

# COMMUNITY BANKING CONNECTIONS®

A SUPERVISION AND REGULATION PUBLICATION

## A Message from Governor Bowman

by Governor Michelle W. Bowman

First Issue 2021



Governor Michelle W. Bowman

The pandemic has tested community bankers like nothing before. Bankers have risen to the challenge with dedication and creativity, embracing innovative ideas to help their customers and communities. Community banks expanded hours and services at drive-up facilities, implemented plans to perform key functions remotely, and found ways to continue meeting customer needs when in-person services were disrupted. Through the ups and downs of business closures and reopenings, bankers maintained operations in part through the expansion of new technologies. “We closed lobbies,” a banker from Nebraska told me, “but we never closed the bank.”

As we look ahead to the future, the eventual end of restrictions on in-person banking does not, and should not, mean that the kind of technological innovation that has been so vital for the past year should disappear. The shift by many customers to remote banking and other technological solutions to help banks operate during the pandemic will likely continue. Technological innovation holds great promise to help community banks compete and succeed in the evolving financial services landscape. For this reason, it is my intent to continue to elevate issues related to technology to the top of the regulatory agenda.

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Like community banks, the Federal Reserve is also continuously investigating how technological innovations can transform the way we offer services. In one space that is familiar to you — payments — I would like to highlight several features of the FedNow Service that will enable financial institutions of every size to provide safe and efficient instant payment services in real time.

### Community Banks’ Pathway to Innovation

The continued success of community banks depends on their willingness to embrace innovation that aligns with their overall business strategy. When used effectively, technology can result in greater efficiencies, lower costs, and better service. We have seen, and are encouraged by, many examples of entrepreneurial community banks embracing technological innovation. Development or adoption of digital deposit and lending products and the use of technology to enhance operational efficiency are increasingly more common among community banks.

Financial technology (or “fintech”) will never completely eliminate what is the hallmark of community banking — personal interaction and relationships with customers and communities. However, there are clear benefits to responsible partnering with a fintech company to

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 I hope that some of our efforts, including refreshed and better-aligned interagency third-party risk management guidance, a due diligence guide for community banks, and a staff paper on fintech partnership practices, will support technological innovation at community banks. 

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leverage technology when a bank has limited in-house expertise or resources. A partnership with a fintech company can lower operating costs and improve a bank's services. Despite these benefits, community banks face challenges finding partners and knowing how to navigate the regulatory and legal environment once an institution identifies a potential partnership arrangement. I hope that some of our efforts, including refreshed and better-aligned interagency third-party risk management guidance, a due diligence guide for community banks, and a staff paper on fintech partnership practices, will support technological innovation at community banks.

#### **Interagency Guidance for Third-Party Risk Management**

To aid community bankers in evaluating the implications of partnering with a third party for technical services, I have directed Federal Reserve staff to work with our colleagues at the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation (FDIC) to enhance and align interagency guidance for third-party risk management. One purpose of this guidance is to eliminate the need for banks — including, and perhaps especially, community banks — to navigate multiple supervisory guidance documents. The proposed guidance will align each agency's existing supervisory expectations into interagency guidance.

#### **A Due Diligence Guide for Community Banks**

There is recognition by the agencies that community banks need information on third-party risk management practices that considers the uniqueness of their business model. Therefore, staffs at the Federal Reserve and the other federal banking agencies are developing a guide that will provide information to community banks on what to consider when conducting due diligence of a potential third-party service provider. The guide will be a resource that community banks can use when conducting due diligence prior to establishing a relationship with a third party, particularly fintech companies.

#### **A Fintech Partnership Staff Paper**

While many community banks recognize the benefits of integrating technology into their strategic objectives, the process of exploring a fintech partnership can be daunting, and these partnerships are not "one size fits all." As I mentioned at a December industry conference on technology and the regulatory agenda, I have asked Board staff to develop a paper describing the spectrum of community bank partnerships with fintech companies, which I hope may serve as a resource for community banks as they navigate this landscape.

#### **Federal Banking Agencies' Service Provider Supervision Program**

Given the increasing importance of technology to the banking industry, we understand that banks benefit from receiving timely information on the results of the federal banking agencies' (agencies) supervision program<sup>1</sup> for certain technology service providers. This is especially true for community banks that may not have the in-house expertise to evaluate a service provider's performance. In my conversations with bankers, I have heard that community bankers would like to receive more timely information on the results of agencies' assessment of the risks posed by a service provider to its client financial institutions.

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<sup>1</sup> Refer to the *Federal Financial Institutions Examination Council (FFIEC) IT Examination Handbook Info Base* and the "Supervision of Technology Service Providers" booklet at <https://ithandbook.ffiec.gov/it-booklets/supervision-of-technology-service-providers.aspx>.

I am pleased that the agencies have recently taken steps to improve the distribution of their supervisory reports on service providers to client financial institutions. The agencies have implemented an automated distribution system that notifies a client financial institution when a new report is available. The FDIC is coordinating this service for the agencies and will make a report for client financial institutions available electronically for 30 days from the date that the agencies release a report. After 30 days, client financial institutions can still request a copy of a service provider report by contacting their primary federal regulator. I should note that service provider reports are available only to client financial institutions and are not made public.

### **Artificial Intelligence and Machine Learning**

The Federal Reserve is also considering whether the rise of artificial intelligence (AI), including machine learning (ML), in banking might require an adjustment in regulation and supervision. This is a topic of interest to banks of all sizes and one that hinges on new technologies. Therefore, the Federal Reserve and the other banking agencies have been jointly conducting significant outreach to the banking industry and other stakeholders to better understand the benefits and risks posed by AI. For more information, listen to the December 16, 2020, Ask the Regulator session, held to engage the industry on AI and ML issues and to support responsible innovation in this area.<sup>2</sup> The Federal Reserve also hosted a symposium in January 2021 on the use of AI in financial services as part of our broader effort to understand AI's application to financial services, assess methods for managing risks arising from this technology, and determine where banking regulators can support responsible use of AI and equitable outcomes by improving supervisory clarity. The Federal Reserve is committed to continuing this dialogue to determine whether there are areas in which we might provide additional clarity on the use of these technologies.

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“ Like community banks, the Federal Reserve is also continuously investigating how technological innovations can transform the way we offer services. ”

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### **The FedNow Service**

The Federal Reserve also embraces technological innovation and is launching a new payment service — FedNow — sometime in 2023 or 2024. The FedNow Service<sup>3</sup> will provide a new interbank 24x7x365 real-time gross settlement service with integrated clearing functionality to support instant payments in the United States. Financial institutions of every size will be able to provide safe and efficient instant payment services in real time. Businesses and individuals will be able to send and receive instant payments conveniently, and recipients will have full access to funds within seconds. I encourage community banks to learn more about FedNow via its website.

### **Looking to the Future**

Supporting community banks as they adapt to new technologies and evolving industry dynamics continues to be a priority in my work at the Board. As part of my continued outreach with bank executives, I look forward to hearing views on ways the Federal Reserve can support the efforts of community banks and the pursuit of technological innovation. ■

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<sup>2</sup> Refer to the Ask the Fed website at <https://bsr.stlouisfed.org/askthefed/Auth/Logon>.

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<sup>3</sup> Refer to the Board's website for the FedNow Service at [www.federalreserve.gov/paymentsystems/fednow\\_about.htm](http://www.federalreserve.gov/paymentsystems/fednow_about.htm).



# Reopening of the Small Business Administration Paycheck Protection Program

The Economic Aid Act extended the authority of the Small Business Administration (SBA) to make Paycheck Protection Program (PPP) loans through March 31, 2021, and revised certain PPP requirements. For information, lenders should refer to the SBA's website at [www.sba.gov/ppp](http://www.sba.gov/ppp) or call the SBA hotline at 1-833-572-0502. Further, lenders are encouraged to read the information on the SBA's PPP loan forgiveness process at [www.sba.gov/funding-programs/loans/coronavirus-relief-options/paycheck-protection-program/ppp-loan-forgiveness](http://www.sba.gov/funding-programs/loans/coronavirus-relief-options/paycheck-protection-program/ppp-loan-forgiveness). The SBA website also provides guidance on the Paycheck Protection Platform that allows a lender to submit its PPP loan requests and loan forgiveness decisions. Only lenders and their authorized representatives may access this platform because SBA authorization is required.

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Editor: **Hilda Guay**  
Project Manager: **Ivy Washington**

Assistant Editor: **Maura Fernbacher**  
Designer: **Monica Conrad**  
Web Architect: **James Terry IV**

Advisory Board: **Andrea Bellucci**, Director, Examinations, Banking Supervision, FRB Dallas, **Virginia Gibbs**, Lead Financial Institution and Policy Analyst, Supervision Group, Division of Supervision and Regulation, Board of Governors, **Carolyn Healy**, Assistant Vice President, Supervision and Regulation, FRB Atlanta, **Brandon Howell**, Lead Financial Institution and Policy Analyst, Supervision Group, Division of Supervision and Regulation, Board of Governors, **Allison Lamb**, Manager, Supervision Group, Division of Supervision and Regulation, Board of Governors, **Jeff Legette**, Assistant Vice President, Supervision and Risk Management, FRB Kansas City, **Mark Medrano**, Assistant Vice President, Supervision and Regulation, FRB Chicago, **Mike Milchanowski**, Assistant Vice President, Supervision and Regulation, FRB St. Louis, **Shalan Miller**, Banking Supervisor, Supervision and Regulation, FRB Cleveland, **J.M. Nemish**, Senior Examiner, Supervision, Regulation, and Credit, FRB Richmond, **Michael Ravid**, Assistant Vice President, Regional and Community Supervision, FRB Boston, **Natalie Richter**, Supervision Manager – CBO, Community Banks, FRB New York, **Sandra Schumacher**, Central Point of Contact/Senior Examiner, Supervision, Regulation, and Credit, FRB Minneapolis, **Joseph Sciacca**, Central Point of Contact II, Financial Institution Supervision and Credit, FRB San Francisco, **Lauren Ware**, Assistant Vice President, Supervision, Regulation, and Credit, FRB Richmond

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# View from the District

## A Seventh District Perspective – Chicago



## Fraud Risk Management for the Ever-Present and Evolving Threat to the Payment Systems

by Julie Williams, Executive Vice President, Supervision and Regulation, Federal Reserve Bank of Chicago



Julie Williams

As the global pandemic has brought transformational changes to the way we live and function as a society, we've seen this crisis bring out the best in humanity. Many people, like our frontline responders, have demonstrated diligence and ingenuity in the face of these challenges. Similarly, Federal

Reserve supervisors have had to adapt to a remote working environment and shift supervision priorities to address the risks arising from the COVID-19 pandemic. However, the pandemic has also created a breeding ground for fraudsters seeking to exploit the financial industry and, consequently, the general public. We have seen firms and their clients targeted by these "bad actors"; therefore, I thought I would share my views on fraud risk management that would be relevant for bankers across the Federal Reserve System.

As an illustration, during the COVID-19 pandemic, a Nigerian crime ring used identity theft to steal millions of dollars from U.S. unemployment programs by filing for benefits with stolen information.<sup>1</sup> The crime ring diverted the funds to unsuspecting individuals who were unaware that the funds were fraudulently obtained. The crime ring then used social engineering techniques, such as online romance scams and phony job postings, to trick these individuals into unwittingly laundering the funds. The State of Washington lost so much money that it had to

temporarily halt unemployment payments to crack down on the fraud.<sup>2</sup> This fraud is suspected to have leveraged personal data stolen from previous cyberattacks. This scheme, and others like it, only add to a diverse set of fraudulent events afflicting the financial services industry.

