

A Pocket Guide to
Detecting Red Flags in Board Reports

October 2003

Office of the Comptroller of the Currency
Washington, D.C.

A Pocket Guide to *Detecting Red Flags in Board Reports*

This pocket guide is a short version of *Detecting Red Flags in Board Reports—A Guide for Directors*, October 2003. For a discussion of each topic, please consult the booklet.

Credit Portfolio Red Flags:

- *Significant shifts in the bank's risk rating profile or increase in the number or dollar amount of problem or watch loans as a percent of loans, in aggregate, or for loan types.*
- *Large or increasing volume of loans granted or renewed with policy exceptions.*
- *Large or increasing volume of credit/collateral exceptions.*
- *Rapid growth in total loan volume or particular types of lending.*

- *Loans remaining on the problem loan list for extended periods of time without resolution.*
- *Loan review personnel reporting to a person(s) other than the board, a board committee, or a unit independent of the lending function.*
- *Delinquent internal loan reviews or late identification of problem loans.*
- *Change in scope and frequency of internal loan reviews.*
- *Large concentrations of credit.*
- *Loans to directors, significant shareholders, management, other insiders, and third parties performing services for the bank, external accountants, auditors, and marketing firms.*
- *Loans to affiliates.*
- *Excessive out-of-territory lending.*

- *Excessive reliance on third-party loan brokers or service providers.*
- *Borrowers on the overdraft or uncollected funds reports.*
- *Growth in the ALLL that is significantly greater or less than the percentage growth in total loans over a given period.*
- *Nonperforming or problem loans as a percentage of total loans increasing at a rate greater than the ALLL.*
- *Loan officer compensation tied solely to growth or volume targets, (i.e. without credit quality attributes).*
- *Insufficient controls when purchasing loans.*

Liquidity Risk Red Flags:

- *Liquidity risk that exceeds risk limits established by the board.*
- *A negative trend or significantly increased risk in any area or product line,*

particularly a decline in indicators of asset quality or in earnings performance or projections.

- *Funding concentration from a single source or multiple sources with a common credit or rate sensitivity.*
- *Rapid asset growth funded by rate and/or credit sensitive funding, such as borrowed funds, brokered deposits, national market certificates of deposit, or deposits obtained through CD listing services.*
- *Increased funding costs because of customer or counterparty concerns about increasing risk.*
- *Eliminated or decreased credit line availability from lenders, including correspondent banks.*
- *Larger purchases in the brokered funds or other potentially volatile markets.*
- *Mismatched funding—funding long-term assets with short-term liabilities or*

funding sources containing embedded options.

- *Frequent exceptions to the bank's liquidity risk policy.*
- *Absence of an effective Contingency Funding Plan that is current and commensurate with the complexity of the bank's funding activities.*
- *Change in significant funding sources.*

Interest Rate Risk Red Flags:

- *Significant changes in net interest income.*
- *High or increasing volume of assets with embedded options, such as residential real estate mortgages, mortgage-backed securities, callable securities, mortgage servicing rights, residual assets, and structured notes.*
- *High or increasing volume of liabilities with embedded options, such as putable*

or convertible funding products or structured CDs.

- *Adverse changes in the level and trends of aggregate interest rate risk exposure.*
- *Noncompliance with the board's established risk tolerance levels and limits.*
- *Lack of an independent review or audit of the interest rate risk management process.*
- *Absence of meaningful risk limits.*
- *Unauthorized or frequent exceptions to the interest rate risk policy.*
- *The inability of management to provide reports that identify and quantify the major sources of the bank's interest rate risk in a timely manner and describe assumptions used to determine interest rate risk.*

Investment Portfolio Red Flags:

- *Purchase of securities that do not meet board guidelines on risk or quality.*
- *Securities purchased without pre-purchase risk analysis.*
- *Absence of management's estimation of portfolio valuation sensitivities.*
- *Purchase of securities in excess of concentration limits.*
- *Purchase of securities with yields well above market levels (possible "yield chasing").*
- *Purchasing a relatively large amount of securities in a short time period.*
- *Frequent use of lending authority to acquire securities.*
- *Frequent policy exceptions.*

