P&G Banking ADVISOR

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P&G Associates

www.pandgassociates.com 877.651.1700

WHAT'S THE COST OF BSA/AML FAILURES?

Avoiding penalties with a comprehensive program

Recent trends in Bank Secrecy Act / Anti-Money Laundering (BSA/AML) enforcement demonstrate how important it is for a bank to maintain a BSA/AML compliance program that's commensurate with its risk. In a January 2018 report, the Congressional Research Service (CRS) observed that, in recent years, the frequency and size of penalties for BSA/AML violations have increased. At the same time, the risk of individual liability (of bank officers and directors, for example) for those violations also has grown.

COMPREHENSIVE COMPLIANCE

To help detect and deter money laundering and terrorist financing, the BSA and related regulations require banks to develop and implement a comprehensive BSA/AML program. To maintain an effective compliance program, your bank needs to take steps including:

- Appointing a BSA compliance officer,
- Setting up a written customer-identification program (CIP), which, under rules that recently took effect, must include procedures for identifying and verifying the identity of beneficial owners of legal entity customers,
- Generating a system for monitoring transactions for suspicious activity and filing suspicious activity reports (SARs) when appropriate,
- Implementing procedures for filing currency transaction reports (CTRs) for cash transactions exceeding $10,000, for related transactions exceeding $10,000 in the aggregate and for transactions that have been structured to avoid reporting,
- Putting procedures in place for comparing your customer database and certain transactions against lists of known or suspected terrorists or terrorist organizations maintained by the Office of Foreign Assets Control (OFAC),
- Having a process for responding to Financial Crimes Enforcement Network (FinCEN) requests for information about persons suspected of involvement in terrorism or money laundering,
- Creating an ongoing employee training program,
- Setting up independent compliance testing, and
- Ensuring you have a system of internal controls designed to ensure ongoing compliance with the BSA.

Federal regulators expect banks to take a risk-based approach to BSA/AML compliance — that is, a bank should tailor its policies, procedures, processes and controls to its specific risk profile. (See "Risk matters" on page 3.)

INCREASING PENALTIES

According to studies cited by the CRS, penalties for BSA/AML violations have been increasingly frequent: From 2012 to 2015, nearly 90% of enforcement actions involved monetary penalties, compared to less than 50% from 2002 through 2011. Penalties have also grown in size, both in absolute terms as well as percentage of capital. Nearly one-third of penalties assessed in recent years topped 10% of an institution's capital.

One notable example is HSBC, which was assessed a $665 million penalty and forfeited around $1.2 billion in 2012 related to its failure to maintain an effective AML program and to conduct appropriate due diligence on foreign correspondent account holders. And in 2014, JPMorgan Chase was hit with more than $800 million in penalties and forfeited $1.7 billion for its role in the Madoff Ponzi scheme.

Also in 2014, MoneyGram's chief compliance officer was assessed a $1 million penalty in his individual capacity for willful violations of the BSA program requirements as well as failure to file SARs on a timely basis to report fraudulent telemarketing operations and other schemes.

COMPLIANCE ISSUES

According to the FDIC (one of several federal agencies that conduct BSA/AML examinations), the most common compliance deficiencies involve failure to meet reporting (CTRs and SARs) and information-sharing obligations and failure to maintain adequate internal controls. In a recent publication ("The Bank Secrecy Act: A Supervisory Update," *Supervisory Insights*, Summer 2017), the FDIC offered guidance on how banks can prevent these deficiencies. Often, it's possible to prevent the most commonly cited violations by maintaining effective internal control structures. For example, to prevent information sharing deficiencies, a bank should designate persons responsible for information sharing and establish policies, procedures and processes for conducting, documenting and reporting on information sharing request searches.

Further, to prevent SAR deficiencies, a bank should ensure its staff is properly trained; implement systems to monitor, identify, research and report unusual activity; and maintain effective, documented decision-making processes regarding whether to file SARs.