Community banks play a vital role in identifying and preventing fraud, including instances similar to that just described. Therefore, community banks need to ensure that their controls are effective in this ever-changing threat landscape to protect their organizations and customers from fraud.

According to an *American Bankers Association (ABA) Deposit Account Fraud Survey*, deposit account fraud totaled \$25.1 billion in 2018, an increase from \$19.1 billion in 2016.<sup>3</sup> Commercial and savings banks surveyed experienced \$2.8 billion in fraud losses, while their fraud risk management efforts identified and prevented \$22.3 billion in losses. As fraud schemes increase in quantity and sophistication, banks are challenged with remaining steadfast in their response to protecting their reputations and assets, as well as those of their customers.

Community bankers benefit from strong relationships with their customers built through consistent interaction and community engagement. This affords community bankers a heightened ability to recognize out-of-pattern transactions and educate staff and customers on fraud awareness. While there is no uniform approach to

<sup>1</sup> See Brian Krebs, "U.S. Secret Service: 'Massive Fraud' Against State Unemployment Insurance Programs," *Krebs on Security* blog, May 16, 2020, available at <https://krebsonsecurity.com/2020/05/u-s-secret-service-massive-fraud-against-state-unemployment-insurance-programs/>.

<sup>2</sup> See the *ABA Deposit Account Fraud Survey* published January 1, 2020, available at [www.aba.com/news-research/research-analysis/deposit-account-fraud-survey-report](http://www.aba.com/news-research/research-analysis/deposit-account-fraud-survey-report).

<sup>3</sup> See Tony Romm, "Unemployed Workers Face New Delays and Paused Payments as States Race to Stamp Out Massive Nationwide Scam," *Washington Post*, June 12, 2020, available at [www.washingtonpost.com/business/2020/06/12/unemployment-benefits-fraud-delays/](https://www.washingtonpost.com/business/2020/06/12/unemployment-benefits-fraud-delays/).

fraud risk management, there are basic principles and recommendations endorsed by industry leaders in fraud awareness and internal controls that provide solutions that can be tailored to meet the needs of any organization.



## Types of Fraud Seen in the Industry

According to the ABA survey, check fraud made up 47 percent, or \$1.3 billion, of deposit account fraud losses in the industry in 2018.<sup>4</sup> What is old is new again, as banks see a rise in counterfeit checks presented through clearing or deposit fraud on new accounts, especially accounts opened online, which are on the rise in the current operating environment.

As the 2018 survey noted, banks continue to suffer losses from debit card fraud. Signature, personal identification number, and automated teller machine fraud accounted for \$1.2 billion, or 44 percent of industry losses, in 2018.<sup>5</sup> Recent declines of in-person spending and increased reliance on technology have created an environment ripe for additional online fraud attempts.

Further, the survey indicated that the remaining \$265 million of bank losses occurred in electronic banking

<sup>4</sup> See the ABA Deposit Account Fraud Survey.

<sup>5</sup> See the ABA Deposit Account Fraud Survey.

transactions, including online bill payments, person-to-person (P2P) and wire transfers, and transactions through automated clearinghouses.<sup>6</sup> Online banking exposes institutions and their customers to account takeovers as cybercriminals use various methods of social engineering, such as phishing emails with website links that appear authentic, to obtain an individual's authentication information, resulting in unauthorized online bill payments, P2P transfers, and even wire transfers.

Despite these disconcerting figures, the ABA survey does not account for consumer losses. According to the 2019 Federal Trade Commission (FTC) *Consumer Sentinel Network Data Book*, there were over 3.2 million reports of fraud resulting in over \$1.9 billion in consumer losses in 2019 alone.<sup>7</sup> As a result of the pandemic, 2020 consumer losses could be even greater as cybercriminals exploit pandemic fears to steal personally identifiable or financial information.<sup>8</sup> Therefore, banks are under immeasurable pressure to protect themselves and their customers from fraud. Fortunately, management can take steps to prevent and detect fraud.

## Industry Fraud Risk Management Practices

As a supervisor of a variety of banking organizations, the Federal Reserve is well positioned to observe industry fraud risk management practices and assess their relative effectiveness. Examiners have noted that many well-managed banks monitor and control fraud exposures using five main principles: (1) risk governance, (2) risk assessment, (3) control activities, (4) investigation and corrective action, and (5) risk monitoring activities. These principles are reinforced and outlined in the Office of the Comptroller of the Currency's (OCC) 2019 bulletin "Operational Risk: Fraud Risk Management Principles."<sup>9</sup> Further, the broader financial community is guided by the Committee of Sponsoring Organizations of the

<sup>6</sup> See the ABA Deposit Account Fraud Survey.

<sup>7</sup> See the 2019 FTC *Consumer Sentinel Network Data Book*, available at [www.ftc.gov/system/files/documents/reports/consumer-sentinel-network-data-book-2019/consumer\\_sentinel\\_network\\_data\\_book\\_2019.pdf](http://www.ftc.gov/system/files/documents/reports/consumer-sentinel-network-data-book-2019/consumer_sentinel_network_data_book_2019.pdf).

<sup>8</sup> See "Coronavirus Advice for Consumers," available at [www.ftc.gov/coronavirus/scams-consumer-advice](http://www.ftc.gov/coronavirus/scams-consumer-advice).

<sup>9</sup> See OCC Bulletin 2019-37, available at [www.occ.treas.gov/news-issuances/bulletins/2019/bulletin-2019-37.html](http://www.occ.treas.gov/news-issuances/bulletins/2019/bulletin-2019-37.html).

Treadway Commission (COSO) and the Association of Certified Fraud Examiners (ACFE), which published a fraud risk management guide<sup>10</sup> in 2016 that offers a blueprint to help organizations understand the current state of their fraud risk management tools and explore potential enhancements. The guide introduced five Fraud Risk Management Principles that align with the COSO Integrated Framework.<sup>11</sup> The ACFE subsequently partnered with Grant Thornton, an accounting and advisory organization, in 2020 to produce the *Anti-Fraud Playbook*,<sup>12</sup> providing actionable practices for these fraud risk management principles.

Although there is no one-size-fits-all approach, the *Anti-Fraud Playbook* outlines guidance based on these five risk management principles, which may assist bankers seeking to build or expand their fraud risk management programs.

**1. Fraud Risk Governance.** Effective fraud risk governance should be tailored to the specific needs and risk profile of an organization. Regardless of an institution's asset size or risk profile, sound risk management practices promote employee accountability. When an institution incorporates measures such as ongoing employee training, an ethics policy, an employee code of conduct, an identity theft program, or an elder abuse policy into organizational governance, a culture of fraud awareness and deterrence is established. Fraud prevention has greater success in banks that empower and reward employees for identifying and preventing fraudulent transactions.

**2. Fraud Risk Assessment.** A fraud risk assessment or data from existing reports can help identify activities that make a bank vulnerable to fraud and assess the likelihood and impact of potential fraud schemes on the institution. Consider how a fraudster may capitalize on vulnerabilities in banking processes to perpetrate fraud. Bankers can leverage data used in a Bank Secrecy Act/Anti-Money Laundering risk assessment, such as a change in the number of clients or new accounts, fraud Suspicious Activity Report (SAR) filings, changes in product offerings,

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<sup>10</sup> See "Fraud Risk Management Guide Executive Summary," September 2016, available at [www.coso.org/documents/COSO-Fraud-Risk-Management-Guide-Executive-Summary.pdf](http://www.coso.org/documents/COSO-Fraud-Risk-Management-Guide-Executive-Summary.pdf).

<sup>11</sup> See "Enterprise Risk Management — Integrating with Strategy and Performance," available at [www.coso.org/Pages/erm.aspx](http://www.coso.org/Pages/erm.aspx).

<sup>12</sup> See the *Anti-Fraud Playbook*, available at [www.grantthornton.com/services/advisory-services/risk-advisory-services/ACFE-global-fraudcon-and-playbook.aspx](http://www.grantthornton.com/services/advisory-services/risk-advisory-services/ACFE-global-fraudcon-and-playbook.aspx).

and increases in cash or wire activity to identify emerging fraud risks or evaluate current controls.

**3. Fraud Control Activities.** The results of a fraud risk assessment (or related data) can drive strategy in developing heightened internal controls to prevent and detect fraud. Controls to consider include:

#### **Preventive controls**

- Fraud awareness training for employees
- Dual controls over activities such as monetary instruments, general ledger entries, and vault access
- Segregation of duties for confirming payments or loan distributions

#### **Detective controls**

- Monitoring systems or reports designed to detect suspicious activity (e.g., unauthorized activity, exception reports, fee waiver analysis, and employee access reports)
- Fraud trend monitoring, which can be a simple Excel spreadsheet using existing data and does not require sophisticated machine learning programs (e.g., fraud to transaction volume ratios and charge-offs for a branch or banker)
- Effective complaint resolution processes
- Ethics and whistleblower reporting channels or hotline
- Mandatory vacation policy<sup>13</sup>

**4. Fraud Investigation and Corrective Action.** Once a process is in place to detect fraud, banks can develop a structure for an effective investigation that will help identify the root cause of the fraud and implement corrective actions. Banks should designate responsibilities for monitoring suspicious activity, escalating complaints received through an ethics hotline or other means, and conducting an investigation when a fraud event occurs. An effective investigative process provides for a comprehensive review of a fraudulent incident and

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<sup>13</sup> See Supervision and Regulation letter 96-37, "Supervisory Guidance on Required Absences from Sensitive Positions," available at <https://spweb.frb.gov/sites/BSRWeb/SR/Policy/PolLtrDocs/sr9637.pdf>.

considers communication of the results and remediation of the incident and related internal control weaknesses.

Additionally, fraud attempts against a bank or its customers, even if unsuccessful, are criminal acts. An organization should have a process to determine if a SAR filing is needed. Consult guidance from the U.S. Treasury's Financial Crime Enforcement Network (FinCEN) that describes when banks, bank holding companies, and subsidiaries are required to file a SAR or to notify law enforcement or regulators.<sup>14</sup>

**5. Fraud Risk Management Monitoring Activities.** Sound fraud risk management includes regular reporting to the board of directors or senior management on the organization's assessment of fraud risk, compensating controls, as well as any incidents and associated exposure. Monitoring reports allow management and the board of directors to measure performance and ascertain appropriate fraud prevention measures. Best practices can include benchmarking current fraud losses against loss history or industry data, such as:

- Fraud losses (e.g., per open account, closed account, or litigation), fraud recoveries, and net fraud losses
- Metrics by fraud type; for example, the Federal Reserve recently released the FraudClassifier Model in an effort to encourage consistent classification of payments fraud<sup>15</sup>
- Automated clearinghouse return rates
- Customers claiming unauthorized activity
- SAR filings related to fraud

## Fraud Risk Management Principles in Action

Assume a personal banker receives an email from Mr. Baker, an authorized signer on a well-known commercial account, requesting a wire transfer. The language in this new email request is similar to previous requests and appears to be from Mr. Baker's legitimate business email

<sup>14</sup> See "FinCEN SAR Electronic Filing Instructions," release date October 2012, available at [www.fincen.gov/sites/default/files/shared/FinCEN%20SAR%20ElectronicFilingInstructions-%20Stand%20Alone%20doc.pdf](http://www.fincen.gov/sites/default/files/shared/FinCEN%20SAR%20ElectronicFilingInstructions-%20Stand%20Alone%20doc.pdf).

