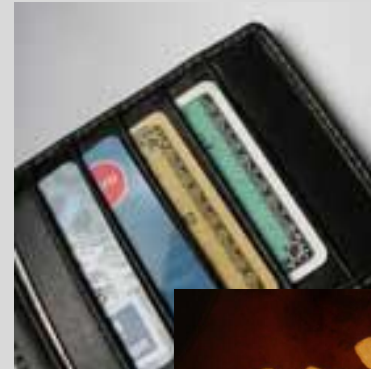
“Each FCU director has the duty to...At the time of election or appointment or within a reasonable time thereafter, not to exceed six months, have at least a working familiarity with basic finance and accounting practices, including the ability to read and understand the Federal Credit Union’s balance sheet and income statement and to ask, as appropriate, substantive questions of management and the internal and external auditors....”

Evaluating Payment System Providers

- NCUA letter 10-CU-26
- Effective December 2010
- Provides guidance to evaluate payment systems used to serve members and make decisions regarding changes to these service providers

Evaluating Payment System Providers

- Historically, most credit unions relied on corporates for processing:
 - Share draft settlements
 - ATM and debit settlements
 - Credit card settlements
 - Electronic funds transfers
 - Wire transfers



Evaluating Payment Systems Providers

- Risk exists with previous listed services
- NCUA provides a checklist to evaluate these services (www.ncua.gov)
- Resources and training are available from the NCUA



Best Practices in Real Estate Appraisals

- NCUA letter 10-CU-23
- Effective December 2010
- Applies to all real estate related financial transactions originated or purchased by a credit union for its own portfolio or assets held for sale



Best Practices in Real Estate Appraisals

- NCUA guidelines available on its website
- Highlights include:
 - Importance of collateral valuation process independent from lending process
 - Effective quality controls over appraisal process including periodic review of appraiser work
 - Expanded “Minimum Appraisal Standards” section to clarify that appraisals must contain opinion of market value as defined in agency regulations

Best Practices in Real Estate Appraisals

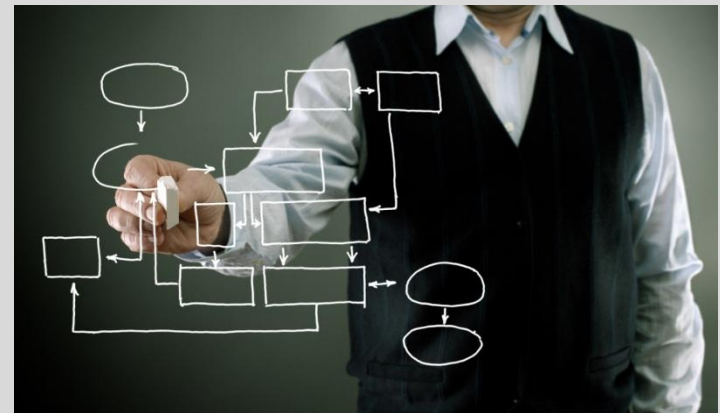
- Highlights (continued):
 - Minimum Appraisal Standards section clarifies that an automated valuation model (AVM) by itself is not an appraisal; contains guidance about having appraisal disclose nature and extent of research performed to verify a property's condition and support market value
 - Greater detail about adjustments for items such as improvements, lease terms, and market conditions

Best Practices in Real Estate Appraisals

- Highlights (continued):
 - Reinforcement of the Agencies' expectations regarding management of third-party relationships as they pertain to real estate lending
 - Need to develop policies for determining an appropriate collateral valuation methodology for various transactions

Investment Due Diligence

- NCUA letter 10-CU-18
- Effective September 2010
- Pertains to credit unions needing risk management processes in place for the nature, scope, and complexity of investment activities

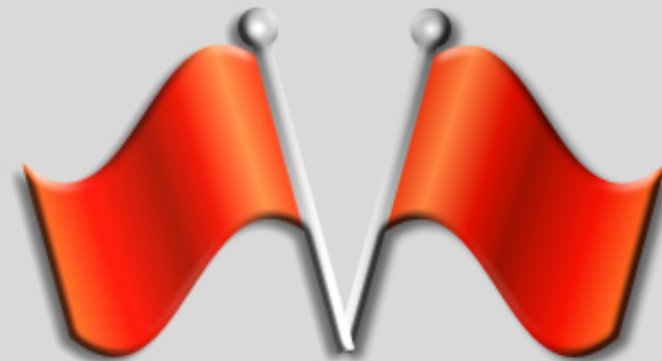


Investment Due Diligence

- Investment risk management should include:
 - Adequate due diligence
 - Reasonable exposure limits
 - Accurate risk management
 - Understanding the investment's structure
 - Knowledge of the collateral performance
 - Determination of the investment's suitability