The FDIC notes that technical violations, such as failure to file timely CTRs, don't necessarily warrant criticism of a bank's BSA/AML program. But they may be red flags signaling more significant deficiencies, such as problems with internal controls or training.

RISK ASSESSMENT

It's impossible to design and implement an effective BSA/AML compliance program without first assessing your bank's money-laundering and terrorist-financing risk. Examiners will determine whether your program is adequate through the lens of your bank's particular risk profile. ■

RISK MATTERS

To understand your bank's BSA/AML compliance obligations, the first step is to conduct a risk assessment. Examiners expect your bank to develop policies, procedures, processes and controls that are adequate in light of your bank's size, location, customer base, and mix of products and services.

For example, a bank with a significant percentage of high-risk customers (such as nonresident aliens or money service businesses) or transactions (such as international wire transfers) might need more rigorous account-opening or transaction-verification procedures — or more sophisticated technology. But for a community bank with fewer risky customers and activities, less stringent measures may suffice.

In evaluating your bank's compliance program, it's important to understand that your BSA/AML obligations are based on the bank's risks, not its resources. In a recent enforcement action against USB, for example, the bank was assessed more than $500 million in penalties for willfully failing to maintain an adequate AML program and file SARs. Among its many deficiencies, the bank capped the number of alerts generated by its transaction-monitoring system based on staffing levels and resources, rather than transaction risk level.

HOW TO DEVELOP A CUSTOMER RETENTION PROGRAM

In the current competitive banking market, it's important to recognize that customers need more than the typical products and usual services as an incentive to choose your bank over another. What does your bank have that others don't — whether it's a personal touch, customized advice and solutions, or a history of local community service? In other words, what strategies can you implement to help attract customers — and retain them over time?

ANALYZE YOUR CUSTOMERS WITH A CORE DEPOSIT STUDY

A good first step is to identify your core deposits and develop an understanding of customer behaviors. Which depositors are loyal, long-term customers? Which depositors are motivated primarily by interest rates? A core deposit study can help you distinguish between the two and predict the impact of fluctuating interest rates on customer retention. Banking regulators have been strongly encouraging banks to conduct these studies as part of their overall asset-liability management efforts.

Core deposit studies assess how much of your bank's deposit base is truly interest rate sensitive by examining past depositor behavior. They also look at factors that tend to predict depositor longevity. For example, customers with multiple banking products (such as checking and savings accounts, mortgages and auto loans) and higher average deposit balances are less likely to switch banks.

ENCOURAGE RELATIONSHIP BUILDING

To build customer loyalty, it's critical to ensure that customers are engaged. According to research by Gallup, engaged customers are more loyal, are more likely to recommend the bank to family and friends, and represent a bigger "share of wallet" (that is, the percentage of a customer's banking business captured by the bank).

Recent retail banking studies show that fewer than half of customers at community banks and small regional banks (less than $40 billion in deposits) are actively engaged, compared to a smaller percentage at large regional banks (over $90 billion in deposits) and an even smaller percentage at nationwide banks (over $500 billion in deposits). That's the good news. The bad news is that 50% of customers at online-only banks are fully engaged.

So, how can community banks do a better job of engaging their customers in order to compete with online banks? The answer lies in leveraging their

"local touch" by knowing their customers, delivering superior service, and providing customized solutions and advice. And to do that, banks must ensure that their front-line employees — tellers, loan officers, branch managers and call center representatives — are fully engaged in their jobs.

Encouraging employees to engage with customers has little to do with competitive salaries and benefits. Rather, it means providing employees with opportunities for challenging work, responsibility, recognition and personal growth.

INCORPORATE ONLINE TOOLS

An increasing number of customers — Millennials in particular — use multiple channels and devices to interact with their banks. These include online banking, mobile banking applications and two-way texting. To build loyalty, banks should enable customers to use their preferred channels and ensure that their experiences across channels are seamless. And don't overlook the importance of social media platforms, such as Facebook and Twitter. Younger customers are more likely to use these platforms to recommend your bank to their friends and families.

