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The Regulatory Focus

A Message from Superintendent Kevin Allard

Welcome to March! It's March Madness time, return to daylight saving time, and the official start of spring. March is also a busy time for the Ohio Legislature as many pieces of legislation are being introduced, including the new biennial budget for the state of Ohio.

I hope by now you have already registered to attend the 2019 Ohio Bankers Day program, April 3-4, at The Hilton Columbus at Easton. As in the past, this year's program is filled with informative speakers, informal discussion, and in-between time for networking and just getting to know your regulators and peers. I am very pleased new Commerce Director Sheryl Maxfield will be a part of this program, as well as our federal counterparts, Chicago Regional FDIC Director John Conneely who will be speaking on the FDIC's transparency and accountability initiative, and Dr. Loretta Mester, president and CEO of the Federal Reserve Bank of Cleveland, who will discuss issues of interest to Ohio bankers.

Midday, three breakout sessions will be offered. First, emerging bank fraud issues and anti-money laundering, including cannabis banking issues; a second session will be a discussion by the Federal Home Loan Bank of Cincinnati on funding trends and options; and the third session includes a panel of CEOs who will discuss their management succession process. I hope you find these two days to be time well spent, and I look forward to seeing all of you there.

As always, if you have any questions on these or any other topics, please feel free to contact me directly at Kevin.Allard@com.ohio.gov or 614-728-2631.

In This Issue:

DFI Accreditation: Meaningful Oversight of State Regulators

By John Johnson, Case Manager

In Ohio, all banks are examined at least every 18 months. However, have you ever found yourself wondering, Who examines the examiners? If so, you will be happy to hear that the Division of Financial Institutions (DFI) is accredited and inspected by a national organization – the Conference of State Bank Supervisors (CSBS).

CSBS was organized in 1902 as the National Association of Supervisors of State Banks. In 1971, the name of the organization was changed to the Conference of State Bank Supervisors to better reflect the ongoing nature of CSBS activities. The mission of CSBS is to "support state regulators in advancing the system of state financial supervision by ensuring safety, soundness, and consumer protection; promoting economic growth; and fostering innovative, responsive supervision." The vision of CSBS is, "to be the recognized leader advancing the quality and effectiveness of regulation and supervision of state banking and financial services." You can learn more about CSBS by visiting its website at www.csbs.org.

The accreditation process for DFI involves an in-depth review of our policies, procedures, and operations to determine if they meet the standards set forth by the CSBS Performance Standards Committee. The accreditation program helps state bank departments standardize their processes, provides guidance and assistance through self-evaluations, socializes best practices for state regulation, and strengthens the state bank system by establishing a shared set of principles. DFI was first accredited by CSBS in October 1989.

The bank accreditation program is designed to determine the agency's adequacy of, and the ability to operate within, the seven principles as outlined below.

- The agency has the legal authority to charter, examine, supervise and regulate all state-chartered banks consistent with basic principles of safety and soundness, and protection of the public interest.
- The agency demonstrates the capability to conduct safety and soundness examinations of state-chartered banks within acceptable time limits. This capability should be supported by a combination of active monitoring and review of federal examinations and other methods in a manner consistent with state statutes, safety and soundness, and the public interest.
- The agency has specialized capabilities as required in each state to assure safety and soundness of all state-chartered banks and full compliance with statutes.
- The agency has a policy, statutory or departmental, which requires an adequate examination frequency based on the risk profile of the state-chartered financial institutions.
- The agency retains qualified staff with expertise to charter, examine, supervise and regulate all state-chartered banks within the examination frequency requirements of the state, and to perform other departmental functions and responsibilities.
- The agency has the statutory authority to carry out its duties and responsibilities independently, including authority to take formal enforcement action(s).
- The agency has sufficient funding to achieve all above-mentioned criteria.

The entire accreditation process takes multiple weeks, and begins with an accreditation questionnaire, completed by DFI and provided to CSBS. In addition to the questionnaire, DFI completes a self-evaluation, and sends certain requested documents to CSBS. The self-evaluation includes multiple topics, and ODFI has to 'pass' in each category within the evaluation.

Next, an on-site inspection is scheduled, and a two-to-three member team from CSBS comes to the DFI headquarters in Columbus to interview employees, review materials and documents, and perform other fact-finding tasks. CSBS develops scores for each section reviewed, and provides a final written report.

Much like a bank examination, the accreditation review can result in findings and/or recommendations noted in the final written report. DFI must review the findings and recommendations and provide a formal reply to CSBS addressing the issues. Once a formal reply is provided, DFI has time to implement corrective actions or adopt the recommendations. CSBS then requires annual updates on the progress for corrective actions, and a re-accreditation review including all steps noted above is scheduled every five years.

