The financial safety of U.S. consumers is protected by a broad array of laws that govern the provision of banking services and products. These laws typically have one or more purposes: (1) to protect consumers from harm or abuse; (2) to provide consumers with information that helps them understand a banking transaction; and (3) to ensure fair access to the credit markets for all consumers. In addition to its fundamental mission of contributing to public confidence in the financial system, one of the FDIC’s primary goals is to ensure that state nonmember banks comply with consumer protection laws and regulations. The agency does this through the compliance examination process as well as through the processing of consumer complaints.

During the past decade, the FDIC’s approach to compliance examinations has evolved. Its original approach was relatively simple and was based almost exclusively on reviewing actual banking transactions for adherence to regulatory and statutory requirements. This approach worked well when consumer laws and regulations were few in number. However, as banks expanded product and service offerings and Congress continued to pass or revise consumer protection laws, the resource demands of implementing an extremely detailed, transaction-oriented approach grew considerably. It became harder to complete examination schedules and write meaningful examination reports. The FDIC recognized that it was impossible, and in many cases unnecessary, to rely so heavily on transaction analysis to evaluate a bank’s compliance posture.

An Evolutionary Process

In 1996, the FDIC reengineered and streamlined its compliance examination procedures and incorporated the important step of risk-scoping. Under the risk-focused approach to examinations, the extent of transaction testing depends on assessing a bank’s risk of noncompliance in a particular area. Compliance examiners were instructed to focus on regulatory areas that posed the greatest risk to the bank and the greatest potential harm to consumers.

In July 2003, the Corporation built on that progress by initiating top-down, risk-focused compliance examinations. Although the 1996 reengineering effort introduced needed adjustments, additional changes in the marketplace needed to be addressed. In response, the FDIC combined the risk-based examination process with an in-depth evaluation of a bank’s compliance management system.

A bank’s “system” is the confluence of directorate and management oversight, internal controls, and compliance audits. The examination approach assesses how well a bank identifies emerging risks, remains current on changes to laws and regulations, ensures that employees understand compliance responsibilities, incorporates compliance into business operations, reviews operations to ensure compliance, and takes effective corrective action to address violations of law or regulation and weaknesses in the compliance program. Based on an assessment of the quality of the compliance management system, compliance examiners use transaction testing to pinpoint regulatory areas for further evaluation. The intensity and extent of transaction testing depend on a bank’s risk profile.

For example, the intensity and extent of transaction testing in a bank that has a solid history of compliance with the flood insurance regulations, administers a well-constructed training program, conducts periodic reviews to ascertain flood insurance compliance, reports any exceptions to the board of directors, and addresses them promptly and thoroughly, can certainly be tempered. Instead, the examiner can consider these positive indicators and reduce the intensity of any transaction review deemed
necessary to ensure that the bank’s system is working properly. In fact, depending on the strength of the bank’s overall corporate compliance program, the breadth of the bank’s own testing, and the degree of reliance the examiner can place on the results, the examiner has the discretion to forego transaction testing for this subject area. Under the old approach, the examiner likely would have delved into the bank’s files without considering these positive indicators.

New Realities, New Challenges

What prompted the FDIC to modify its compliance examination program in 2003? A careful look at the marketplace showed that much had happened in the financial and regulatory communities since 1996, as indicated by the following developments:

- The number and complexity of federal consumer protection laws had significantly increased. Congress had enacted new laws pertaining to privacy, fair credit reporting, identity theft, and securities sales, to name a few.

- Attention to corporate governance compelled banks to review and strengthen internal controls, policies, and practices.

- Agency examination resources were taxed every time a new law was enacted, as were bank resources.

- The industry raised concerns about regulatory burden that prompted regulators to review their practices and consider alternative ways to fulfill examination mandates.

Such factors prompted the FDIC to ask a number of questions about its approach to compliance examinations:

- Was the compliance examination program positioned to absorb and adapt to these and future industry and legislative changes?

- How could we break the cycle of incrementally adding more examination resources every time a new law was passed or an old one was substantially revised?

- Did our examination reports include information that could help bank management design and implement more effective compliance programs?

- Could we modify our internal processes to reduce the resource demands associated with on-site examinations?

- Had we provided our compliance examiners with clear expectations about our examination process?