- *Use of one securities dealer for most, or all, securities purchases and sales.*
- *Investment purchases from securities dealers not approved by the board of directors.*
- *Sale of securities previously designated as HTM, or transfer of securities from HTM to AFS.*
- *The classification of securities with high value sensitivity as HTM.*
- *Large volumes of non-rated, below-investment-grade (lower than BBB or Baa), or out-of-area bonds (may indicate a credit quality problem).*
- *Exclusive reliance on rating agencies' ratings for nongovernment securities.*
- *Investment yields that are well above or below the market or peer group average.*
- *Significant changes in the type, quality, or maturity distribution of the portfolio.*

- *Significant deterioration in the market value of investments.*
- *Absence of credit risk assessment for safekeeping agent.*

Financial Derivatives Red Flags:

- *Participation in transactions without appropriate knowledge of derivatives or experience in the market.*
- *Substantial exposure to a counterparty whose ongoing ability to meet its obligations is uncertain.*
- *Rapid growth in the notional amount of derivative contracts.*
- *A large ratio of derivative notional amounts to total assets.*
- *Written options on derivatives, such as interest rate caps or floors.*
- *Concentration of credit risks (total credit exposure) with a derivatives counterparty.*

- *Use of complex or illiquid derivative contracts.*
- *Derivatives embedded in cash market securities.*
- *“Off market” derivative contracts (e.g., a loan to or from a counterparty).*
- *Derivative contracts executed without an assessment of interest rate and/or credit risks.*
- *Large net payments or receipts of cash.*
- *Unilateral collateral posting (collateral arrangements should be bilateral).*
- *Use of only one firm for all, or nearly all, derivative transactions.*
- *Activity in new derivative products without subjecting the product to a new product review.*
- *Insufficient understanding of accounting rules for derivatives (FAS 133).*

- *Insufficient understanding of rules for derivative transactions with affiliates (12 CFR 223).*
- *Absence of legally enforceable netting agreements.*

Asset Securitization Red Flags:

- *High level of residual assets relative to capital.*
- *Over-reliance on securitization as a funding source.*
- *Credit line increases without appropriate credit analysis.*
- *Increase in policy exceptions, scorecard overrides, or multiple reaging of delinquent accounts.*
- *Significant growth or pressure for growth.*
- *Shift in pricing and credit enhancement levels required by the market.*

- *Asset-backed securitization activities not fully integrated with critical bank planning processes.*
- *Adverse performance trends.*
- *Transactions with affiliates that are not at arm's length terms.*

Credit Commitment Red Flags:

- *Advancing funds to borrowers in financial difficulty, noncompliance with covenants, or other circumstances that make lending to them imprudent.*
- *Inadequate funding sources for anticipated use of loan commitments and lines of credit.*

Mortgage Banking Red Flags:

- *High level of mortgage servicing assets relative to capital.*

- *Unsupported prepayment speeds, discount rates, and other assumptions in MSA valuation models.*
- *Rapid increases in mortgage loan production volume relative to the bank's capital or asset size without corresponding increases in staff or systems.*
- *Large gains or losses on the sale of mortgage loans.*
- *High or increasing level of third-party originated mortgage loans without proper controls.*
- *High or increasing level of policy exceptions.*
- *High or increasing volume of stale loans in mortgage inventory.*
- *High or increasing delinquency or foreclosure rates on serviced loans.*
- *Inadequate audit coverage of mortgage banking activities.*

- *Unauthorized exceptions to policy guidelines.*
 - *Absence of meaningful risk limits.*
-

Audits and Internal Control Red Flags:

- *Internal audit staff reporting to other than the board of directors or its audit committee.*
- *Any indications that management is trying to control or inhibit communications from internal audit staff to the board of directors.*
- *Unexplained or unexpected changes in external auditor or significant changes in the audit program.*
- *A reduction of, or increased turnover in, internal audit staff.*
- *A significant decrease in the audit budget.*
- *Internal or external auditors relying heavily on the other's conclusions.*

- *Employees in key or influential positions who were not on vacation or otherwise absent for two consecutive weeks during the year.*
- *Audit reports that do not address identified internal control weaknesses.*
- *Significant internal control or other deficiencies noted in audit reports that have not been corrected.*
- *The inability of management to provide timely and accurate financial, operational, and regulatory reports.*
- *Unreconciled differences between trial balances, subsidiary ledgers, and the general ledger.*
- *A qualified, adverse, or disclaimer opinion from an external auditor.*
- *An external auditor or audit firm that has a financial interest in the bank, loan from the bank, or other conflict of interest.*