The accreditation process provides consistent and independent reviews that arm DFI with national perspectives, best practices, and support for adoption of the most current examination and surveillance techniques. In addition, the banking sector in Ohio benefits from a regulator that meets or exceeds all national standards.

Replacing Libor

By David Lee

The London Interbank Offer Rate (Libor) is slated for termination at the end of 2021. Libor has been used for decades to set rates on mortgage loans, commercial loans, student loan securitizations, floating rate debt, interest rate derivatives, business processes and non-financial contracts. Libor's use in approximately $200 trillion dollars of financial instruments has outgrown the much smaller base of major bank borrowing transactions from which Libor is calibrated. Concerns about the efficacy of Libor have existed for years and resulted in the search for a more robust alternative to Libor which could be supported with an adequate number of transactions.

Alternative Benchmarks

In 2014, the Federal Reserve Board and the New York Fed convened the Alternative Reference Rate Committee (ARRC), a committee of banks and non-banks charged with finding alternative rates, developing transition plans and developing best practices to insure contracts are designed to be resilient to possible cessation or material alteration of current or new benchmarks.

After reviewing several alternative rates, the ARRC recommended the Secured Overnight Funding Rate (SOFR) as the replacement of USD Libor. SOFR is a general representation of the risk-free cost of borrowing cash overnight collateralized by U.S. Treasury securities based on hundreds of daily repo transactions. This rate is published daily by the NY Fed. Currently, only the overnight rate is available, but efforts are in process to provide an array of maturities similar to those offered by Libor.

Risks

Given the extensive use of USD Libor as a reference rate, most financial market participants – including retail customers, investors, issuers, corporations, providers of financial services, and large financial institutions – are subject to the risks associated with the transition from Libor to an alternative benchmark. A particular risk relates to legacy agreements tied to Libor, but lack effective fallback provisions to deal with the elimination of Libor as a reference rate. Imagine the confusion around a 10-year, floating-rate loan tied to Libor but lacking fallback language to deal with the disappearance of Libor after 2021.

Recommended Actions

After reviewing agreements and contracts to determine those tied to Libor, separate the agreements into three categories:

- **Agreements ending before the end of 2021**
  -No action required as Libor will be available.

- **Agreements tied to Libor, but mature after 2021**
  -If there is inadequate fallback language in current contracts, amend agreements to incorporate adequate fall-back provisions.

- **Transactions that have not yet been executed**
  -Incorporate adequate fallback provisions or replace the Libor language with a different model.

Libor in Community Banks

Most mortgages and other consumer products tied to Libor also contain fall-back provisions allowing the noteholder to name a successor rate if Libor is discontinued. Similarly, corporate loans usually name the prime rate or the effective federal funds rate plus a spread as a fallback. Now is the time, however, to identify the language in standard contracts and begin assessing whether the SOFR or another benchmark will be used.

15 Years Since Check 21

By Ingrid White

Recently, the Mars Rover "Opportunity" quit operating after 15 years of successfully mapping the surface of Mars. It was originally supposed to operate for six months after landing, so it far exceeded its life expectancy. Throughout those 15 years, it mapped about 28 miles of the surface of Mars. Its downfall was an atmospheric storm that darkened the sky for months and made it impossible for Opportunity's solar panels to regenerate themselves. After more than 1,000 restart messages were sent to no avail, NASA finally pulled the plug and said "farewell."

Also 15 years ago, my son Ethan was born. I think about his age a lot and how he has certainly matured, but also how much growing and learning he has left to do. I especially think about this when I'm in the passenger seat of the car, gripping the arm rest as he careens down Route 33 towards Plain City.
I was shocked to realize it has already been 15 years since the Check Clearing for the 21st Century Act, or "Check 21," was passed, which permitted check truncation and authorized substitute checks to stand in the legal shoes of original checks. Depository banks were permitted to effectively email an image of both sides of the check to the bank it was drawn upon, without the need for final settlement with the original check. It also authorized remote capture and deposit of checks. The legislation was passed on Oct. 28, 2003 and became effective exactly one year later.

In the dark ages of the 20th century, physical checks were consolidated and sorted at central processing centers and then flown around the country to their bank of origin. Before electronic clearing, this resulted in several days' time between the deposit of the check and when it was cleared, and monies actually transferred between the depositary and payor bank. Consumers spending checks liked this delay, or float, as it gave them more time to ensure their bank had the funds to cover the checks they had written.

Merchants and check payees, waiting for the funds to clear into their accounts, as well as the banks that honored their deposits, assumed a much greater risk that a check could bounce days after the deposit. Even during the 1990s, final clearing of checks in the United States was still done physically. Even though much of the settlement procedure was electronic, the original paper checks still had to be returned to the account holder's bank at the end of the process for legal validity. To accomplish this, the Federal Reserve Bank system and the banking industry itself operated a fleet of jets to transport checks across the country each night after the end of business.