Indirect Lending and Due Diligence

- NCUA letter 10-CU-15
- Effective August 2010
- Credit unions should understand risks related to indirect lending
- Examiners will be looking for ‘Red Flags’



Indirect Lending and Due Diligence: Red Flags

- Red Flag Examples
 - High concentration of indirect loans to total loans or net worth without adequate controls in place
 - Incentive programs for loan office bonuses tied to indirect loan volume
 - Inadequate analysis of overall portfolio performance
 - High instances of first payment default, payment deferment and account re-aging

Indirect Lending and Due Diligence: Red Flags

- Red Flag Examples
 - Frequent refinancing of past due interest, repairs and add-on expenses
 - Insufficient loan documentation
 - Poor dealer management
 - Includes reliance of dealer to obtain credit reports; accepting loan payments from dealers; dealer-created down payments through incentives, inflated or fraudulent trade-in or purchase price; or continuous overdrafts in dealer reserve accounts

Indirect Lending Due Diligence

- Credit unions should have an effective due diligence program to manage risk
- Program should have:
 - Successful planning process
 - Consistent underwriting standards
 - Financial and operational review process
 - Formalized contracts and written agreements
 - Effective risk management including the ability to detect and prevent fraud

SAFE Act of 2008

- Secure and Fair Enforcement for Mortgage Licensing (SAFE) Act
- Initial registration period: January 31 through July 29, 2011
- Applies to all federal and privately insured credit unions



SAFE Act

- All credit unions and their employees who are mortgage loan originators (MLOs) making residential mortgage loans, including:
 - First mortgages
 - Second mortgages
 - Home equity lines of credit
 - Refinanced loans
 - Reverse mortgages
 - Land purchased for the construction of a residence

- Who is an MLO?
 - Someone who both:
 - Takes a residential mortgage loan application
AND
 - Offers or negotiates terms of a residential mortgage loan for compensation or gain



- Credit unions must:
 - Develop policies and procedures (10/1/10 deadline)
 - Ensure MLOs are properly registered and not allow unregistered MLOs to perform these duties
 - Ensure information is updated when MLO changes occur
 - Provide other registry information as required and update information according to deadlines

- MLOs must:
 - Provide basic information
 - Obtain a unique MLO identifier
 - Maintain current registration as long as duties are performed
 - Make certain registry is updated if changes occur
 - Authorize registry to obtain information related to certain legal administrative actions
 - Attest to the accuracy of all information provided to the registry
 - Authorize the registry to make certain information available to the public

SAFE Act

- No licensing or continuing education requirements under federal registration system
- If a credit committee is used, at least one committee member must register
- CUSO employees need to be licensed according to state requirements
- Fees are still being determined

Dodd-Frank Legislation

- Much of Dodd-Frank is still to be determined
- Increases amount of deposit insurance to \$250,000
- Provides for establishment of a Consumer Financial Protection Bureau (CFPB)
- Provides for updated unified RESPA-TILA disclosures by July 21, 2011

Dodd-Frank Legislation

- Debit Interchange
 - Allows Fed to set interchange rate on debit transactions
 - Final rule was to be issued by April 21, 2011 (delayed)
- Mortgage Reform and Anti-Predatory Lending
 - To be finalized by January 21, 2013
- Underwriting Standards
 - Mortgage originators must determine if borrowers have ability to repay the loan
 - To be finalized by January 21, 2013

Dodd-Frank Legislation

- Bans prepayment penalties
 - Regulation due by January 21, 2013
- Appraisals:
 - Requires certified or licensed appraiser prior to making higher risk mortgages;
 - Joint agency statement to be issued by January 21, 2013
- Lower threshold for higher priced mortgages
 - Regulation due by January 21, 2013

Enterprise Risk Management

- 2011 will see continued focus on ERM
- Flow of information should continue to management and Board
- Credit unions should continue implementing an ERM strategy