MAKE YOUR MARK

Obviously, the best way to satisfy customers is to learn what they are seeking from their banking experiences and provide it as much as possible. A bank that identifies, and meets, current and potential customers' needs is ahead of the game — and will generate a stable customer base. The strategies outlined above should pay off in a profitable bottom line for many years to come. ■

CECL'S IMPACT ON BANK ACQUISITIONS

As the effective date of the new Current Expected Credit Loss (CECL) model approaches, most banks are focusing on adoption of the new standard and making the changes necessary for a smooth transition. But for banks that plan to grow via acquisition, it's also important to consider how the standard will affect their accounting for loans and other financial instruments acquired in these transactions.

WHAT'S CECL IN BRIEF?

The new model discards today's incurred-loss model, which delays recognition of credit losses until they become "probable," in favor of a forward-looking approach. Under the new approach, banks will recognize an immediate allowance for all expected credit losses over the life of loans held for investment, held-to-maturity debt securities and other covered financial instruments.

CECL's effective date varies depending on the type of institution, as follows:

- For SEC filers — fiscal years beginning after December 15, 2019, including interim periods within those fiscal years,
- For other public business entities (PBEs) — fiscal years beginning after December 15, 2020, including interim periods within those fiscal years, and
- For nonpublic banks — fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021.

So, for example, the effective date for a nonpublic bank with a calendar year end would be January 1, 2021. The bank would present a full-year income statement under CECL for 2021, but quarterly reporting requirements wouldn't begin until 2022.

WHAT'S THE IMPACT ON ACQUISITION ACCOUNTING?

Banks involved in acquisitions will need to evaluate CECL's impact on the way they account for acquired loans and other financial instruments. One important consideration is the flexibility CECL affords to banks in selecting methodologies for modeling expected credit losses and calculating their allowance for loan and lease losses (ALLL). Discrepancies between the modeling assumptions used by the acquirer and the target can have a significant impact on the calculation of the ALLL post-acquisition, which in turn can affect the combined institution's capital requirements.

Another critical factor is CECL's treatment of acquired loans — both performing loans and those whose credit quality has declined. Under current rules, acquired performing loans are marked to fair value but no ALLL is carried over. But under CECL, expected losses will be included in the ALLL and recorded in the income statement as a credit loss expense in the quarter the acquisition is consummated.

So-called purchased credit-deteriorated (PCD) loans will be treated differently. PCD loans constitute a broader category than purchased credit-impaired (PCI) loans under current rules, so it's likely that an acquisition will include PCD loans. CECL discards the complex accounting treatment of PCI loans in favor of a simpler approach. For PCD loans, like non-PCD loans, the ALLL will be adjusted to reflect expected losses, except that the initial allowance will be added to the purchase price rather than recorded as a credit loss expense. In other words, PCD loans will have no impact on the income statement in the quarter the acquisition is completed.

BANKS INVOLVED IN ACQUISITIONS WILL NEED TO EVALUATE CECL'S IMPACT ON THE WAY THEY ACCOUNT FOR ACQUIRED LOANS AND OTHER FINANCIAL INSTRUMENTS.

WHAT ADDITIONAL DUE DILIGENCE IS REQUIRED?

It's important for an acquiring bank to evaluate a target's methodologies for modeling expected credit losses as well as its mix of PCD and non-PCD loans. This information is necessary to understand the potential impact of the transaction on the ALLL, earnings and regulatory capital.

Keep an eye on regulatory developments. Recently, the federal banking agencies published a joint proposal that would, among other things, allow banks to phase in the impact of CECL adoption on regulatory capital over a three-year transition period. To discuss how CECL will affect your bank's acquisitions, including acquisitions completed before the effective date, please contact us. ■

BANK WIRE

GROWING PAINS: WHAT IF YOUR BANK'S ASSETS CROSS THE $500 MILLION AND $1 BILLION THRESHOLDS?