However, the events of Sept. 11, 2001 accentuated a weakness in the system: as you may remember, all air travel in the country was shut down for a week after the attacks. This caused a crisis in the nation's financial system as checks backed up, eventually requiring emergency intervention by the Federal Reserve. It was then work in earnest began around finding a modern solution to this problem.

Between 2001 and 2003, before Check 21 could become law, there were a lot of practical moving parts needing to be ironed out within the banking industry, such as how the images and payment information would be passed between banks, how duplicate items would be controlled, and how to prevent multiple postings. For instance, as a young attorney in New Hampshire in 2002, I worked on drafting a New Hampshire version of a uniform amendment to New Hampshire's UCC Articles 3 and 4 relative to demand drafts (defined as "a writing not signed by a customer that is created by a third party under the purported authority of the customer for the purpose of charging the customer's account with a bank.") The legislation placed the same warranties around demand drafts that existed for the negotiation of checks – making sure the creator of the demand draft was authorized by the drawer to create the item. This type of legislative amendment made it easier for demand drafts to be honored and provide legal recourse for their fraudulent use. Demand drafts, along with remote capture and deposit and Check 21 truncation, helped modernize merchant pre-authorizations and recurring payments.

Today, almost no payments are settled between banks using paper checks. Even substitute checks—the workaround allowed by Check 21 –were "practically zero" by 2011, according to a study published by the Federal Reserve Bank of Philadelphia. The study, "Getting Rid of Paper: Savings from Check 21," estimates going electronic is saving the banking system $1.2 billion a year, with consumers and businesses getting $2 billion in benefits from faster payment processing. Consumers are also embracing the new digital age of payments. The Federal Reserve Bank of Atlanta reports on its website while checks represented nearly half of non-cash payments in 2003, by 2012, they represented only 15 percent.

It is almost an understatement to say innovation and technological deployment in the payment space is moving very fast today. For instance, after conducting years of research and on the recommendation of the Faster Payments Task Force, the Federal Reserve and the banking industry have established the Faster Payments Council (FPC), whose mission is to provide a "world class payments system where Americans can safely and securely pay anyone, anywhere, at any time, with near-immediate funds availability." The goal will be to develop the protocols and tools for faster, more efficient, and more secure payments processing to approach 'real-time settlement.' At Ohio Banker's Day on April 4, attendees will hear from Federal Reserve Bank of Atlanta Vice President Julius Weyman as he talks in depth about the evolution of payments since the passage of Check 21, following the key trends in major retail payments from that time up to the present. He will consider both business and consumer perspectives and issues, spotlighting their respective challenges and risks. Mr. Weyman will also provide a view of some things likely to take shape in the years ahead.

My son Ethan –that nascent driver—has lived entirely in the post-Check 21 era. He will probably never write a check in his life; his payment products will all be based on cards or phones, or maybe even chips embedded in his skin. He may not need to use a signature to authorize a transfer– just a thumb print or a retinal or facial scan. Perhaps in 15 or 20 years we will have voice-activated payment transfers, or who knows? How far we have come in the last 15 years – and what will the world look like in another 15? It is almost impossible to imagine.

Unwrapping and Clarifying the New 24-month Exam Provision in the Ohio Revised Code

By Matt Walker

As you may be aware, Ohio House Bill 489, which was recently passed and signed into law, made several changes relevant to Ohio financial institutions. One of those changes is the enactment of a new section of the Ohio Banking Code, Ohio Revised Code Section 1121.101, which provides that composite 1-rated banks with assets less than $10 billion may not be examined by the Division more frequently than once every 24 months. It is important to note this provision will not apply to the Division's federal counterparts, nor does it restrict the Division's authority to conduct joint exams or to conduct examinations when an institution is considered to be at risk. It also does not apply to visitations, off-site surveillance, or other times when the Division may conduct limited-scope reviews for a specific purpose, such as a corporate application filing.

In practice, however, the exam schedule of Ohio-chartered banks will not be affected. This is because most banks are on an alternating exam program, meaning their examination is performed on an alternating basis by the Division and the institution's federal prudential regulator. The result is typically 36-month intervals between Division exams. Larger institutions with more than $3 billion in assets, and institutions under a regulatory enforcement action are similarly not affected, as they are jointly examined. Joint and alternating exam programs are designed to maximize resources and limit the amount of time regulators are on-site at your institution.

Ohio Banking Commission

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2019 Ohio Bankers Day

April 3–4 at The Hilton Columbus at Easton

REGISTER HERE!

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