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TIME TO REVISIT YOUR AML PROGRAM

THE PROS AND CONS OF ASSET CONCENTRATION

HAS COVID-19 HURT YOUR COMMUNITY REINVESTMENT ACT RATING?

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TIME TO REVISIT YOUR AML PROGRAM

If you haven't already done so, now is a good time to revisit your bank's anti-money laundering (AML) program. The COVID-19 pandemic has impacted AML compliance in many ways. It has increased risks, changed the behavior of bank customers, and accelerated implementation of online account opening and other technologies. In light of these changes, all banks should evaluate their AML programs, starting with a risk assessment.

HAVE YOUR RISKS CHANGED?

In an effort to prevent and detect money laundering and terrorist financing, the Bank Secrecy Act (BSA) and related laws and regulations require banks to develop and implement a comprehensive AML program. An effective program should include, among other things, a written customer identification program (CIP), a system for monitoring transactions for suspicious activity and filing suspicious activity reports (SARs) when appropriate, and procedures for filing currency transaction reports (CTRs) for currency transactions that exceed $10,000. It also should include internal controls designed to ensure ongoing compliance with BSA requirements.

Banks are expected to take a risk-based approach to compliance. In other words, you need to tailor your AML policies, procedures, processes and controls to your specific risk profile. That means developing and implementing an AML program that's adequate in light of your bank's size, location, customer base, product and service mix, and other risk factors. It's a good idea to update your risk assessment to reflect changes in your risk profile. For example:

- Your bank's increased reliance on remote workers and digital platforms may have weakened some internal controls,
- Reduced face-to-face interaction among bank personnel may create challenges in monitoring, discussing and documenting suspicious activities,
- Customers' increased use of online banking tools may increase your bank's AML risks and place new demands on its monitoring capabilities, and
- Heavier use of online account opening may heighten AML risks, requiring more robust due diligence related to customer identification.

If your bank's risks have increased, it may be appropriate to implement more rigorous account-opening procedures, such as requiring bank personnel to collect and verify additional information for high-risk customers or transactions.

HAS CUSTOMER BEHAVIOR CHANGED?

To identify unusual or suspicious activities, banks need to collect and analyze information about customer activity patterns and establish a baseline for "normal" activities. But changes in customer behavior brought about by the pandemic may have altered the baseline, making it more difficult to distinguish between legitimate and potentially illicit activities. For example, during the pandemic, many businesses that historically relied primarily on cash transactions have sharply increased their use of digital payment methods. Many banks will need to redefine "normal" customer behavior to help identify potential aberrations.

It's also possible that the annual review of customers exempt from currency transaction reporting will reveal that certain businesses no longer qualify for the exemption. This may happen if shutdowns or other effects of the pandemic have caused a business's number of currency transactions to drop below the threshold.

HAVE YOUR PRODUCTS AND SERVICES CHANGED?

During the pandemic, many banks have introduced new products and services — such as online account opening, remote deposit capture and mobile banking apps — to accommodate social distancing and other public health measures. All of these products and services can increase a bank's AML risks, so it's critical to implement AML monitoring, identification and reporting systems designed to mitigate these risks.

For example, it might be more difficult to detect fraud when checks are deposited remotely, so additional controls or monitoring procedures may be necessary. These may include enhanced customer due diligence, more rigorous analysis of expected and actual account activity, or the setting of transaction limits on remote deposit capture.

CHANGES ON THE HORIZON: THE AML ACT OF 2020

It's generally expected that the Biden administration will make anti-money laundering (AML) compliance a priority, spurred on by new tools and resources provided by the Anti-Money Laundering Act of 2020. Among other things, the act:

- Increases government resources for combating money laundering,
- Enhances whistleblower rewards and protections, which could lead to more enforcement actions, and
- Expands and raises penalties for Bank Secrecy Act (BSA) violations, including additional penalties for repeat violations and a requirement that violators who are partners, directors, officers or employees of a financial institution repay bonuses received during the calendar year in which the violation occurred (or the following year).