<sup>15</sup> See the Federal Reserve FedPayments Improvements FraudClassifier Model, available at <https://fedpaymentsimprovement.org/strategic-initiatives/payments-security/fraudclassifier-model/>.

account, so the wire is processed. The next day, the bank learns that the email was compromised as a result of a spear-phishing attack. Such fraudulent emails typically appear to come from a client and contain a time-sensitive request for payment, which can result in a loss to the bank.

How can these incidents be prevented? The post-incident review might identify that the employee was overdue for fraud awareness training or might have been suspicious about the urgency of the request. This would be a gap in fraud risk governance (principle 1). This incident could have been included in the fraud risk assessment (principle 2) noting the increased risk to the bank given the year-over-year increase in volume and dollars of outgoing wire activity and any previous wire transfer fraud attempts. The investigation of this incident results in corrective actions (principle 4), such as an additional control to have a different client specialist (segregation of duties, also mitigating internal fraud) call the client at a number on file to authenticate all payment requests received via email (principle 3). Finally, reporting to the board of directors or management could include this incident through SAR reporting, if required, or a "significant case" summary (principle 5) to ensure transparency of exposure, compensating controls, and the associated losses. From there, management can ensure employee training is enhanced, past-due training is completed, and the newly implemented controls are documented and executed, thus restarting the circle of fraud risk management principles.

## Know, Educate, and Engage Your Customers

ABA survey respondents rated consumer victimization scams (e.g., fake check scams, internet job scams, and lottery scams), phishing emails, business email compromise schemes, and social engineering among the leading risks to the industry and its customers in 2020, and, as expected, these scams appear to have increased throughout the pandemic.

Community bankers have the benefit of knowing their customers and the ability to identify out-of-pattern activity. Bankers can train customer-facing employees to identify potential fraud victims (i.e., discuss large cash transactions or unusual wire requests to see if the reason for the transaction appears suspicious) and understand

how to escalate incidents in which customers may have acted under fraudulent pretenses.

Do you remember the Nigerian unemployment scam discussed earlier? Many community banks successfully identify similar situations because they know their clients and recognize large wire or cashier's check requests to be out of pattern. Upon further review, banks could determine that the funds were received from an unemployment agency in a different state than given to a differently named beneficiary. This awareness can result in the return of funds and prevent losses to unemployment programs.

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**“** Bankers can provide their customers with information on common fraud schemes, tips for transacting safely and effectively using authentication controls, and ways to identify and report a fraudulent transaction. **”**

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To further combat fraud, bankers can educate customers about fraud risks and preventive measures their customers can take to reduce the risk of becoming victims. Bankers can provide their customers with information on common fraud schemes, tips for transacting safely and effectively using authentication controls, and ways to identify and report a fraudulent transaction. For example, banks can use their own websites to share current scams, such as the Nigerian crime ring unemployment fraud, or reference external resources. The FTC website, [www.consumer.ftc.gov](http://www.consumer.ftc.gov), provides guidance on identity theft, and the Federal Bureau of Investigation's Internet Crimes Complaint Center website, [www.ic3.gov](http://www.ic3.gov), identifies current scams and options for reporting fraud. These websites outline the types of fraud scammers have used during the pandemic.

### What to Do After Fraud Is Identified

Even the best fraud risk management program cannot stop all fraud; however, recovery is possible when the fraud is

identified in a timely manner. A bank's incident response process should outline options to recover funds that left the institution. This includes losses experienced by the bank as well as incidents in which a customer was targeted that may result in bank exposure. Again, community banks have the advantage of knowing their customers, which helps to identify unusual activity, and the likelihood of material recovery is higher if the fraud is identified quickly and the proper recovery steps are followed.

Recovery processes vary for different transactions, and it is important to understand all available options, such as wire recalls, late check returns, or indemnification agreements obligating the receiving bank to return fraudulently obtained funds. One of the most effective recovery methods is contacting the recipient bank to discuss the fraudulent transaction and take timely corrective measures, especially when working with another community bank. Educating bank staff on these options will inevitably improve response time and result in higher recovery rates.

### Fighting Fraud at Your Institution

At the Federal Reserve Bank of Chicago, the Supervision and Regulation Department understands that fraud threats against financial institutions and consumers continue to evolve. We have established a fraud awareness initiative to keep our supervisory staff and internal stakeholders abreast of fraud trends. Although it is impossible to identify and prevent all attempted fraud, successful fraud risk management starts with awareness and education regarding the fraud risks for your bank employees and customers. We encourage our state member banks to report significant fraud incidents to their respective supervisory points of contact. Knowing these risks and considering how the recommendations of the regulatory agencies, COSO, and the ACFE may be incorporated into your fraud risk management processes can go a long way toward protecting your bank and your customers from falling victim to fraud. Going above and beyond to protect your customer may result in a customer for life. ■

# Relief for Community Banking Organizations Experiencing Unexpected Asset Growth

compiled by Virginia Gibbs, Lead Financial Institution and Policy Analyst, Community Bank Supervision – Communications Section, Division of Supervision and Regulation, Board of Governors of the Federal Reserve System\*

Community banking organizations have played an instrumental role in the nation's financial response to the coronavirus disease 2019 (COVID event). In some cases, community banks' participation in federal coronavirus response programs — such as the Small Business Administration's (SBA) Paycheck Protection Program (PPP) — and efforts to work with their customers have contributed to a rapid and unexpected increase in banks' assets. As a number of federal banking regulations contain asset-based compliance thresholds, a community banking organization may have found itself subject to new regulatory requirements that the organization would not have anticipated at the beginning of 2020.

Asset-based thresholds in regulations are designed, in part, to appropriately calibrate regulatory requirements given a banking organization's risk profile and, in some cases, the potential risk that the banking organization poses to U.S. financial stability. However, the balance sheets of community banking organizations may have grown, in many instances temporarily, as a result of banks' responses to the COVID event. Therefore, the Federal Reserve Board, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) (collectively, the agencies) have provided temporary regulatory and reporting relief to community banking organizations to address the consequences of the unanticipated asset growth in 2020. These relief efforts provide community banking organizations with more time for their balance sheets to return to precrisis levels. If a bank expects its asset growth to be long lasting, a bank has additional time to assess its options and either plan to

reduce its assets or prepare for any additional regulatory and reporting standards.

This article provides an overview of the actions taken by the agencies to provide temporary regulatory and reporting relief to those community banking organizations experiencing unexpected asset growth during the COVID event.

## Regulatory Relief

On December 2, 2020, the agencies published in the *Federal Register* an interim final rule (referred to as the "interagency interim rule") to permit community banking organizations<sup>1</sup> as of December 31, 2019, to use asset data as of December 31, 2019 (referred to as the "measurement date"), to determine the applicability of various regulatory asset thresholds during calendar years 2020 and 2021.<sup>2</sup> This means that asset growth in 2020 or 2021 will not trigger new regulatory requirements, including reporting requirements, for these community banking organizations until January 1, 2022, at the earliest.<sup>3</sup>

The agencies limited this regulatory burden relief to community banking organizations, as these organizations have fewer resources available to prepare for and comply with previously unanticipated regulatory requirements, especially during a time of economic uncertainty and disruption. Further, community banking organizations have originated a disproportionately large percentage

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\*The material in this article is drawn from several *Federal Register* notices concerning the actions of the Federal Reserve Board to provide regulatory relief to supervised institutions in response to the pandemic. Links to these source documents are provided in the article. The term *COVID event*, as used in this article, refers to the complex set of responses in both the private and public sectors to the outbreak of COVID-19.

<sup>1</sup> The interagency interim rule defines the term *community banking organizations* as national banks, savings associations, state banks, bank holding companies, savings and loan holding companies, and U.S. branches and agencies of foreign banking organizations with under \$10 billion in total assets.

<sup>2</sup> See 85 *Federal Register* 77345 (December 2, 2020). The public comment period ended on February 1, 2021; see [www.federalregister.gov/documents/2020/12/02/2020-26138/temporary-asset-thresholds](http://www.federalregister.gov/documents/2020/12/02/2020-26138/temporary-asset-thresholds).

<sup>3</sup> See 85 *Federal Register* 77345.

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“ Asset-based thresholds in regulations are designed, in part, to appropriately calibrate regulatory requirements given a banking organization’s risk profile and, in some cases, the potential risk that the banking organization poses to U.S. financial stability. However, the balance sheets of community banking organizations may have grown, in many instances temporarily, as a result of banks’ responses to the COVID event. ”

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of PPP loans, as compared with these organizations’ market share as a percentage of total banking system assets. According to SBA statistics, all lenders with less than \$10 billion in assets collectively originated 2.7 million PPP loans totaling \$233.7 billion and represented more than 52.6 percent of the number of loans originated under the program.<sup>4</sup> The low risk of the PPP and the likelihood that many PPP loans will be forgiven in the near term means that an increase in asset size at community banking organizations during the COVID event is likely to be temporary and less likely to reflect a change in an organization’s risk profile or business activities.

This temporary regulatory relief is automatically available to all community banking organizations. However, in the *Federal Register* notice for the interagency interim rule, the agencies noted that there may be limited instances, such as when a bank’s assets increased as a result of a merger or acquisition, when it may be appropriate for an agency to deny the relief with respect to an individual institution.<sup>5</sup> As explained in the notice, the agencies retained the discretion to determine whether a community banking organization is ineligible for relief with respect to one or more asset thresholds. For a Federal Reserve–supervised institution, it is expected that the reservation of authority would

be invoked only in exceptional cases, and the Federal Reserve Board would be required to make an institution-specific determination that an institution is ineligible for the relief based on its risk profile.

For a summary of the Board regulations with asset-based regulatory thresholds that were addressed by the interagency interim rule, see the table under "Section II. Discussion, A. Interim Final Rule" at [www.federalregister.gov/documents/2020/12/02/2020-26138/temporary-asset-thresholds](http://www.federalregister.gov/documents/2020/12/02/2020-26138/temporary-asset-thresholds).

There are also supervisory guidance documents that include asset-based thresholds of \$10 billion or below. In the *Federal Register* notice of the interagency interim rule, the agencies confirmed that thresholds included in supervisory guidance documents for community banking organizations are exemplary only and not suggestive of requirements, and noted that they will take the same perspective on asset-based thresholds in guidance that they are taking with regard to asset-based regulatory thresholds.

## Regulatory Reporting Relief

The Reports of Condition and Income (Call Reports) contain various total asset thresholds that are measured annually as of the June 30 report date and trigger additional reporting requirements once an institution crosses a threshold, generally starting with the reports for the first calendar quarter of the next calendar

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<sup>4</sup> See SBA, “Paycheck Protection Program (PPP) Report: Approvals Through 08/08/2020,” available at <https://home.treasury.gov/system/files/136/SBA-Paycheck-Protection-Program-Loan-Report-Round2.pdf>.

<sup>5</sup> The interagency interim rule includes a reservation of authority provision, pursuant to which an agency may determine that a community banking organization is ineligible for relief with respect to one or more asset thresholds.

year.<sup>6</sup> Therefore, similar to the relief provided in the interagency interim rule, the agencies issued a proposal to temporarily revise applicable Call Report instructions to provide reporting relief for those community banking organizations experiencing a temporary asset growth.<sup>7</sup>

As explained in the proposal, an institution would be permitted to use the lesser of its total assets as of December 31, 2019, or as of the current quarter-end report date to determine whether it meets the \$10 billion total asset threshold.<sup>8</sup> For the Call Reports through December 31, 2021, a community banking organization would be permitted to determine the applicability of asset-based reporting thresholds set at \$10 billion or lower by using asset data as of December 31, 2019, if the bank's assets as of that date were less than its assets on the date as of which the applicability of a given threshold would normally be determined.<sup>9</sup>

The proposed revisions to the Call Reports would not affect the substantive reporting instructions for any item, schedule, or report. Rather, this proposed action merely affects which institutions are required to submit certain items, schedules, or reports. The proposal notes that the agencies reserve the authority to determine that relief would not be appropriate with regard to a specific institution.