- *An external auditor or audit firm that performs both financial statement audit services and other non-audit services, including outsourced internal audit services, for the bank.*
- *An external audit lead audit partner who has performed external audit services for the bank for more than five consecutive years.*
- *Internal audit not meeting the audit schedule, or not adequately covering significant risk areas.*

Consumer Compliance Red Flags:

- *Lack of periodic reports to the board on compliance matters.*
- *The compliance officer reporting to someone other than the board of directors or a committee of the board.*
- *Significant deficiencies identified in compliance reviews that have not been corrected in a timely manner.*

- *Significant turnover, including the compliance officer, or a reduction in the staff responsible for ensuring compliance with laws or specific consumer products.*
- *Lack of evidence that compliance was adequately considered when new products and delivery systems were developed and introduced, or when new marketing materials were designed.*
- *A significant increase in customer dissatisfaction and complaints (either received directly or sent to the OCC).*
- *Significant deviation from policy or operational standards.*
- *Inadequate review of the compliance function by internal audit.*
- *Lack of evidence that bank employees are receiving current and adequate compliance training appropriate for their positions and responsibilities.*
- *Lack of due diligence when the bank purchases compliance third-party vendor services and products.*

- *Rapid or significant growth in a product line.*

Fair Lending Red Flags:

- *An existing or proposed lending policy that includes, directly or indirectly, reference to any prohibited basis (race, color, national origin, religion, sex, age, marital status, familial status, handicap, receipt of public assistance, or the exercise of a right under the Consumer Credit Protection Act).*
- *An existing or proposed lending policy whose standards for underwriting, pricing, or setting terms and conditions are vague or unduly subjective, or which allow substantial loan officer discretion.*
- *Any statements by officers, employees, or agents, indicating a preference, prejudice, or stereotyping on a prohibited basis, or an aversion to doing business in minority areas.*

- *Segmentation of product markets, advertisements, promotions, application channels, or other access to credit along the lines of racial or national origin characteristics of applicants or geographic areas.*
- *Consumer complaints alleging discrimination in specific transactions.*
- *Substantially fewer loans originated in areas with relatively high concentrations of minority group residents than in areas with comparable income levels, but relatively low concentrations of minority residents.*
- *Disparities in Home Mortgage Disclosure Act (HMDA) data.*
- *Low levels of minority applicants even though minorities represent a significant part of the service area.*
- *Use of credit scoring models that have not been validated.*

CRA Red Flags:

- *Substantial disparities in the numbers of loans originated within groups of contiguous low- or moderate-income geographies.*
- *Reports that show lending performance, particularly when viewed against primary competitors, are significantly below the performance of other lenders in the bank's assessment area.*
- *Reports that show that the bank has few or no qualified investments in its assessment area, even though investment opportunities exist.*
- *Customer complaints about the level of services and products offered in some parts of the bank's trade area compared with those offered in other areas served by the bank.*
- *Substantial errors in CRA and HMDA data and requests for data resubmission.*

BSA Red Flags:

- *Audit is not risk focused.*
- *Audit does not test for suspicious activity.*
- *Bank personnel are not trained regularly on the BSA and how to identify possible suspicious activity.*
- *Correspondence is received from the Internal Revenue Service that indicates the bank is filing incomplete or incorrect currency transaction reports.*
- *The volume of SARs or CTRs is very high or very low.*
- *The bank acquires large deposit relationships, but management is unfamiliar with the depositor's business or line of work.*
- *Account activity is inconsistent with the known business of the account holder.*
- *Customers use an unusually large volume of wires, official checks, money orders, or*

traveler's checks, especially to or from a high-risk geographical area.

- *Bank customers route funds through multiple foreign or domestic banks or wire funds in and out within a short period.*
- *Customers have multiple accounts for no apparent reason or make frequent transfers between accounts either within or outside the bank.*
- *Customers have an unusually large volume of cash or use a disproportionate amount of cash versus checks.*
- *Accounts have dramatic changes or spikes in activity or in the volume of money flowing through the account.*
- *Customer asks that their transactions be exempted from CTR reporting requirements, or that the CTR not be filed, or makes cash deposits just under the CTR reporting threshold.*
- *Transactions to or from entities or high-risk geographic locations that do not*

comport with the customer's known business operations.

