

How to Use This Manual

ELEMENTS OF A COMPLIANCE REVIEW

Management recognizes the importance of an effective internal monitoring process to ensure continued compliance with banking-related regulatory requirements. These compliance monitoring procedures are an *integral element* of the bank's overall compliance program. To achieve an optimum level of compliance with applicable laws, regulations, and rulings, these monitoring procedures will provide for a method of periodic review, and offer the compliance officer or internal auditor the tools necessary to conduct these reviews.

PART A — COMPLIANCE MONITORING WORK PAPERS

Part A of *Compliance Monitoring Program for State Non-Member Banks* contains all of the work papers, except the actual procedures (with accompanying worksheets and checklists), necessary to conduct an effective internal audit. These work papers are intended for use by the individual responsible for the compliance program in your bank, usually the compliance officer. Using these elements in conjunction with the procedures in Parts B and C will help ensure your continued compliance with regulatory requirements. These work papers include a compliance monitoring schedule, numerous product/service guidelines, a regulatory risk sampling grid, a sample memo of request, and an internal compliance review checklist. A description of each work paper follows.

Compliance Testing Schedule

Internal compliance reviews will be periodically performed in accordance with the "Compliance Testing Schedule," located in section A1. This Compliance Testing Schedule should be approved by management.

The timing and review frequencies set forth in this Schedule are based on the relative risk ratings assigned through the use of a regulatory risk model. In addition, the Compliance Testing Schedule incorporates the following elements:

- Inherent regulatory risk associated with each banking law, regulation, or ruling, product and/or service
- Regulatory reporting, recordkeeping, and submission dates
- Findings of the Federal Insurance Deposit Corporation (FDIC) examinations, internal and external audits, and reviews/assessments conducted by other third parties.

The Compliance Testing Schedule should be reviewed on at least an annual basis.

Product/Service Guidelines

The Product/Service Guidelines are intended to provide direction in determining the banking laws, regulations, and rulings that govern a particular product/service. These Guidelines are located in section A2. The bank has the option of performing certain internal compliance reviews by lending product or by law, regulation, or ruling.

For example, a review could be conducted to test compliance with the requirements of the Equal Credit Opportunity Act (Regulation B). Loan transactions should be selected for review that are governed by Regulation B. The Product/Service Guidelines could be used as a reference to determine the type of lending products (e.g., personal unsecured loans, residential real estate mortgages) governed by Regulation B.

As an alternative, a review could be conducted to test compliance with all of the banking laws, regulations, and rulings that impact residential real estate mortgages. This type of review would incorporate all of the monitoring procedures impacting residential real estate mortgages. The “Residential Real Estate Mortgages Product/Service Guidelines” could be used as a guide to ensure that the review includes all of the banking laws, regulations, and rulings which impact this type of loan for the purpose of testing.

Part C of the monitoring procedures includes worksheets and checklists that incorporate all of the laws, regulations, and rulings that impact each lending product (for example, residential real estate mortgages).

Regulatory Risk Sampling Grid

A Regulatory Risk Sampling Grid has been developed to assist in the planning of compliance monitoring activities. It is located in section A3. Relative risk ratings were assigned to each product and/or service, as well as each law, regulation, or ruling. The regulatory risk models are intended to assist in planning the nature, scope, and timing of internal compliance reviews. Sample size guidelines for each internal compliance review are presented in the Regulatory Risk Sampling Grid.

Sample size parameters are based on:

- Regulatory risk
- Penalty exposure
- Volume of new transactions per annum
- Average dollar amount of the new transactions
- Number of decision centers
- Staff experience/turnover
- Automated support controls
- Dual control systems

The Regulatory Risk Sampling Grid should be reviewed annually. Sample sizes included in the Regulatory Risk Sampling Grid should be updated to reflect the results of regulatory examinations, internal reviews, new legislation, recent court decisions, and other risk factors specific to the bank.

Sampling Method

It is recommended that the sample selected emphasize recent transactions, for the purpose of testing. Transactions should be selected using the “judgmental sampling” method.

The judgmental sampling method is used to review a portion of the population/universe of all applicable transactions (e.g., loans originated, deposit accounts opened). Therefore, conclusions may be reached by only testing a representative portion of the entire population/universe.