<sup>6</sup> These thresholds include the \$5 billion threshold for limiting a bank's eligibility to use the simplified Federal Financial Institutions Examination Council (FFIEC) 051 version of the Call Report, and the \$100 million, \$300 million, \$1 billion, and \$10 billion thresholds for reporting certain additional data items in the Call Reports.

<sup>7</sup> See 86 *Federal Register* 10157 (February 18, 2021), available at <https://www.federalregister.gov/documents/2021/02/18/2021-03210/agency-information-collection-activities-submission-for-omb-review-comment-request>.

<sup>8</sup> Redlined copies of the proposed changes of the FFIEC 031, FFIEC 041, and FFIEC 051 Call Report forms clarifying affected footnotes and draft Supplemental Instructions providing guidance on the temporary adjustment to the measurement date for certain total asset thresholds are available on the FFIEC's web page for each report, which can be accessed from the FFIEC's Reporting Forms web page at [www.ffiec.gov/ffiec\\_report\\_forms.htm](http://www.ffiec.gov/ffiec_report_forms.htm).

<sup>9</sup> See 86 *Federal Register* 10157 (February 18, 2021).

As part of the *Federal Register* notice<sup>10</sup> for the interagency interim rule, the Federal Reserve also temporarily revised the reporting instructions for a number of its regulatory reports to provide that community banking organizations will be permitted to determine the applicability of asset-based reporting thresholds set at \$10 billion or less using asset data as of December 31, 2019.<sup>11</sup> Therefore, a community bank holding company's asset growth in 2020 or 2021 will not trigger new reporting requirements until January 1, 2022, at the earliest.<sup>12</sup>

## Community Bank Leverage Ratio Eligibility

The agencies have previously adopted rules permitting institutions that meet certain criteria to use the community bank leverage ratio (CBLR) framework to measure such institutions' regulatory capital.<sup>13</sup> As part of the interagency interim rule, the agencies have revised their capital rules to allow a community banking organization that temporarily exceeds the \$10 billion total asset threshold to use the CBLR framework from December 31, 2020, to December 31, 2021, provided the bank meets the other qualifying criteria for the CBLR framework. Therefore, as explained in the agencies' notice on proposed changes to the Call Reports, a bank that qualifies for and elects to use the CBLR framework under this temporary relief should report CBLR information in Call Report Schedule RC-R, Part I, except

<sup>10</sup> See 85 *Federal Register* 77351–77352 (December 2, 2020) for Table 1, Reporting Requirements for Affected Federal Reserve Under Interim Final Rule and After Regulatory Burden Ends, available at [www.federalregister.gov/documents/2020/12/02/2020-26138/temporary-asset-thresholds](https://www.federalregister.gov/documents/2020/12/02/2020-26138/temporary-asset-thresholds).

<sup>11</sup> The following regulatory reports were temporarily revised: Financial Statements for Holding Companies (FR Y-9 reports; OMB No. 7100-0128); Statements of U.S. Nonbank Subsidiaries of U.S. Holding Companies (FR Y-11 and FR Y-11S; 7100-0244) (FR Y-11 reports); Reports of Foreign Banking Organizations (FR Y-7N, FR Y-7NS, and FR Y-7Q; 7100-0125) (FR Y-7 reports); and Statements of Foreign Subsidiaries of U.S. Banks (FR 2314 and FR 2314S; OMB No. 7100-0073) (FR 2314 reports).

<sup>12</sup> See 85 *Federal Register* 77351–77352 (December 2, 2020).

<sup>13</sup> See 12 CFR 217.12 (Federal Reserve Board) at <https://ecfr.federalregister.gov/current/title-12/chapter-II/subchapter-A/part-217/subpart-B/section-217.12>; 12 CFR 3.12 (OCC) at <https://ecfr.federalregister.gov/current/title-12/chapter-I/part-3/subpart-B/section-3.12>; and 12 CFR 324.12 (FDIC) at <https://ecfr.federalregister.gov/current/title-12/chapter-III/subchapter-B/part-324/subpart-B/section-324.12>.

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**“** In some cases, community banks’ participation in federal coronavirus response programs — such as the Small Business Administration’s Paycheck Protection Program — and efforts to work with their customers have contributed to a rapid and unexpected increase in banks’ assets. **”**

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that item 32 (Total assets) on that schedule should reflect the lesser of the bank’s total assets as of December 31, 2019, or as of the quarter-end report date.<sup>14</sup>

### **FDIC Audit Requirements Relief**

On October 20, 2020, the FDIC approved an interim final rule to provide temporary relief from the audit and reporting regulatory requirements (12 CFR 363) for insured depository institutions (IDIs) that have experienced temporary asset growth due to participation in federal coronavirus response programs.<sup>15</sup> Pursuant to the FDIC’s interim final rule, an IDI determines whether it is subject to the audit and reporting requirements for fiscal years ending in 2021 based on the lesser of its (a) consolidated total assets as of December 31, 2019, or (b) consolidated total assets as of the beginning of its fiscal year ending in 2021.<sup>16</sup> The intent of the FDIC’s interim final rule is to neutralize burdens that IDIs may incur or have incurred because of temporary increases in their consolidated total assets resulting from participation in recent COVID

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<sup>14</sup> See 86 *Federal Register* 10157 (February 18, 2021).

<sup>15</sup> See 85 *Federal Register* 67427 (October 23, 2020) at [www.federalregister.gov/documents/2020/10/23/2020-23630/applicability-of-annual-independent-audits-and-reporting-requirements-for-fiscal-years-ending-in](http://www.federalregister.gov/documents/2020/10/23/2020-23630/applicability-of-annual-independent-audits-and-reporting-requirements-for-fiscal-years-ending-in).

<sup>16</sup> See 85 *Federal Register* 67427.

event-related stimulus activities. The FDIC reserved the authority to require an IDI to comply with one or more 12 CFR 363 requirements if the FDIC determines that asset growth was related to a merger or acquisition.<sup>17</sup>

### **Conclusion**

Community banking organizations continue to support the U.S. economic recovery from the COVID event. In some cases, a community banking organization may find that this activity has resulted in an unexpected increase in its assets that could trigger additional regulatory or reporting requirements. Therefore, agencies have provided regulatory and reporting relief to help community banking organizations manage this unplanned and temporary asset growth. A community banking organization with questions on the interagency interim rule or other regulatory relief should contact its primary federal regulator. In the case of Federal Reserve-supervised institutions, bankers should contact their point of contact at their local Reserve Bank. ■

# Regulation O Revisited

by Robert Crepinsek, Examiner, Supervision, Regulation & Credit, Federal Reserve Bank of Boston, and William Mark, Lead Examiner, Supervision & Regulation, Federal Reserve Bank of Chicago

As part of bank examinations and holding company inspections, examiners assess institutions' processes and controls designed to ensure compliance with all banking laws, rules, regulations, and supervisory requirements. One of those regulations is Regulation O, or Reg O, which governs extensions of credit by banks to certain bank employees, or insiders.<sup>1</sup> Reg O was designed to ensure insiders are not given preferential treatment and to safeguard against insider abuse. This article provides a general overview of Reg O and touches on the adjusting of certain Reg O restrictions as a result of the pandemic.

## Definition of Insiders

So, who is considered an insider? Insiders include executive officers, directors,<sup>2</sup> and principal shareholders (and the related interests of these individuals) of the bank and its affiliates. Reg O defines *executive officer* as any person who participates (or has the authority to participate) in major policymaking functions, regardless of title or compensation, though it specifically lists the chairman of the board, the president, every vice president, the cashier, the secretary, and the treasurer as executive officers, unless excluded through bylaws or by a resolution of the board of directors and in practice the individual does not participate in major policymaking functions.<sup>3</sup> *Principal shareholder* is anyone who directly or indirectly, or acting in concert with one or more persons, owns,

<sup>1</sup> Transactions with insiders are also governed by general standards of safety and soundness, prohibitions against fraud and abuse, and corporate fiduciary duties, as well as, in some circumstances, other provisions of federal banking law such as section 23A of the Federal Reserve Act (12 U.S.C. § 371c).

<sup>2</sup> According to the U.S. Code of Federal Regulations, 12 CFR 215.2(d) (1), a "director of a company or bank means any director of the company or bank, whether or not receiving compensation." See [www.federalreserve.gov/supervisionreg/regocg.htm](http://www.federalreserve.gov/supervisionreg/regocg.htm).

<sup>3</sup> For affiliated companies, a signed resolution by the board of directors could remove an executive officer from the list of insiders, as long as the individual does not participate in major policymaking functions and the affiliate is not the parent bank holding company or does not represent more than 10 percent of consolidated assets.

controls, or has the power to vote more than 10 percent of the shares of the bank or its holding company. Shares owned or controlled by immediate family members are attributed to the individual; for purposes of Reg O, immediate family members are limited to spouse, minor children, and adult children living with the individual.

As related interests of the insider include any company controlled by the insider, there should be a clear understanding of what constitutes control. For purposes of Reg O, it results from directly or indirectly (individually or with others) owning, controlling, or having the power to vote 25 percent or more of any class of voting securities of a company. It also includes controlling the election of a majority of the directors of a company, or having the power to exercise a controlling influence over the management or polices of a company. Further, there is a presumption of control for any director or officer of a company who directly or indirectly owns, controls, or has the power to vote more than 10 percent of any class of voting securities of that company, or for any person who directly or indirectly owns, controls, or has the power to vote more than 10 percent of any class of voting securities if no other person owns a greater percentage. Presumptions of control do not apply simply by virtue of holding the position as a director or officer of an unaffiliated company. So first, management needs to have an accurate accounting of all loans made by the bank to its insiders and their related interests. The next consideration is loans made to insiders of any bank affiliates. In a typical bank holding company structure, affiliates of the bank include the parent holding company and all its subsidiaries.

## Limits and Restrictions on Loans to Insiders

Loans to insiders have limits on an individual as well as an aggregate basis. The lending limit to an individual, including related interests, is 15 percent of the bank's unimpaired capital and surplus for loans that are not

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**“ Noncompliance with Reg O subjects the bank to compliance, operational, and legal risks, which together could translate into increased reputational risk. ”**

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fully secured, and an additional 10 percent for loans that are fully secured by readily marketable collateral.<sup>4</sup> Loans fully secured by obligations of the U.S. government or agencies or loans secured by deposits held at the bank do not apply toward the limit. On an aggregate basis, loans to insiders are limited to the equivalent of the bank's unimpaired capital and surplus, or up to two times unimpaired capital and surplus for banks with less than \$100 million in deposits, as long as a signed resolution by the board of directors justifies the higher limit. The higher limit for smaller banks is also conditioned on the bank meeting applicable capital requirements and having a satisfactory CAMELS<sup>5</sup> composite rating in its most recent report of examination.