Upon consideration of these questions, the FDIC concluded that additional regulatory responsibilities were certainly adding to the length of our examinations, placing stress on our examiners and the industry. Our examination reports could add more value if we explained the significance of violations in the context of a bank’s operational weaknesses.

In addition, the FDIC had long impressed on bank boards of directors and senior management that they are ultimately responsible for compliance, and that they need to include compliance as a core risk management function. Examination experience told us that the industry was listening, and larger banks in particular were migrating toward a top-down risk management orientation. However, our examination process appeared to be a step behind.

And finally, looking to the presence or absence of violations as the chief determinant of a bank’s compliance performance presented an incomplete picture of its overall compliance risk management structure. For example, evaluating a bank’s overall compliance posture on violations alone ignores whether new
products can be successfully implemented from a compliance standpoint, whether the bank is positioned to absorb future regulatory changes, or whether a staff training program is sufficient to facilitate ongoing compliance.

The business case for change was clearly there. A strategy emerged that was based on three components—reorienting the process, changing on-site examination workflow, and revamping examination reports.

Reorienting the process toward a top-down, risk-focused approach to examinations that focuses on a bank’s compliance management system was a natural first step. This approach places emphasis on the directorate’s and senior management’s administration of the bank, which includes identifying, monitoring, and managing risk and ensuring that the bank complies with consumer protection, fair lending, and community reinvestment laws and regulations.

Although the details of a particular bank’s system will vary depending on its history and business plan, effective compliance management systems share common characteristics. Senior management sets the tone by supporting compliance and providing resources that will ensure a strong system. The compliance officer has sufficient knowledge and authority and keeps current on regulatory changes, and the compliance officer reviews new products before roll-out to avoid potential problems. The bank has in place, and follows, policies and procedures appropriate to its product lines. Staff is trained commensurate with its responsibilities, and internal monitoring identifies and remedies problems before they multiply. Consumer complaints are treated as an early warning system for potential problems, and the bank’s audit program helps management understand the causes of problems so future occurrences can be prevented.

Small banks without a wide variety of products may not have a single dedicated compliance officer or an independent audit function. However, they will have sufficient resources devoted to compliance to enable staff to understand and carry out its responsibilities. Small banks also will have a functioning internal monitoring system.

Changing examination workflow fosters efficiencies and new ways of thinking about how compliance fits into a bank’s overall corporate risk management plan. Starting each compliance examination by looking for violations of federal consumer laws and regulations and then drawing conclusions about how a bank manages its compliance responsibilities did little to address operational weaknesses or prevent future violations. Under the new approach, examiners first establish a compliance risk profile that reflects the quality of the bank’s compliance management system. Succeeding examination staff will use the risk profile as part of the process of establishing the scope of the examination. This approach can increase efficiency by focusing the examiner’s attention on substantive changes to the bank’s operations and compliance infrastructure since the previous examination and enabling examiners to direct finite examination staff resources toward areas that present the greatest risks.

Revamping the compliance report of examination to specifically relate violations to what they mean in the context of the bank’s compliance management system helps foster meaningful corrective actions. Writing the report in a way that helps management understand where its system works well and where it needs to tighten controls and procedures puts violations in context.

The revised examination report format places comments and conclusions about board and management oversight, the compliance program, and the internal review program on the first page, along
with recommendations for corrective action. Separate subsections for each compliance management system element include summary statements that characterize each element as strong, adequate, or weak. Moreover, the examiner discusses the positive and negative aspects of each element to support the summary, and the recommendations are tied to these comments.

**Expected Outcomes of the Top-Down, Risk-Focused Approach**

The FDIC’s intent is that the new approach will result in a smoother, more efficient examination process as compliance risk profiles are established for each supervised bank. In addition, rather than simply enumerating a list of violations, examination reports will become more meaningful as they will address the quality of the bank’s compliance management system and make recommendations for correcting weaknesses.

Any time saved through this new approach will permit examiners to concentrate on the problems of banks with weak compliance management systems and those that require more than a normal level of supervisory attention. Of critical importance, this approach will help move compliance from the back room to the boardroom by establishing a tone and climate that support the incorporation of compliance risk management into the way employees do business, all the way down the line.