This sampling method requires that transactions be randomly chosen. However, it is essential that all products and services governed by each banking law, regulation, or ruling be included in the documentation sample. As previously mentioned, the Product/Service Guidelines can be used as an aid in this regard.

Additionally, the transactions selected for review should include items originated by every department, office, and officer to ensure that the documents chosen are an adequate representation of the population/universe of available transactions.

Memo of Request

The person responsible for the compliance program (we will refer to this individual as the compliance officer) may issue a “Memo of Request” to the employee(s) responsible for conducting the internal compliance review. A sample Memo of Request is located in section A4. This memo can serve to remind bank personnel of their individual internal compliance review responsibilities. Ideally, the memo of request should be issued 30 days prior to the review submission date.

All reviews should generally be completed during the month in which the review is scheduled as “due,” pursuant to the Testing Schedule.

Internal Compliance Review Checklist

This document should be distributed to all persons in the bank who have completed a compliance review of their area. The Internal Compliance Review Checklist, found in section A5 of this manual, is intended to serve as a tool to test the adequacy of internal controls and should be answered after completing the monitoring procedures (found in Parts B and C) and submitted with all other work papers relating to the review.

PART B — COMPLIANCE MONITORING PROCEDURES: REVIEW BY LAW, REGULATION, AND RULING

The monitoring procedures are located in Part B. Generally, the monitoring procedures reference examination procedures, worksheets, and checklists written by the various regulatory agencies. Procedures, worksheets, and checklists have been selected based on the adequacy and accuracy of the

material presented among the resources available. In several instances, checklists have been designed by the authors to complement or complete the procedures.

The monitoring procedures are reviewed frequently by the authors and will be updated, as necessary, to incorporate amendments, revisions, or official interpretations of banking laws, regulations, and rulings. An update to the monitoring procedures is noted by a solid black line under recently added information. The revision date is noted on each revised page.

Citations, or “cites,” that correspond to checklist or worksheet questions are included in certain monitoring procedures. The cites are noted in brackets after each general heading or checklist/worksheet question. These cites are to be used as a guide only and will be reviewed/updated at appropriate intervals. Bank employees using these audit procedures should refer to the actual law, regulation, or ruling to determine compliance, or possibly contact legal counsel, if necessary.

Each checklist item generally requires a yes, no, or N/A (not applicable) response. A negative response typically indicates an exception. Accordingly, all negative responses disclosing reportable exceptions should be communicated to the compliance officer through a written report. Negative responses should be thoroughly documented in the work papers. If necessary, a narrative should accompany supporting documentation. In the event no exceptions are noted, this should be mentioned in a written report.

Previously issued internal reports as well as reports issued by the FDIC (or other summary information), or other third parties, internal auditor, and/or external auditor should be reviewed to ensure that all exceptions previously identified have been corrected. The compliance officer or senior management may be requested to provide copies of these reports and/or give additional assistance in this regard.

To ensure the accurate and timely completion of the monitoring procedures, complete and unrestricted access to records and transactions normally should be provided to appropriate bank personnel.

PART C — COMPLIANCE MONITORING PROCEDURES: REVIEW BY LENDING PRODUCT

Management recognizes that compliance monitoring of certain products, particularly in the lending area, might be more easily and efficiently performed on a “by product” basis. In other words, instead of performing several reviews of Residential Real Estate Mortgages to test compliance with the requirements of various laws (e.g., Equal Credit Opportunity Act (Regulation B), Fair Credit Reporting Act, Fair Housing Act, Truth-in-Lending Act (Regulation Z), Real Estate Settlement Procedures Act (HUD’s Regulation X), Flood Disaster Protection Act), it may be more productive to review one sampling of Residential Real Estate Mortgages for compliance with all laws, regulations, or rulings that impact this lending product.

Conversely, it will remain most efficient to perform operational-related reviews by law, regulation, or ruling. Several operational-related regulatory requirements are driven by an “event” (e.g., the filing of a Currency Transaction Report, electronic funds transfer). This section will facilitate the conversion of Monitoring Procedures previously used in the lending area for reviews performed “by regulation” to reviews performed “by product.”