In addition to the quantifiable limits, Reg O includes general prohibitions based on terms and creditworthiness. In general, loans made to insiders must be on substantially the same terms, such as interest rates and collateral, as loans made to non-insiders, with the same underwriting

standards applied at origination.<sup>6</sup> In addition, the loan must not involve more than the normal risk of repayment or present other unfavorable features. Further, any loan to an insider of an amount more than \$25,000 or 5 percent of unimpaired capital and surplus, whichever is higher, must be preapproved by a majority vote of the board of directors, and the insider must abstain from the approval process.<sup>7</sup> Prior approval is also required when an extension of credit, regardless of the amount, results in aggregate debt to the individual and their related interests exceeding \$500,000.<sup>8</sup>

## Recordkeeping

In general, banks should maintain the necessary records for ensuring compliance with Reg O. Although Reg O does not prescribe a specific recordkeeping methodology, the regulation does provide detail on the types of records required, as well as two suggested methodologies for collecting relevant data on extensions of credit to insiders of affiliates. Required records include an accounting of (1) all insiders, (2) all extensions of credit to these insiders, and (3) all extensions of credit to insiders of bank affiliates. For the third category, the regulation identifies two potential methodologies for use: the survey and the borrower inquiry methods.

As the name suggests, the survey method involves conducting an annual survey of the bank's affiliates to identify each insider at those affiliates. From the resulting list, the bank would then have to maintain a listing of the amount and terms of every extension of credit to each identified insider. The borrower inquiry method requires the borrower to indicate whether the borrower is an insider of an affiliate when applying for a loan. Once again, the onus is on the bank to maintain accurate records of all extensions of credit to those self-identified insiders. It is permissible for a bank to have an alternative method

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<sup>4</sup> In situations in which state law establishes a lower limit for loans to one borrower, the lending limit established by the state applies.

<sup>5</sup> “CAMELS” refers to the supervisory rating framework that federal and state bank regulators use in communicating an assessment of a bank’s condition. On a 1 to 5 rating scale, examiners assign a composite rating and six component ratings: Capital (C), Asset Quality (A), Management (M), Earnings (E), Liquidity (L), and Sensitivity to market risk (S). To be deemed satisfactory, a bank must receive a CAMELS composite rating of no less than 2.

<sup>6</sup> From the *Commercial Bank Examination Manual*, “preferential terms include lower interest rates than those offered on similar types of loans, lower collateral requirements (or unsecured), longer maturities, no personal guarantee (if required from the general public), made for purposes not available to the general public, or lacking financial or other information generally required.”

<sup>7</sup> As described in 12 CFR 215.4(b)(1).

<sup>8</sup> As outlined in 12 CFR 215.4(b)(2).

for identifying and maintaining records on all extensions of credit to insiders of the bank's affiliates, as long as the bank's primary federal regulator deems it effective.

## Overdrafts

An extension of credit is "a making of or renewal of a loan, a granting of a line of credit, or an extending of credit in any manner whatsoever."<sup>9</sup> Of the seven specific examples of extensions of credit detailed in Reg O,<sup>10</sup> anecdotal evidence suggests that overdraft activity results in the most common contraventions of Reg O. This is likely in part due to their temporary nature and the set of additional restrictions that apply to overdrafts. Overdrafts of \$5,000 or less are not considered extensions of credit if made pursuant to a written, preauthorized, interest-bearing extension of credit plan, or a written, preauthorized transfer of funds from another account.<sup>11</sup>

In addition, banks are prohibited from paying overdrafts to executive officers and directors. The prohibition on overdrafts, however, does not apply to the payment of inadvertent overdrafts if the aggregate amount of overdrafts on an account does not exceed \$1,000, the account is not overdrawn for more than five business days, and the executive officer or director is charged the same fee as any other customer. The prohibition on the payment of overdrafts does not apply to principal shareholders who are not also an executive officer or director, or to the related interests of insiders.

## Executive Officers

Some additional restrictions apply to executive officers of the bank (but not to the executive officers of the bank's affiliates). Extensions of credit for the education of an executive officer's children or for the purchase,

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<sup>9</sup> As defined in 12 CFR 215.3(a).

<sup>10</sup> 12 CFR 215.3(a) lists seven examples of extensions of credit: repurchase agreement; overdraft; standby letter of credit; acquisition of any indebtedness upon which the insider may be liable as maker, drawer, endorser, guarantor, or surety; increase in existing indebtedness; advance on unearned salary greater than 30 days; and any other obligation to pay money or its equivalent whatsoever. Section 215.3(b) provides examples of items not considered extensions of credit, including balances of less than \$15,000 on a bank-issued credit card.

<sup>11</sup> According to 12 CFR 215.3(b)(6).

construction, maintenance, improvement, or refinancing of a residence are permissible without limitation (for the residence, provided the extension of credit is secured by a first lien and the residence is owned by the executive). Loans fully secured by deposits held at the bank or by U.S. government obligations also have no limits. Loans for any other purpose are permissible as long as aggregate loans to that executive officer do not exceed the higher of 2.5 percent of the bank's unimpaired capital and surplus or \$25,000, but in no event more than \$100,000.<sup>12</sup> In addition, any extension of credit to the executive officer must be:

- promptly reported to the board of directors;
- on the same terms and conditions available to the general public;
- preceded by the submission of a detailed current financial statement of the executive officer; and
- made subject to the condition in writing that the extension of credit will, at the option of the bank, become due and payable should the executive officer have debt with an unaffiliated bank in excess of the limit.

## Risk Management

Noncompliance with Reg O subjects the bank to compliance, operational, and legal risks, which together could translate into increased reputational risk. Further, inadvertent violations could result in examination findings requiring the board to improve risk management practices for the identified risk associated with extensions of credit to insiders. Significant, repeat, or willful contraventions of Reg O could escalate to civil money penalties. Therefore, if lending to insiders is a standard bank practice, the bank should have risk management processes commensurate with the level of activity. Determining the level of risk should start with a risk assessment, either internally or by the bank's outsourced internal audit function. The level of risk assigned would justify the extent and frequency of prescribed internal audit reviews for compliance with Reg O, as well as with related internal policies and procedures.

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<sup>12</sup> Based on a tier 1 leverage ratio of 10 percent, only banks with less than approximately \$40 million in assets would have a limit of less than \$100,000.

From an examination perspective, the most important considerations are that:

- management has established a process for proactively identifying and quantifying all extensions of credit to insiders of the bank and its affiliates;
- such extensions do not give preference to any insider and remain below regulatory limits for individual insiders as well as in aggregate for all insiders; and
- associated risk management practices are in place to prevent, recognize, and correct potential Reg O violations.

Extensions of credit to an insider include loans made to any company controlled by the insider. To ensure an accurate accounting of loans to insiders, management also needs to identify all companies owned or controlled by officers, directors, and principal shareholders. For a small community bank, even one owned by a shell bank holding company, this could be a relatively simple task; however, for a large bank holding company with multiple nonbank subsidiaries, the task is more substantial.<sup>13</sup> As with all risk management processes, internal controls should be scaled to the size and complexity of the institution.

Management could take action to reduce, or at least control, the risk of a Reg O violation by including detail in loan approval documents that the board reviewed the loan to an insider and confirmed compliance with Reg O. Such documentation could include an affirmation that the loan is consistent with similar loans made to the general public. Maintaining a master list of insiders at the bank also facilitates Reg O compliance, demonstrating management's commitment to an accurate accounting of applicable loans. A running total of aggregate loans to executive officers, directors, and principal shareholders

<sup>13</sup> Supervision and Regulation (SR) letter 19-16, "Status of Certain Investment Funds and Their Portfolio Investments for Purposes of Regulation O and Reporting Requirements Under Part 363 of FDIC Regulations," discusses the application of examiner discretion to temporarily address the treatment of portfolio companies of mutual fund complexes that may have become principal shareholders of specific banks or bank holding companies. While SR letter 19-16 has limited ramifications for small community banking organizations, it does reflect the intricacies of applying the definition of insiders under Reg O. The SR letter is available at [www.federalreserve.gov/supervisionreg/srletters/sr1916.htm](http://www.federalreserve.gov/supervisionreg/srletters/sr1916.htm).

(and their related interests) relative to the bank's unimpaired capital and surplus can also be included in standard reporting packages prepared by bank management for review by directors or trustees prior to regularly scheduled board meetings. In addition, while not solely for Reg O compliance purposes, periodic review of employee checking account activity by the internal audit function for irregularities, such as overdrafts, could identify potential Reg O violations. Lastly, a consistent, disciplined practice of making loans to insiders that are no more favorable than those to the general public will provide the most assurance that the bank will remain in regulatory compliance.

## Adjustment to Certain Reg O Restrictions in Light of COVID-19

On April 17, 2020, the Federal Reserve Board announced a temporary rule change in support of the Paycheck Protection Program (PPP), which was created in connection with the Coronavirus Aid, Relief, and Economic Security (CARES) Act. The PPP was designed to facilitate lending to small businesses affected by COVID-19.<sup>14</sup> In order not to restrict access to PPP loans to certain insiders of banks, particularly in rural areas, the Board's interim final rule excluded certain PPP loans from being considered extensions of credit. On July 4, 2020, the President signed into law the Prioritized Paycheck Protection Program Act (PPP Act), which extended the PPP to August 8, 2020. Consequently, the Board extended the exclusion of PPP loans originated by that date from the quantitative limits on loans to insiders contained in Reg O.

Importantly, the Small Business Administration (SBA) explicitly prohibited banks from favoring, in processing time or prioritization, a PPP loan application from a director or equity holder, and the Board announced that it would administer both rule changes accordingly.

The Board's temporary rule changes are consistent with interim final rules made by the SBA, administrator of the PPP and PPPP Act. The SBA's interim final rule applied to outside directors or holders of less than 30 percent equity

*Continued on page 22*

<sup>14</sup> See the July 15, 2020, Board press release at [www.federalreserve.gov/newsevents/pressreleases/bcreg20200715a.htm](http://www.federalreserve.gov/newsevents/pressreleases/bcreg20200715a.htm).

# Community Bank Liquidity: Balance Sheet Management Fundamentals

by Alex Lightfoot, Senior Risk Specialist, Supervision + Credit, Federal Reserve Bank of San Francisco and Anthony Gonitzke, Senior Examiner, Supervision + Credit, Federal Reserve Bank of San Francisco

Banking organizations have been a source of strength, rather than strain, for the economy, entering the COVID-19 pandemic with substantial capital and liquidity and improved risk management and operational resiliency.<sup>1</sup> During the initial stages of the pandemic, bank deposits grew at extraordinary rates through June 2020, as investors continued to favor safe assets and consumers increased savings (see the figure on the next page). Although this has helped to increase banks' overall deposits and their overall level of liquid assets, the stability of this newfound funding remains uncertain.

For community banks, liquidity conditions remain favorable, with liquidity levels generally stable or increasing and with lower reliance on noncore funding. However, many community bank management teams have indicated they expect considerable runoff of deposits during the next several quarters. Further, community banks have indicated that they face a challenge in finding attractive investment opportunities for excess funds. Therefore, community banks are likely considering the investment of these funds and the liquidity risk of its asset management strategy. Longer-term assets, such as loans, may provide higher yields than interest-bearing bank balances or securities. However, given the unpredictability of these funds' behavior, a community bank may also be considering a shorter-term strategy of investing in more liquid assets, such as readily marketable securities and interest-bearing bank balances.