Effective compliance program management at a bank starts at the top—with the board of directors and senior management, who are responsible for the bank’s management and control. The top-down, risk-focused approach to compliance examinations complements the importance of directorate and senior management accountability for a bank’s compliance risk management system. In addition, the new approach helps to ensure that the FDIC’s compliance examination program continues to be effective in a dynamic environment. As the industry paradigm has shifted to enterprise-wide compliance risk management, so has the FDIC’s approach to supervision.

*John M. Jackwood*

*Senior Policy Analyst*
The Federal Home Loan Bank (FHLB) System is an increasingly important funding source for community banks. What risks are associated with the growing importance of FHLB advances in banks’ funding mix? Such risks could include an unexpected increase in cost or reduction in availability of advances in general and the mismanagement of advances by specific institutions. While there is no immediate systemic threat to the overall cost and availability of advances, individual institutions must be mindful of the risks undue reliance on advances can pose. Examiner review of the heaviest users of advances indicates that most banks manage these products prudently—but the exceptions have given rise to supervisory concern.

Traditionally, community banks have relied on deposits as the primary funding source for earning assets. (In this article, institutions with total assets less than $1 billion are considered community banks.) As shown in Chart 1, core deposits remain the primary source of funding for these institutions.1 There has been, however, a noteworthy trend in community bank funding patterns during the past ten years. Core deposits have been declining as a percentage of total assets as these institutions have become more dependent on other borrowings to meet funding needs.2 Core deposit migration is due, in part, to bank deposit accounts losing significant ground to higher-yielding mutual funds and to the euphoria of the stock market during the late 1990s. For instance, during the ten years ending December 31, 2003, mutual fund assets increased 258 percent, while core deposits as a percentage of community bank total assets declined 11.52 percent.3

Even with recent negative publicity surrounding mutual fund sales practices,

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1Core deposits exclude certificates of deposit greater than $100M, brokered deposits, and foreign deposits.
2Other borrowings include primarily FHLB advances, fed funds purchased, and repurchase agreements.
3Mutual fund asset data for December 2003 were provided by the Investment Company Institute.
investors have not lost faith in this investment alternative. This observation is supported by the recently reported 2.5 percent growth in mutual fund assets for month-end December 2003. To a large extent, the decline in core deposit funding has been offset by an increase in different types of wholesale funding, such as FHLB advances and brokered certificates of deposit (CDs). In fact, community bank use of other borrowings and brokered CDs increased by 123 percent and 394 percent, respectively, from 1993 to 2003. During this time, FDIC-insured institutions significantly increased their reliance on FHLB advances (see Chart 2).

Most notably, the rate of advance usage accelerated from 1994 through 2000, before tapering off in response to the recession and the resultant lackluster stock market performance. However, as the economy and the equity markets began to rebound in 2003, FDIC-insured institutions started to increase borrowing levels from the FHLB System. Determining the specific composition of advances in any given bank is difficult without visiting the financial institution, as the amount and nature of advance information reported in the Call Report is extremely limited. Call Report data show that commercial banks were liable for $237 billion in FHLB advances as of September 30, 2003, which is 52 percent of the $456 billion in advances outstanding to FDIC-insured institutions. Savings associations and savings banks held 39 percent and 9 percent of advances, respectively. Accordingly, commercial banks are now a core constituent and borrower of the FHLB System.

In light of community banks’ growing use of advances, this article focuses on two areas of supervisory attention:

1. the impact of the FHLB System’s risk profile on FDIC-supervised institutions; and

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**Chart 2**

![Industry Usage of FHLB Advances](source: Federal Home Loan Bank System)
(2) whether the types and degree of advance usage by FDIC-supervised institutions raise any concerns.

**The FHLB System**

The FHLB System recently has been the focus of negative financial news and increased regulatory scrutiny. In the second half of 2003, FHLB-New York reported a loss of $183 million on its investment portfolio and suspended its third quarter dividend payment. Consequently, Standard & Poor’s (S&P) lowered the long-term counterparty credit rating for FHLB–New York to AA+ with a stable outlook because of higher credit exposures and operating losses. Late in third quarter 2003, S&P revised its outlook to negative from stable for FHLB–Pittsburgh and FHLB–Atlanta because of heightened interest rate risk exposure and earnings volatility. S&P also revised its outlook for FHLB–Chicago, –Indianapolis, and –Seattle to negative from stable. In a November 17, 2003, press release, S&P stated that the ratings action reflects its concern regarding the banks’ change in risk profile, which has led to a higher degree of interest rate risk exposure and higher demands for risk management. The change in risk profile stems from actively growing fixed-rate residential mortgage portfolios as a part of the mortgage partnership programs developed in the FHLB System. S&P stated that the ratings actions do not affect the AAA rating on the senior debt of the banks in the system based on their status as government-chartered entities.