Asset Management Red Flags:

- *Unanticipated or unexplained changes in business strategies.*
- *Substantial changes or growth in account types, account balances, or products and services offered.*
- *The existence of accounts with unusually high cash balances or large extended overdrafts.*
- *Accounts that are closed shortly after being opened and funded.*
- *High volumes of exchanged annuities, switched mutual funds, or early redemptions of retail brokerage investments.*
- *Purchases or sales of securities held in a fiduciary capacity through a retail brokerage unit that were not previously*

approved by the board or investment committee.

- *Fiduciary assets or relationships of a kind the bank lacks expertise to manage (e.g., mineral interests or farm/ranch properties).*
- *Unresolved significant audit and compliance findings.*
- *Significant levels of documentation deficiencies and policy exceptions, including exceptions to account and business acceptance policies.*
- *Unexplained or frequent changes in vendors, service providers, or auditors.*
- *Significant outsourcing of services without management oversight and control.*
- *Purchase or sale of assets between fiduciary accounts and the bank or bank insiders.*
- *Sale, loan, or transfer of fiduciary account assets to the bank or bank insiders.*

Management Information Systems Red Flags:

- *MIS systems that result in unauthorized disclosure of customer information and/or lapses of security in protecting customer information.*
- *MIS systems that fail to keep pace with or prove unreliable in the face of existing or new business lines.*
- *Systems problems attributed to integration of systems; e.g., in conjunction with an acquisition.*
- *MIS reports reflecting problems relating to vendor management or outsourcing arrangements.*
- *Increasing levels of fraud loss.*
- *Lack of an adequate business continuity plan.*
- *An information technology system that cannot be described readily by appropriate management. Management*

is unable to provide a basic diagram of the system architecture or a comprehensive list of service providers.

- *MIS reports that are untimely, incomplete, or inaccurate.*
- *MIS reports that lack relevance or are too detailed for use as an effective decision-making tool.*
- *Inconsistency of information contained within MIS reports.*
- *A lack of system audits or unresolved audit deficiencies.*

Internet Banking Red Flags:

- *A system that does not have regular reviews and certifications by independent auditors, consultants, or technology experts.*
- *Unresolved or repeat audit deficiencies.*
- *Management that is unable to provide a basic description of the system*

architecture, a comprehensive inventory of service providers, or effective vendor management.

- *Systems, products, or services are inconsistent with the bank's strategic plan.*
- *Systems without contingency and business resumption plans, or with a low level of operational reliability.*
- *Web sites that do not meet customers' needs for information security and privacy, and those without effective customer authentication.*
- *No evidence that the bank's compliance officer reviewed information prior to distribution on the Web site.*

Overall Assessment Red Flags:

- *A composite, component, or specialty rating that is lower than in previous examinations. Directors should be particularly concerned about ratings of 3, 4, and 5.*

- *A risk category that is rated moderate and increasing, or high.*
- *A risk category in which the direction of risk is rated as increasing.*
- *A risk category in which the quantity of risk is moderate or high, and the quality of risk management is rated as weak.*
- *A risk category in which the rating is inconsistent with the risk tolerance of the bank.*
- *“Matters Requiring Attention” or items of concern in the “Overall Conclusions” section of the report of examination.*
- *Many or repetitive violations of law.*
- *High or increasing level of classified assets.*
- *Reference to noncompliance with bank policy or recurring internal control deficiencies.*

- *Reference to an activity for which directors may be liable or subject to civil money penalties.*
- *Reference to noncompliance with one of the OCC's administrative actions (cease-and-desist order, formal agreement, memorandum of understanding, or commitment letter).*

A single copy of this pamphlet is available free of charge from: OCC Public Information Room, Communications Division, Mail Stop 3-2, Washington, D.C. 20219 or by faxing your request to (202) 874-4448.

Multiple copies may be purchased at the rate of \$2.00 for five copies and \$10.00 for 25 copies. Please send your check payable to "Comptroller of the Currency" to: Comptroller of the Currency, Accounts Receivable, 250 E Street, SW, Mail Stop 4-8, Washington, D.C. 20219