This conundrum is known commonly as the earnings–liquidity tradeoff, as there is generally an inverse relationship between the yield on an earning asset and its degree of liquidity risk. An overall lower level of liquid assets increases liquidity risk and reduces a bank's

ability to withstand liquidity stress events, both specific to the institution and in the wider market. Therefore, to manage liquidity risk appropriately, management teams should ensure that a sufficient cushion of liquid assets is maintained relative to the composition of funding and reasonably unanticipated funding needs. To aid a bank in navigating liquidity risk over the coming months, this article aims to illuminate the principles in sound funds management practices.

## Liquidity Risk Management Guidance

The primary interagency guidance on liquidity risk management for community banks is Supervision and Regulation (SR) letter 10-6, "Interagency Policy Statement on Funding and Liquidity Risk Management."<sup>2</sup> The guidance articulates the process that depository institutions should consider in identifying, measuring, monitoring, and controlling their funding and liquidity risks. This article highlights a few aspects of the interagency guidance, namely liquid asset cushions, funding composition, and liquidity stress testing.

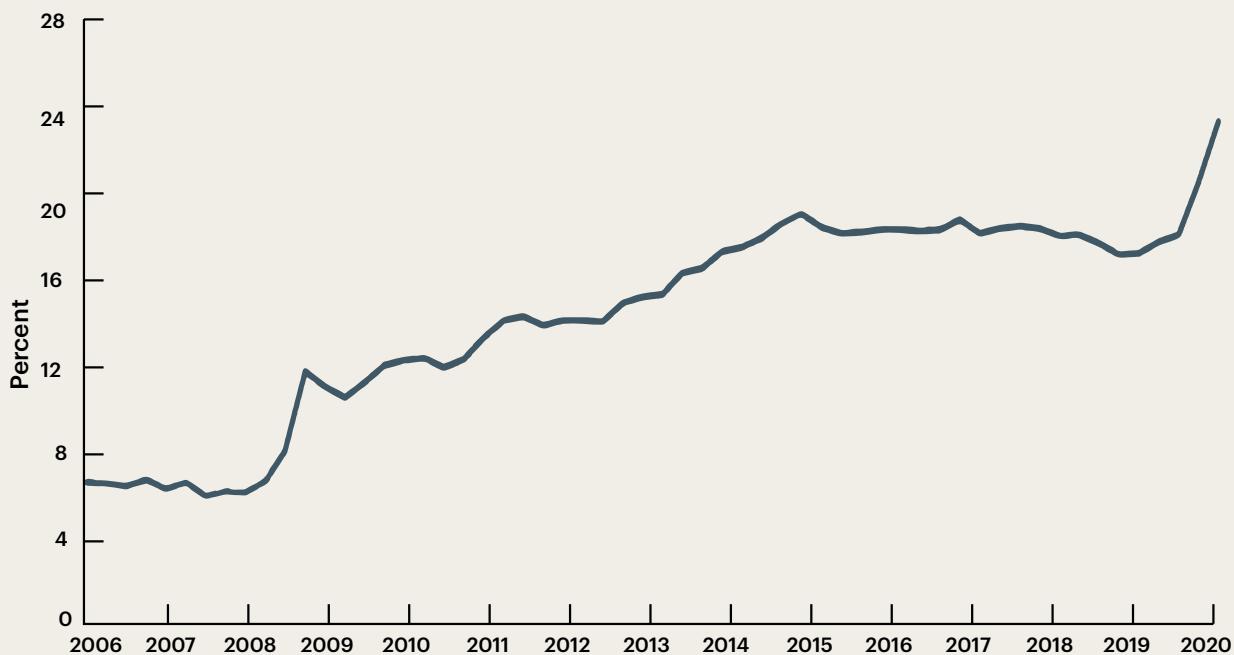
As a result of the COVID-19 pandemic, SR letter 20-15, "Interagency Examiner Guidance for Assessing Safety and Soundness Considering the Effect of the COVID-19 Pandemic on Institutions,"<sup>3</sup> was developed to aid examiners in the review of supervised institutions, particularly community banks. This interagency guidance recognizes the uncertainty surrounding the effect of the pandemic on banks' liquidity positions and directs examiners not to criticize a bank for the appropriate use of the Federal Reserve's discount window or lending programs. Moreover, the letter states that a bank's "prudent use of its liquidity buffer to support economic recovery" will not be criticized. The focus of

<sup>1</sup> See the Federal Reserve's *Supervision and Regulation Report* (November 2020), available at [www.federalreserve.gov/publications/2020-november-supervision-and-regulation-report.htm](http://www.federalreserve.gov/publications/2020-november-supervision-and-regulation-report.htm).

<sup>2</sup> SR letter 10-6 is available at [www.federalreserve.gov/boarddocs/srletters/2010/sr1006.htm](http://www.federalreserve.gov/boarddocs/srletters/2010/sr1006.htm).

<sup>3</sup> SR letter 20-15 is available at [www.federalreserve.gov/supervisionreg/srletters/sr2015.htm](http://www.federalreserve.gov/supervisionreg/srletters/sr2015.htm).

**Figure: Liquid Assets as a Share of Total Assets**



Notes: Liquid assets are cash plus estimates of securities that qualify as high-quality liquid assets as defined by the liquidity coverage ratio requirement. Data include only firms that filed the FR Y-9C and exclude savings and loan holding companies.

Source: FR Y-9C. This chart appears as Figure 5 in the Federal Reserve's *Supervision and Regulation Report* (November 2020), available at [www.federalreserve.gov/publications/2020-november-supervision-and-regulation-report-banking-system-conditions.htm](http://www.federalreserve.gov/publications/2020-november-supervision-and-regulation-report-banking-system-conditions.htm).

the supervisory review of a bank's liquidity risk will be on management's ability to adapt to the pandemic in its liquidity planning.

### Cushion of Liquid Assets

A cushion of liquid assets is a key component in a bank's overall liquidity position. The interagency supervisory guidance highlights that management should ensure that unencumbered, highly liquid assets are readily available. SR letter 10-6 states that "liquid assets are an important source of both primary and secondary funding at many institutions" and liquid assets allow banks to "effectively respond to potential liquidity stress." The guidance makes clear the importance of having a cushion of liquid assets and that the appropriate level of liquid assets ultimately depends on a bank's specific risk profile and activities.

Regulators have not been prescriptive in defining what constitutes a liquid asset or opined on the quality of the various types of liquid assets for community banks like they have done for the largest financial institutions.<sup>4</sup> Community banks typically calculate a liquid asset ratio as the sum of the following Uniform Bank Performance Report (UBPR) categories divided by the bank's total assets: interest-bearing bank balances, federal funds sold and repurchase agreements, unpledged securities, and trading assets. With no prescriptive calculation, institutions have the flexibility to monitor liquidity using a liquid asset ratio that reflects the nuances of their balance sheets and business models.

<sup>4</sup> The largest institutions are subject to the liquidity coverage ratio rule (LCR), which is a standardized liquidity metric that compares a bank's liquid assets to stressed outflows over a 30-day time horizon; however, the LCR rule does not apply to community banks.

An institution's management may choose a more granular definition of liquid assets and funding sources based on the behavior of the institution's borrowers and depositors. For instance, management may subtract reserve requirements for balances held at a Federal Reserve Bank from interest-bearing bank balances or can exclude investment securities on an individual basis if management's analysis identified them as not being readily marketable and liquid. A more granular calculation provides additional transparency into the bank's true liquidity level. Lastly, it should be noted that cash and due from balances would generally not be included in the ratio calculation, as these funds are needed for ongoing daily bank operations. Because of this, Federal Reserve examiners would typically not consider these funds as a source of liquidity for funding purposes, unless management can provide a well-supported rationale for inclusion.

In addition to selecting a method to measure liquid assets, as outlined in SR 10-6, management should determine the appropriate level of liquid assets. Using the liquid asset ratio as defined above, state member banks (i.e., a state bank that is a member of the Federal Reserve System), on average, held 21.4 percent of liquid assets as of September 30, 2020.<sup>5</sup>

The appropriate level of liquidity for an institution depends on the institution's risk profile. The composition and characteristics of funding sources and assets, as well as the level of off-balance sheet exposure are all important components. To the extent that a bank has considerably lower levels of liquid assets than its peers, it may be prudent to review historic and prospective funding needs to maintain sufficient levels of liquid assets to meet reasonably unexpected needs. Interagency guidance indicates that the level should be supported by the bank's internal liquidity stress testing (more on that later).

## Composition of Funding

Management's understanding of its funding composition can aid funding stability and management of funding concentrations. In general, a community bank's primary funding source is its deposits. Deposits are generally augmented by other types of funding, such as Federal

Home Loan Bank borrowings and other types of borrowings, with the latter sources typically viewed as secondary sources of funding.

Management generally categorizes its funding sources as core or noncore funding, depending on their characteristics. A community bank's core funding is generally composed of deposits that are sourced from the bank's local market. These deposits are typically lower cost and relatively stable. While the Call Report instructions define the types of deposit accounts that are included in core deposits, some of the deposits within these categories may not be low cost or stable. From a liquidity risk management perspective, and to address the uniqueness of a bank's deposit base, management may wish to identify other deposits to include as noncore deposits when assessing the stability of the bank's deposit base and liquidity position.

Noncore funding is considered higher risk and is typically more volatile than core funding. Bank-specific or macroeconomic stress events can have a negative effect on noncore funding, which in turn can adversely affect the cost of these funds through higher interest rates, place restrictions on the maximum interest rates paid, increase collateral requirements, or lead to withdrawal or discontinuation of funds. Further, given that noncore funds are generally more volatile and costly, management should consider the level of reliance placed on these funds in the composition of its funding sources.

Management can consider conducting a deeper analysis into the behavior of its deposit base when determining whether a funding source is core or noncore. This analysis can help determine funding stability, or lack thereof, as some "core" sources might be volatile. Likewise, certain noncore funds may have more core-like attributes. If management believes that certain types of deposits do not fit within Call Report definitions for internal reporting purposes, management can attempt to identify and distinguish which deposits are truly core and noncore and provide well-documented support for these types of decisions. For example, a definitional core deposit could have a higher than usual cost or have underlying characteristics that place pressure on the stability of that deposit. As a result, a bank may consider these

<sup>5</sup> This percentage is based on aggregate Call Report data.

deposits as noncore. A bank should have appropriate support to explain the reason for changing the traditional characterization of these funds.

Given that the long-term stability of deposits acquired during the COVID-19 pandemic is unknown, liquidity risk management could be strengthened by identifying and closely monitoring the behavior of these newly acquired deposits separate from other deposits. Further, management is encouraged to use scrutiny before investing funds from deposit growth attributable to the pandemic, such as funds from Paycheck Protection Program (PPP) loans. Given the uncertain characteristics of these deposits, this scrutiny can include analysis on the tradeoff within investing in longer-term, less liquid assets, which could be more difficult to convert to cash, compared with more liquid assets.

Bank management can benefit from being aware of any funding concentrations that may exist and manage them appropriately. In general, examiners will assess funding concentrations against total assets as a method to determine the funding source of the bank's assets. SR letter 10-6 provides several key elements for management to consider. In particular, "policies should clearly articulate a liquidity risk tolerance that is appropriate for the business strategy of the institution considering its complexity, business mix, liquidity risk profile, and its role in the financial system." Moreover, a bank's policies should include concentration definitions, risk limits approved by the bank's board of directors, and definitions for measurement calculations.

SR letter 10-6 reminds bankers that risk management should focus on funding concentrations that address:

- "diversification of funding sources and types, such as large liability and borrowed funds dependency, secured versus unsecured funding sources, exposures to single providers of funds, exposures to funds providers by market segments, and different types of brokered deposits or wholesale funding"; and
- "term, repricing, and market characteristics of funding sources with consideration given to the nature of the assets" being funded. "This may include diversification targets for short-, medium-, and long-

term funding; instrument type and securitization vehicles; and guidance on concentrations for currencies and geographical markets."