As your bank grows — either organically or through acquisitions — it's important to prepare for additional requirements that kick in after you reach $500 million or $1 billion in assets. Under the Federal Deposit Insurance Corporation Improvement Act (FDICIA), banks with assets between $500 million and $1 billion must:

- Provide audited comparative financial statements to the relevant federal regulator,
- Comply with stricter auditor independence standards,
- Submit management representations regarding financial statement preparation, internal control over financial reporting (ICFR) and compliance with certain laws and regulations, and
- Have an audit committee with a majority of members who are outside directors independent of management.

Banks that cross the $1 billion threshold must also:

- Submit additional management representations, including an assessment of the effectiveness of ICFR as of the end of the fiscal year,
- Provide an auditor's opinion regarding the effectiveness of ICFR, and
- Ensure that *all* audit committee members are outside directors independent of management.

Generally, when a bank crosses one of these thresholds, the new requirements take effect at the beginning of the next fiscal year. ■

MARIJUANA BUSINESSES: AN OPPORTUNITY FOR COMMUNITY BANKS?

As a growing number of states legalize marijuana for medical use, recreational use or both, there's increasing demand by marijuana businesses for banking services. But many banks, particularly federal institutions, are reluctant to do business with marijuana growers, processors or sellers — even if they're operating legally under state law — for fear of running afoul of federal marijuana prohibitions. This may create an opportunity for state or community banks — though it's important to consult legal counsel before venturing into this market. Note that federal lawmakers are considering legislation that would allow banks to accept deposits from marijuana businesses. ■

RED FLAGS: HOW CAN YOU SPOT DISASTER-RELIEF FRAUD?

Law enforcement agencies are cracking down on disaster-relief fraud, including fraudulent applications for emergency assistance benefits and fraudulent solicitation of charitable donations. Banks are in a good position to help identify and prevent these activities. A recent advisory from the Financial Crimes Enforcement Network (FinCEN) urges banks to watch for a few warning signs. Banks suspecting this activity should file a Suspicious Activity Report if the activity meets the filing thresholds, and contact local law enforcement.

For benefits fraud, red flags include:

- Deposits of multiple emergency assistance payments into the same account,
- Deposits of emergency assistance checks, when the account holder is a retail business and the payee/endorser is someone other than the account holder,
- Cashing of multiple emergency assistance checks by the same individual, and
- Using an emergency assistance check to open a new account, if the account holder is different from the depositor.

For charity fraud, watch out if:

- The payee's name is similar, but not identical, to a reputable charity, or
- The charity is using money transfer services to collect funds. ■

P&G Associates

P&G Associates ("P&G") has been meeting the specific risk management needs of community banks of all sizes since 1991. As a high quality and affordable alternative to national firms, P&G provides internal audit, regulatory compliance, BSA/AML, information technology and enterprise risk management review services and software. P&G is exclusively dedicated to the banking industry, providing clients with dedicated, focused and hand-held services reflective of a wide range of skills, experience and industry expertise. As a Firm, we have also been proactive in assisting our clients with the designing, implementation and testing of the internal control environment to assist management with the attestation requirement under the Sarbanes-Oxley Act.

P&G's uniqueness is characterized by its experienced staff and partners. Their hands-on involvement on each engagement provides our clients with a wide range of skills, experience and industry expertise. We employ the use of Subject Matter Experts — designated individuals performing audits in their specific field of expertise. The use of such professionals provides a unique value-added approach that is both efficient and productive.

We believe that a significant aspect of our services is our degree of involvement and responsibility to assist management by making suggestions for improvement, keeping them informed of professional developments and by acting as an independent counsel and sounding board on general business matters and new ideas.

We pride ourselves in our ability to provide effective and practical solutions that are commensurate with our clients' needs by emphasizing high-quality personalized service and attention. Our services are truly customized.

For **Solutions** *to your internal audit needs, please contact our service coordinators at (877) 651-1700, or log-on to www.pandgassociates.com to learn more.*

P&G Associates

www.pandgassociates.com

Headquarters:
646 US Highway 18
East Brunswick, NJ 08816

Offices:
New York, NY
Philadelphia, PA
Chicago, IL
Miami, FL