ACH Rules Changes

- Elimination of opt-out requirements for ARC and BOC entries (March 18, 2011)
- Collection of return fees (September 16, 2011)
- Expanded use of XCK application (September 16, 2011)
- Recurring TEL transactions (September 16, 2011)

New Federal Garnishment Rules

- Effective May 1, 2011; changes apply to credit unions
- When garnishment order is received for an account where federal benefit payments were directly deposited, the financial institution has two business days to turn around

New Federal Garnishment Rules

- Determine if there are protected funds and issue a notice to the account holder.
- Notice must be sent out within three days after the review
- If garnishment includes “Notice of Right to Garnish Federal Benefits,” then follow customary procedures and no action is necessary

Overdraft Payment Supervisory Guidance

- Board and management are to ensure:
 - Risks associated with offering automated overdraft payment programs are mitigated
 - Compliance with all consumer protection laws and regulations, including disclosures, communications, fees, and other features/options
 - Demonstrate compliance with new opt-in requirements for ATM withdrawals and one-time point-of-sale debit card transactions

Overdraft Payment Supervisory Guidance

- Credit union supervisor expectations:
 - Steps to include annual review of overdraft program's key features
 - Review marketing, disclosure, and implementation of such programs to minimize potential member confusion and promote responsible use
 - Train staff to explain program features and choices
 - Prominently distinguish account balances from any available overdraft coverage amounts (including ATM)
 - Monitor programs for excessive or chronic use

Overdraft Payment Supervisory Guidance

- Institute appropriate daily limits
- Consider eliminating overdraft fees for transactions overdrawing an account by a de minimis amount
- Consider employing cost effective, existing technology, as appropriate (text, email, telephone or cell phone), to alert members when account balance is at risk of generating a fee for nonsufficient funds
- Consider providing information to members on how to access free or low-cost financial education workshops
- Review check-clearing procedures of the credit union and any third-party vendor to ensure they operate to avoid maximizing fees

BSA Reorganization of Regulations

- Revision of BSA regulations effective March 1, 2011
- Does not alter existing BSA regulatory obligations or impose new requirements
- Credit unions may need to revise existing policies, procedures and software monitoring systems to reflect the new citations

BSA Reorganization of Regulations

- FinCEN issued a rule to reorganize and transfer BSA regulations to a new chapter in the Code of Federal Regulation (CFR)
- Title 31, Chapter X: Financial Crimes Enforcement Network
- New structure organizes BSA regulations by industry and identifies regulations applicable to all regulated industries and individuals subject to the BSA in order to make regulatory obligations uniform
- Continue using existing BSA-related forms referencing 31CFR103 until FinCEN issues revised forms

Residential Mortgage Foreclosure Concerns

- Urges management to perform in-depth review of mortgage documentation and foreclosure management process
 - MERS (Mortgage Electronic Registration System)
 - Concerns with process to initiate foreclosures and questions on reassigning interest
 - Review the process of missing and defective loan documents; flawed documentation, missing notes, and improper assignments of other legal documents led to allegations of inappropriate action

Residential Mortgage Foreclosure Concerns

- Robo-signing: practice of executing foreclosure affidavits without verifying if supporting information is accurate
 - Concern with agents found executing flawed or untrue affidavits to speed the process
- Contractual put-back risk is a concern when relating to the practice of requiring originating lender to repurchase a mortgage sold on the secondary market
 - Examples show misrepresentations on the loan application or underwriting that did not conform to stated standards

Residential Mortgage Foreclosure Concerns

- It is imperative the BOD and management reviews the foreclosure process to ensure:
 - Appropriate policies and procedures
 - Experienced and knowledgeable staff
 - Effective internal controls
 - Adequate oversight, due diligence, and control of third-party servicers
 - Legally compliant documentation
 - Appropriate reporting to the Board

March 31, 2011 Call Report Changes

- Significant Changes:
 - Additional detail presented in Business Lending section for business loan type categories
 - Reporting of off-balance sheet commitments on Liquidity, Commitments, and Sources page
 - For each type of unfunded commitment, both the amount committed directly by the credit union and the amount committed through a third party (indirect) will be reported
 - See NCUA Letter 11-CU-02 (March 2011)

QUESTIONS?



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Thank You!



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