Taking a step further, management can avoid noncore-funding concentrations by developing an aggregate noncore funding limit. As recognized in the Federal Reserve's *Commercial Bank Examination Manual*, small community banks, especially those in rural or highly competitive areas, may face a challenge in avoiding a funding concentration.<sup>6</sup> However, a bank's board of directors and senior management need to establish limits and develop appropriate management information system reporting to manage its funding concentrations. This is even more important as community banks continue to face competition for deposits from large banks, online banks, financial technology firms, and nonbanks, as well as outflows from rural areas to urban cities.

## Liquidity Stress Testing

Interagency supervisory guidance indicates that it is prudent for banks to "conduct stress tests regularly for a variety of institution-specific and marketwide events across multiple time horizons" taking into account their own "complexity, risk profile, and scope of operations."<sup>7</sup> These tests help banks effectively manage liquidity risk by identifying and quantifying potential liquidity strains. The results of testing can aid a bank in evaluating the appropriateness of its asset liquidity levels. The extent and complexity of a community bank's internal analysis of liquidity needs under stressed conditions depend on the bank's asset size and complexity, commensurate with the bank's risk profile and business model. This analysis is expected to capture the bank's entire balance sheet, including off-balance sheet exposures, and incorporate a range of reasonably unanticipated situations that could subject the institution to liquidity stress.

Reasonably unanticipated liquidity scenarios should include appropriate assumptions that are supported and reflect idiosyncratic and systemic risks. The results of this scenario analysis inform a bank's board of directors

<sup>6</sup> See the Commercial Bank Examination Manual, available at [www.federalreserve.gov/publications/supervision\\_cbem.htm](http://www.federalreserve.gov/publications/supervision_cbem.htm).

<sup>7</sup> See SR letter 10-6.

and management about the bank's preparedness to meet reasonably unexpected liquidity needs. In addition, this analysis can inform management in determining the appropriate levels of asset liquidity to hold or justify internal targets or limits.

Finally, most liquidity events are abrupt and result in immediate and significant outflows, illustrating the importance of having a cushion of liquid assets available during stress events. The timing and availability of contingency funding sources should be considered to determine whether sufficient funding will be available if the bank needs it. Further, the results of this analysis should help inform management on the appropriate level of liquid assets that provides an effective cushion against stress events.

### Key Takeaways

Liquidity can be broken down into two main components: (1) liquid assets, which provide a cushion to meet unexpected cash outflows, and (2) a measure of stressed outflows, determined primarily by the composition of funding. Although there is no required minimum level of

liquid assets, the level maintained by a community bank should be informed and supported by management's liquidity analysis. One approach management can consider is comparing the bank's UBPR liquidity metrics to those of other state member banks or peer averages to better understand their liquidity risk profile relative to the broader population. On the liability side, management should focus on obtaining a stable deposit base and, if possible, avoid funding concentrations and significant use of nonstable funding sources. The avoidance of concentrations in noncore funding sources can be achieved with prudent concentration limits by noncore funding type, as well as an aggregate funding concentration limit. Additionally, close monitoring of recent increases in deposits arising from the pandemic is encouraged, given the unknown long-term behavior of these deposits. If both sides of the balance sheet exhibit sound liquidity metrics, the institution can more easily manage its liquidity risk under stressful conditions. With an appropriate level of liquid assets and a well-diversified funding base, institutions will have the ability to remain resilient during periods of liquidity stress. ■

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## Regulation O Revisited

Continued from page 17

interest in a PPP lender, provided that the director or equity holder is not given preferential treatment in PPP loan processing. The interim final rule also stated that SBA lending restrictions would continue to apply to officers and key employees of a PPP lender.<sup>15</sup> The temporary rule changes adjusted certain Reg O restrictions by permitting directors and principal shareholders to access PPP funding without impacting aggregate loans to insiders reportable under Reg O.

### Conclusion

Reg O provides guidance on extensions of credit to insiders. The bank examination process typically involves

substantiating that a bank is operating in accordance with the regulatory quantitative and qualitative limits and restrictions on loans to insiders. Even inadvertent violations have the potential to adversely impact an organization's reputation. To avoid any such contravention, management and the board must maintain a system of internal controls supported by active board and senior management oversight, policies and procedures, diligent risk monitoring and reporting, and regular independent reviews to ensure ongoing Reg O compliance. ■

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<sup>15</sup> See <https://home.treasury.gov/system/files/136/Interim-Final-Rule-Additional-Eligibility-Criteria-and-Requirements-for-Certain-Pledges-of-Loans.pdf>.



# 2021 Writers' Cohort

## Meet a Cohort Member

The past few issues of *Community Banking Connections* have featured profiles of members of the publication's Writers' Cohort, which was formed in 2019. In this issue, read about Kerri Allen, who took her career to new heights when she relocated from the East Coast to the Rocky Mountains. Kerri discusses her career at the Kansas City Fed's Denver Branch as well as the hobby that has her literally scaling new heights.

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### Kerri Allen

Examiner, Examinations & Inspections, FRB Kansas City



#### **How long have you been with the Fed and what brought you here?**

I've been with the Fed for about seven years. Joining the Federal Reserve was part of my transition when I made the decision to relocate from Washington, D.C., to Denver, which ultimately necessitated a career shift. I applied for a cash analyst position at the Denver Branch of the Kansas City Fed through Indeed.com, and the rest is history! After working as an analyst in Cash Services for two and a half years, I joined the Examinations & Inspections Department within Supervision and Risk Management in 2016 and became a commissioned examiner in 2019.

Prior to working for the Fed, I spent nearly five years working for a government consulting firm in D.C. For most of that time, I supported a broadband technology grant program executed by the Department of Commerce as part of the American Recovery and Reinvestment Act. The primary goal of this program was to expand physical broadband infrastructure and increase broadband adoption, with the overall goal of shrinking the country's digital divide.

## If you weren't working at the Fed, what career would you pursue?

Over the years, in both my personal and professional life, I've become increasingly interested in the topic of financial literacy. My interest started when I supported the broadband technology grant program in Washington, D.C. Working on behalf of this program sparked my initial interest in financial literacy and inclusion, given the interrelatedness of the issues of digital and financial inclusion. In the future, I hope to contribute, in either a future role or volunteer capacity, to increasing financial literacy through working with children or other groups to help provide them with the tools, knowledge, and empowerment to take charge of their financial futures.

## What interests are you most passionate about?

In 2013, I moved to Denver to pursue a more active and "outdoorsy" lifestyle inspired by the mountains. True to that goal, my primary hobbies include hiking, rock climbing, and skiing. I got into climbing through friends/coworkers at the Denver Branch. When I worked in Cash, several individuals throughout the Branch started climbing together at a local gym and invited me to join them. It started out as a fun way to get exercise and build relationships with coworkers at the same time, and six years later, I've stuck with it. As a kid, I was always really into gymnastics and would climb anything in sight, so it was exciting to discover a new hobby that seemed to come naturally to me. I enjoy climbing because it provides both

a physical and mental challenge, pushes me to confront and overcome fear, and builds confidence. It's also a hobby that teaches useful outdoor safety skills and is a fun way to engage and build trust with others.

Additionally, I've always enjoyed traveling and look forward to exploring some new destinations in post-pandemic life! Up to this point, I've chosen several destinations that have challenged me to put my intermediate Spanish-speaking skills to use, including Peru, Mexico, El Salvador, and various parts of Spain. Spanish was my favorite class in high school, and I continued studying it during college at the University of Pittsburgh. Although I don't practice nearly enough these days, I have tried to maintain as much vocabulary as possible, primarily through the use of language learning apps.

## What is your favorite movie of all time and why?

Although it's hard to choose one, I'd say my favorite movie of all time is *Little Women*, based on the novel by Louisa May Alcott. It's a timeless classic with powerful themes. I could probably watch it once a year and cry each time. Although I love both the older and newer versions, the older version is my favorite because Winona Ryder plays the role of Jo March so perfectly. I also come from a family of women and, despite the difference in time period, have found many of the dynamics to be quite relatable. ■

## Cohort Chairs:

**Ben Clem**, Senior Examiner, Supervision, Regulation, and Credit, FRB Richmond

**Jennifer Grier**, Senior Examiner, Supervision, Regulation, and Credit, FRB Atlanta

## Cohort Members:

**Kerri Allen**, Examiner, Examinations & Inspections, FRB Kansas City, **Anthony Gonitzke**, Senior Examiner, Financial Institution Supervision and Credit, FRB San Francisco, **Jordan Jhamb**, Financial Analysis Associate, RCFI, FRB New York, **William Mark**, Lead Examiner, Supervision and Regulation, FRB Chicago, **Kalyn Neal**, Examiner/Supervisory Specialist, Examinations & Inspections, FRB Kansas City, **Alex Shelton**, Portfolio Central Point of Contact/Senior Examiner, Supervision, Regulation, and Credit, FRB Richmond, **Scott Zurborg**, Senior Large Bank Examiner, Supervision and Regulation, FRB Chicago

In response to the COVID-19 crisis, the Federal Reserve and its federal and state regulatory counterparts continue to take steps to ease regulatory burden and support the flow of credit and liquidity. For a comprehensive list of Federal Reserve or interagency rulemakings and statements related to the pandemic, visit the Federal Reserve's COVID-19 Resources page, available at [www.federalreserve.gov/covid-19.htm](http://www.federalreserve.gov/covid-19.htm). Below are highlights of the regulatory and policy actions taken by the Federal Reserve in recent months.

## Actions Related to Safety and Soundness Policy

- **Suspicious Activity Reporting FAQs:** On January 19, 2021, Supervision and Regulation (SR) letter 21-2, "Answers to Frequently Asked Questions Regarding Suspicious Activity Reporting and Other Anti-Money Laundering Considerations," was issued to provide clarity to industry questions regarding certain Suspicious Activity Report filing requirements and compliance processes. The FAQs do not alter existing Bank Secrecy Act/anti-money laundering legal or regulatory requirements or establish new supervisory expectations. The SR letter is available at [www.federalreserve.gov/supervisionreg/srletters/SR2102.htm](http://www.federalreserve.gov/supervisionreg/srletters/SR2102.htm).
- **Relief from Regulation O:** On December 22, 2020, the Federal Reserve and the other federal banking agencies issued an interagency statement to explain that the federal banking agencies will continue to exercise discretion to not take enforcement action against asset managers that become principal shareholders of banks or banks that make extensions of credit to the related interests of such asset managers that otherwise would violate Regulation O. SR letter 20-31, "Status of Certain Investment Funds and Their Portfolio Investments for Purposes of Regulation O and Reporting Requirements Under Part 363 of FDIC Regulations," is available at [www.federalreserve.gov/supervisionreg/srletters/sr2031.htm](http://www.federalreserve.gov/supervisionreg/srletters/sr2031.htm).
- **Internal Appeals Process and Ombudsman:** On December 4, 2020, SR letter 20-28/Consumer Affairs (CA) letter 20-14, "Internal Appeals Process for

## Material Supervisory Determinations and Policy

"Statement Regarding the Ombudsman for the Federal Reserve System," was issued to provide information on the Federal Reserve Board's updated policy statement governing the internal appeals process for material supervisory determinations. The letter also discusses amendments to the Board's Ombudsman policy and practices. The SR letter is available at [www.federalreserve.gov/supervisionreg/srletters/SR2028.htm](http://www.federalreserve.gov/supervisionreg/srletters/SR2028.htm).