In addition to rating agency attention, policymakers have expressed concerns regarding the regulation of housing government-sponsored enterprises (GSEs). In the “Analytical Perspectives” portion of the fiscal year 2005 budget of the United States (budget proposal), the Bush administration strongly suggests that regulatory reform is necessary for the housing GSEs, including the FHLB System. The budget proposal includes a detailed analysis that indicates that GSEs do not hold enough capital and outlines problems encountered last year by the FHLB Banks and other housing finance GSEs. Furthermore, the analysis warns that because of the large size of these entities, even a small mistake by a GSE could have consequences throughout the economy.

FDIC-supervised institutions could be affected negatively if these recent events result in higher advance rates. FHL Banks can lend money to members at lower rates because, as GSEs, they can borrow at cheaper rates. Traditionally, GSEs benefit from an implied guarantee to the extent investors perceive that they are backed by the federal government. Although highly unlikely, loss of GSE status coupled with negative ratings actions or downgrades would probably result in much higher borrowing costs for FHL Banks and borrowing members, many of which are FDIC-supervised and -insured institutions.

Even though the FHLB System has recently sustained some negative press and closer regulatory scrutiny, these factors do not pose significant negative implications for FDIC-supervised institutions at this time. This finding is evidenced by Moody’s third quarter 2003 reaffirmation of its Aaa bank-deposit rating on the FHL Banks, which attests to their profitability, liquidity, and asset quality. However, regulators should continue to monitor FDIC-supervised and -insured institutions’ level and use of FHLB advances.

**Community Bank Use of FHLB Advances**

The upward trend in advance use by FDIC-supervised institutions coupled
with the lack of Call Report information on the composition of FHLB advances prompted the FDIC in 2002 to review the largest users of FHLB advances it supervises. The sample consisted of 79 banks; each bank had advances equal to at least 25 percent of total assets as of June 30, 2002. The sample included the top ten FHLB advance users (as a percentage of assets) in each Region and area office. This supervisory review was conducted primarily to determine the types of advances community banks used (although 10 percent of the sample banks had total assets in excess of $1 billion). Of particular interest was the level of advances containing options, referred to as structured advances. Historically, such advances have been characterized by higher levels of interest rate risk and have required more rigorous risk management techniques.

In 2003, a second supervisory review was conducted to analyze trends in the types of advances community banks used, in the aggregate and among FDIC Regions and area offices. The 2003 review focused on banks with a significant increase in advances year-over-year, not only on banks with a relatively high use of advances. In addition to having a high asset concentration of advances, sample banks displayed at least a 25 percent increase in their use of advances between June 30, 2002, and June 30, 2003. Because both requirements had to be met for inclusion in the sample, the sample cutoff for advances as a percentage of assets was lowered from 25 percent to 15 percent. Although the average asset size of the banks in the sample increased in 2003, the sample population remained essentially community banks.

The survey results indicated that fixed-rate, nonstructured advances were the most popular type of advances used by sample banks in 2003 and 2002. Floating-rate advances showed a significant increase in popularity in the 2003 survey, but they remained a relatively small percentage of total advances. Structured advances accounted for just under one-third of total advances in both years. The relatively heavy use of structured advances by some institutions in the sample would not have been identified through current reporting requirements.

The review captured the dollar amount and types of structured advances

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<table>
<thead>
<tr>
<th>Characteristics of Banks in the Sample</th>
<th>June 30, 2003</th>
<th>June 30, 2002</th>
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</thead>
<tbody>
<tr>
<td>Total Number of Banks</td>
<td>107</td>
<td>79</td>
</tr>
<tr>
<td>Total Assets</td>
<td>$128.5 billion</td>
<td>$41.5 billion</td>
</tr>
<tr>
<td>Average Total Assets</td>
<td>$680 million*</td>
<td>$521 million</td>
</tr>
<tr>
<td>Average FHLB Advances/Assets**</td>
<td>57 percent</td>
<td>63 percent</td>
</tr>
<tr>
<td>Banks With FHLB Advances/Assets &gt; 35 percent</td>
<td>57 percent</td>
<td>63 percent</td>
</tr>
<tr>
<td>Composition of FHLB Advances</td>
<td>13 percent</td>
<td>5 percent</td>
</tr>
<tr>
<td>Average Structured Advances/Total Advances</td>
<td>30 percent</td>
<td>32 percent</td>
</tr>
</tbody>
</table>

*For the 2003 sample, average total assets excludes two large banks with $34 billion and $23 billion in total assets.