Monitoring procedures used for reviews by product refer to examination worksheets and checklists written by the various regulatory agencies. Procedures, worksheets, and checklists have been selected based on the adequacy and accuracy of the material presented among the resources available. In several instances, checklists have been designed by the authors to complement or complete the procedures.

Citations that correspond to checklist or worksheet questions are included in certain monitoring procedures. The “cites” are noted in brackets after each general heading or checklist/worksheet question. These cites are to be used as a *guide* only and will be reviewed and updated. Bank employees using these monitoring procedures should refer to the actual law, regulation, or ruling to determine compliance, or possibly contact legal counsel, if necessary.

For the reviews to be performed by product, all monitoring questions/procedures have been incorporated into a series of worksheets and checklists to be used for each product type. The worksheets and checklists include all applicable laws, regulations, and rulings, but incorporate only those sections of the law or regulation which apply to the particular product reviewed.

Each checklist item generally requires a “yes,” “no,” or “NA” (not applicable) response. A negative response typically indicates an exception. Accordingly, all negative responses disclosing reportable exceptions should be communicated to the compliance officer through a written report. Negative responses should be thoroughly documented in the work papers. If necessary, a narrative should accompany supporting documentation. In the event no exceptions are noted, this should also be mentioned in a written report.

Reviews by Lending Product

Performing reviews by lending product provides an opportunity to test for compliance with all laws, regulations, and rulings that impact each product. When performing reviews by lending product, it is recommended that the sample selected include both accepted and rejected loan applications. Advertisements or other promotional materials for the lending product may be reviewed as part of the lending product review, or included in a separate advertisement/marketing review.

This method is preferred by some bankers who believe this approach mirrors the thought process followed by lenders when a loan is originated. That is, the loan officer automatically considers the various laws, regulations, and rulings that apply to the type of credit in question. Since performing reviews this way closely parallels the lending process, monitoring activities can be used to test the adequacy of application and origination procedures.

Also, since the loan file was selected for review purposes, it is logical to review all the loan documents and the entire transaction from application to consummation. If a bank holding company dictates the product line for all subsidiaries, this review option is preferable so that specific products can be targeted and tested for compliance throughout the organization at appropriate intervals. Systemic exceptions that deserve the attention of corporate management can be easily identified and addressed quickly. As an added advantage, this option also closely parallels the way an examiners tests for compliance with lending related laws and regulations in a typical community bank compliance exam.

Note: Generally, it is not considered efficient to perform reviews on deposit products (e.g., demand deposit accounts (DDAs), savings deposits) to test for regulatory compliance. This is because the

provision of many laws and regulations that impact deposit products are triggered by an “event.” For example, the filing of a Currency Transaction Report is reviewed as part of the Bank Secrecy Act (BSA), and deposit advertisements would be reviewed through a Regulation DD review. This is the way the examiners test for compliance with operational regulations and is most efficient. It would be nearly impossible to review deposit products and realistically cover all of the laws and regulations that apply.

WORK PAPER EXPECTATIONS

All exceptions disclosed through completing the monitoring procedures should be adequately documented. Work papers should be neatly organized. Completed procedures and checklists as well as supporting work papers should be maintained.

A work paper review by the compliance officer should ensure that all compliance monitoring review procedures were properly performed and checklists were accurately completed, as required. This review by the compliance officer should be documented.

COMMUNICATION OF FINDINGS

At the conclusion of each internal compliance review, a written report should be prepared. The written report should identify the scope, findings, and conclusion of the review as well as any recommendation(s) for corrective action. Additionally, the time period considered during the review and the number of files or other items that comprised the basis of the review should be specifically identified.

It is suggested that the compliance officer be responsible for summarizing the results of all reviews. An overview of all review findings should be provided to the board of directors.

INTERNATIONAL BANKING FACILITIES

Regulatory compliance monitoring is important for an office of a foreign bank operating in the United States, particularly if that facility offers any type of consumer loans or deposit products. The compliance monitoring function should be guided by whichever of the federal financial regulatory agencies is the licensing agency. For example, the Office of the Comptroller of the Currency (OCC) may have licensed a U.S. branch under the International Banking Act, and therefore, it is important to conduct compliance monitoring reviews using the national bank monitoring procedures. Unfortunately, there is no simple way to provide a key to which agency is the licensing agency; rather, it is important to establish specifically which examining group will be reviewing the office.