- **London Interbank Offered Rate (LIBOR) Transition:**
  - The Federal Reserve Board supported the release of a proposal and supervisory statements that would enable a clear end date for U.S. dollar (USD) LIBOR and would promote the safety and soundness of the financial system. The November 30, 2020, press release is available at [www.federalreserve.gov/newsevents/pressreleases/bcreg20201130b.htm](http://www.federalreserve.gov/newsevents/pressreleases/bcreg20201130b.htm).
  - The federal banking agencies encouraged banks to cease entering into new contracts that use USD LIBOR as a reference rate as soon as practicable and in any event by December 31, 2021, in order to facilitate an orderly — and safe and sound — LIBOR transition. The November 30, 2020, press release is available at [www.federalreserve.gov/newsevents/pressreleases/bcreg20201130a.htm](http://www.federalreserve.gov/newsevents/pressreleases/bcreg20201130a.htm).

- Interim Final Rule on Temporary Asset Thresholds:** The federal banking agencies announced an interim final rule that provides temporary relief for certain community banking organizations related to certain regulations and reporting requirements as a result, in large part, of their growth in size from the coronavirus response. The November 20, 2020, press release is available at [www.federalreserve.gov/newsevents/pressreleases/bcreg20201120a.htm](http://www.federalreserve.gov/newsevents/pressreleases/bcreg20201120a.htm).
- Clarifying Bank Secrecy Act Due Diligence Requirements for Banks and Credit Unions:** Federal financial institution regulatory agencies issued a joint fact sheet clarifying that bank and credit union compliance efforts to meet Bank Secrecy Act due diligence requirements for customers that are charities and other nonprofit organizations should be based on the money-laundering risks posed by the customer relationship. The November 19, 2020, press release is available at [www.federalreserve.gov/newsevents/pressreleases/bcreg20201119b.htm](http://www.federalreserve.gov/newsevents/pressreleases/bcreg20201119b.htm).

## Other Board Actions and Events

- Amendments to Regulation D:** The Federal Reserve Board issued a notice of proposed rulemaking for public comment to amend Regulation D (Reserve Requirements of Depository Institutions). Concurrently, the Board adopted as a final rule, without change, an interim final rule amending Regulation D to lower reserve requirement ratios on transaction accounts maintained at depository institutions to zero percent. The December 22, 2020, press release is available at [www.federalreserve.gov/newsevents/monetary20201222a.htm](http://www.federalreserve.gov/newsevents/monetary20201222a.htm).
- New Member of the Board of Governors:** On December 18, 2020, Christopher J. Waller was sworn in as a member of the Board of Governors of the Federal Reserve System. The press release is available at [www.federalreserve.gov/newsevents/pressreleases/other20201218a.htm](http://www.federalreserve.gov/newsevents/pressreleases/other20201218a.htm).
- Computer Security Incident Notifications:** Federal financial regulatory agencies announced a proposal that would require supervised banking organizations to promptly notify their primary federal regulators

in the event of a computer security incident. The December 18, 2020, press release is available at [www.federalreserve.gov/newsevents/pressreleases/bcreg20201218a.htm](http://www.federalreserve.gov/newsevents/pressreleases/bcreg20201218a.htm).

- Network of Central Banks and Supervisors for Greening the Financial System (NGFS):** The Federal Reserve Board announced that it has formally joined the NGFS as a member. The NGFS supports the exchange of ideas, research, and best practices on the development of environment and climate risk management for the financial sector. The Board began participating in NGFS discussions and activities more than a year ago. The December 15, 2020, press release is available at [www.federalreserve.gov/newsevents/pressreleases/bcreg20201215a.htm](http://www.federalreserve.gov/newsevents/pressreleases/bcreg20201215a.htm).

## SPEECHES

### Speeches Related to the U.S. Economy and Monetary Policy

- Vice Chair Richard H. Clarida gave a speech at The Road Ahead for Central Banks, a seminar sponsored by the Hoover Economic Policy Working Group, Hoover Institution, Stanford, CA, (via webcast) on January 13, 2021.** His speech, titled “The Federal Reserve’s New Framework: Context and Consequences,” is available at [www.federalreserve.gov/newsevents/speech/clarida20210113a.htm](http://www.federalreserve.gov/newsevents/speech/clarida20210113a.htm).
- Governor Lael Brainard gave a speech at the Inaugural Mike McCracken Lecture on Full Employment sponsored by the Canadian Association for Business Economics (via webcast) on January 13, 2021.** Her speech, titled “Full Employment in the New Monetary Policy Framework,” is available at [www.federalreserve.gov/newsevents/speech/brainard20210113a.htm](http://www.federalreserve.gov/newsevents/speech/brainard20210113a.htm).
- Vice Chair Richard H. Clarida gave a speech at the C. Peter McCollough Series on International Economics Council on Foreign Relations, New York, (via webcast) on January 8, 2021.** His speech, titled “U.S. Economic Outlook and Monetary Policy,” is available at [www.federalreserve.gov/newsevents/speech/clarida20210108a.htm](http://www.federalreserve.gov/newsevents/speech/clarida20210108a.htm).

## Speeches Related to Supervision and Regulation

- **Governor Lael Brainard gave a speech at the AI Academic Symposium hosted by the Board of Governors of the Federal Reserve System, Washington, D.C., (a virtual event) on January 12, 2021.** Her speech, titled “Supporting Responsible Use of Artificial Intelligence (AI) and Equitable Outcomes in Financial Services,” is available at [www.federalreserve.gov/newsevents/speech/brainard20210112a.htm](http://www.federalreserve.gov/newsevents/speech/brainard20210112a.htm).
- **Governor Lael Brainard gave a speech at the Financial System & Climate Change: A Regulatory Imperative, hosted by the Center for American Progress, Washington, D.C., on December 18, 2020.** Her speech, titled “Strengthening the Financial System to Meet the Challenge of Climate Change,” is available at [www.federalreserve.gov/newsevents/speech/brainard20201218a.htm](http://www.federalreserve.gov/newsevents/speech/brainard20201218a.htm).
- **Vice Chair for Supervision Randal K. Quarles gave a speech at the Federal Reserve Board, Harvard Law School, and Wharton School Conference, Bank Supervision: Past, Present, and Future, (via webcast) on December 11, 2020.** His speech, titled “The Eye of Providence: Thoughts on the Evolution of Bank Supervision,” is available at [www.federalreserve.gov/newsevents/speech/quarles20201211a.htm](http://www.federalreserve.gov/newsevents/speech/quarles20201211a.htm).
- **Governor Michelle W. Bowman gave a speech at the Independent Community Bankers of America ThinkTECH Policy Summit (a virtual event) on December 4, 2020.** Her speech, titled “Technology and the Regulatory Agenda for Community Banking,” is available at [www.federalreserve.gov/newsevents/speech/bowman20201204a.htm](http://www.federalreserve.gov/newsevents/speech/bowman20201204a.htm).

## Speeches Related to Consumer Policy

- **Governor Lael Brainard gave a speech at the Chicago Community Trust, Chicago, on December 1, 2020.** Her speech, titled “Modernizing and Strengthening CRA Regulations: A Conversation with the Chicago Community Trust,” is available at [www.federalreserve.gov/newsevents/speech/brainard20201201a.htm](http://www.federalreserve.gov/newsevents/speech/brainard20201201a.htm).
- **Governor Michelle W. Bowman gave a speech at the Financial Stability: Stress, Contagion, and Transmission 2020 Financial Stability Conference, hosted by the Federal Reserve Bank of Cleveland and the Office of Financial Research, Cleveland, (via webcast) on November 19, 2020.** Her speech, titled “The Changing Structure of Mortgage Markets and Financial Stability,” is available at [www.federalreserve.gov/newsevents/speech/bowman20201119a.htm](http://www.federalreserve.gov/newsevents/speech/bowman20201119a.htm).
- **Governor Lael Brainard gave a speech at the National Congress of American Indians 77th Annual Convention & Marketplace (via webcast) on November 10, 2020.** Her speech, titled “Modernizing and Strengthening CRA Regulations: A Conversation with the National Congress of American Indians,” is available at [www.federalreserve.gov/newsevents/speech/brainard20201110a.htm](http://www.federalreserve.gov/newsevents/speech/brainard20201110a.htm).

## TESTIMONY

**Chair Jerome H. Powell testified on the Coronavirus Aid, Relief, and Economic Security Act before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, D.C., on December 1, 2020.** Chair Powell submitted identical remarks to the Committee on Financial Services, U.S. House of Representatives, on December 2, 2020. The testimony is available at [www.federalreserve.gov/newsevents/testimony/powell20201201a.htm](http://www.federalreserve.gov/newsevents/testimony/powell20201201a.htm).

**FEDERAL RESERVE SYSTEM**

**COMMUNITY BANKING**

**CONNECTIONS**

A SUPERVISION AND REGULATION PUBLICATION

**A Message from Governor Bowman**  
By Governor Michael H. Bowman

**First Issue 2021**



**Governor Michael H. Bowman**

The pandemic has tested community bankers like nothing before. Bankers have risen to the challenge with dedication and drive, embracing innovative ideas to help their customers and communities. Community banks expanded their drive-up facilities, implemented projects to provide key services remotely, and found ways to continue serving customers even as in-person services were diminished. Through the ups and downs of business closures and reopenings, bankers maintained operations in part through the expansion of new technologies. “closed tellers,” a banker from Nebraska told me, “but we never closed the bank.”

An optimistic look ahead to the future, the eventual end of remote banking and personal banking, may not, at first, sound like the kind of technological innovation that was so vital for the past year should disappear. The shift by many customers to remote banking and other technologies is here to stay. Technological innovation holds great promise to help community banks compete and succeed in the evolving financial services landscape. For this reason, it is my intent to continue to elevate issues related to technology to the top of the regulatory agenda.

**Community Banks’ Pathway to Innovation**

The continued success of community banks depends on their willingness to embrace new technologies with their overall strategic vision. In some cases, technology can result in greater efficiencies, lower costs, and better service. We have seen, and are encouraged by, many examples of enterprising community banks embracing technology innovation. Adoption of digital deposit and lending products and the use of technology to enhance operational efficiency are increasingly more common among community banks.

**Financial technology (or “fintech”) will never completely eliminate what is the hallmark of community banking – personal interaction and relationships with customers and communities. However, there are clear benefits to responsive partnering with a fintech company to**

**View from the District: Fraud Risk Management for the Era-Prevent and Evolve Trends in the Payment System**  
**Regulation D Revisited**  
**Small Business Credit Reporting**  
**Experiencing Challenged Asset Growth**  
**Regulation CC: The Truth in Lending Act Balance Sheet Management Frameworks**  
**2021 Winters’ Cohort: Meet a Cohort Member**  
**S.C. Byfield**

## Connect with Us

What banking topics are most relevant to you? What aspects of the supervisory process or the rules and guidance that apply to community banks would you like to see clarified? What topics would you like to see covered in upcoming issues of *Community Banking Connections*?

With each issue of *Community Banking Connections*, we aim to highlight the supervisory and regulatory matters that affect you and your banking institution the most, providing examples from the field, explanations of supervisory policies and guidance, and more. We encourage you to contact us with any ideas for articles so that we can continue to provide you with topical and valuable information.

**Direct any comments and suggestions to  
[editor@communitybankingconnections.org](mailto:editor@communitybankingconnections.org).**

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