**The decline in this ratio from 2002 to 2003 is not attributed to an actual decline in use but rather to a change in the criteria for choosing banks in the sample. In the 2002 sample, each bank had advances equal to at least 25 percent of total assets; however, this ratio was changed to 15 percent for the 2003 sample.

The bank population represented each FDIC Region and area office and was derived using judgmental sampling, with emphasis placed on the banks with high concentration levels and, for the 2003 review, rapid growth over the sample period.
reported by the sample banks. The most commonly used structured advances were callable, putable, and convertible advances. The FHL Banks use various terms for these structured advance products; but for purposes of the survey, FDIC provided sample banks with the following terminology and definitions to ensure consistency. Callable and convertible advances are very similar in that the borrowing bank has effectively sold an option to the FHLB in return for a relatively low interest rate. The initial interest rates on these products are lower than a fixed-rate advance with the same maturity, owing to the embedded option. The interest rate remains fixed for a predetermined amount of time (lockout period), after which the FHLB has the option to call the advance or convert it to a floating-rate advance. These types of borrowings carry risk associated with the uncertainty of the option exercise. Also, when the option is exercised, it will be at a point when it is financially disadvantageous for the borrower. The FHLB charges substantial prepayment penalty fees for early payoff of an advance. Typically, the prepayment fee for an advance with an option includes the FHLB’s hedge-unwind cost related to the borrowing plus the present value of the foregone profit on the advance. With a putable advance, the borrowing bank effectively purchases an option from the FHLB that allows the bank to prepay the advance without penalty on a predetermined date or dates. Because the borrowing bank controls the embedded option, the bank must pay a premium for the advance, generally in the form of an above-market interest rate. Therefore, putable advances are offered at a higher cost than fixed-rate advances with a similar maturity date. The FHLB System’s 2003 financial report indicates that only a little over 2 percent of total advances outstanding at year-end 2003 were putable advances.

Potential supervisory concerns with structured advances include the following: (1) these products can have a significant impact on a bank’s interest rate risk profile as they are used in increasing quantities; (2) they often are used as part of leverage programs that tend to focus on short-term enhancement of return on equity with a concomitant increase in the institution’s risk profile; (3) several banks have recently paid substantial prepayment penalties to retire costly structured advances before maturity; and, in some instances, (4) bank management did not possess the requisite knowledge and understanding of these products to manage the risks effectively.

The 2003 sample banks appeared to have a preference for convertible advances, whereas the 2002 banks preferred callable advances. The popularity of convertible advances over other structured advances is probably an indication that the sample banks decided to take advantage of the historically low interest rate environment. Almost a year later, convertible advances could still be obtained at a very low interest rate. For example, as of April 6, 2004, several FHL Banks offered five-year convertible advances with a one-year lockout period at an initial interest rate ranging from 1.28 percent to 1.62 percent.\(^7\)

Sample banks in various Regions showed notable differences in terms of advance composition and use.\(^8\) In both reviews, sample banks in the Chicago Region were the heaviest users of FHLB

\(^7\)The range of interest rates for a five-year/one-year convertible advance was obtained from FHLB–Atlanta, –Chicago, –Des Moines, and –Topeka websites as of April 6, 2004.

\(^8\)FDIC Regions are defined as the following geographic areas: Atlanta Region (AL, FL, GA, NC, SC, VA, WV); Chicago Region (IL, IN, KY, MI, OH, WI); Dallas Region (AR, CO, LA, MS, NM, OK, TN, TX); Kansas City Region (IA, KS, MN, MO, ND, NE, SD); New York Region (CT, DC, DE, MA, MD, ME, NH, NJ, NY, PA, PR, RI, VI, VT); San Francisco Region (AK, AS, AZ, CA, FM, GU, HI, ID, MT, NV, OR, UT, WA, WY).