The act also may make it easier for banks to identify the owners of certain legal entities. Under the Financial Crimes Enforcement Network's (FinCEN's) Beneficial Ownership Rule, banks must verify the identity of a customer's beneficial owners — that is, individuals who, directly or indirectly, own 25% or more of an entity or have "significant responsibility to control, manage, or direct the legal entity." The act directs FinCEN to establish a national beneficial ownership database targeted at smaller companies. Assuming banks are provided with access to the database, it should greatly ease banks' customer due diligence burdens.

WHAT IS THE NEW NORMAL?

As we emerge from the pandemic, many businesses will need to adjust to a new normal, and banks are no exception. Many of the changes that affect banks' AML risks, such as increased reliance on remote work and digital banking, are here to stay. So, it's more important than ever for banks to assess their risks and adjust their AML programs accordingly. ■

THE PROS AND CONS OF ASSET CONCENTRATION

By definition, the purpose of community banks is to serve their particular communities and the industries that fuel those local economies. This can lead to potential risk, including losses, if assets become concentrated in an industry that is struggling. There are pros and cons to asset concentration — the key is to understand how to keep the right balance.

BENEFITS AND DRAWBACKS

Asset concentrations increase a bank's risk by exposing it to significant potential losses. For example, banks with concentrated assets are vulnerable to significant losses in the event of a local industry or economic downturn. But that doesn't mean that banks should avoid such concentrations at all costs. On the contrary, asset concentrations enable banks to better serve their communities by taking advantage of local industry expertise and market knowledge. It's important to take an approach that weighs the risks against the benefits — and to implement measures to mitigate those risks.

First, evaluate your credit risk management policies, keeping in mind that asset concentration risks are felt well beyond the area of concentration. Suppose a bank has a heavy concentration of loans to businesses in a particular industry. A downturn in that industry could not only affect the ability of businesses in the industry to repay their loans, but could also make it harder for individuals who work in the industry to repay their auto loans or mortgages.

So, it's critical to consider the impact of asset concentrations on your entire loan portfolio and to implement policies to address the elevated risk. Such policies might include tightening underwriting standards, placing caps on asset concentrations, conducting global cash-flow analyses, performing stress tests and monitoring loans carefully.

It's also necessary to ensure that your bank's level of capital and reserves is commensurate with its concentration risk and aligns with the bank's strategic plan. If your bank has a significant concentration of loans in a particular industry, market or loan type, it's important to consider the relationships among these loans when evaluating the sufficiency of your capital and determining an appropriate allowance for loan and lease losses (ALLL).

DIVERSITY MATTERS

In addition, take a judicious approach to diversification. An obvious solution to a risky asset concentration is to diversify. But diversification presents its own risks, so it's important to handle the process carefully. For example, a bank with a heavy concentration of loans in an industry or geographic territory might diversify by making loans to businesses in other industries or territories. But doing so might require the bank to venture out of its comfort zone into areas where it doesn't possess the same level of knowledge and expertise.

Look for ways to diversify *within* a particular industry. For example, a bank with a high concentration of agricultural loans should consider lending to both crop producers, such as corn or soybean farmers, and livestock producers. This can mitigate the bank's risk because economic and other external forces that hurt one industry segment may help the other. A decline in crop prices, for instance, would harm crop producers but it would benefit livestock producers by reducing their feed costs.

Another diversification strategy is to increase the size of your bank's securities portfolio. Doing so instantly shrinks the bank's loan-to-asset ratio. (A high ratio is often a red flag.) But keep in mind that investing in securities poses problems of its own and may divert capital away from the community the bank serves.

ADJUST AS NECESSARY

While understanding that the mission of your community bank involves serving your community, you should fulfill that mission in a way that ensures your loans are as safe and secure as possible. This means developing a detailed understanding of your local economy's structure and potential risks, and adjusting as needed on an ongoing basis to keep asset balance within your bank's loan portfolios. ■

HAS COVID-19 HURT YOUR COMMUNITY REINVESTMENT ACT RATING?

The COVID-19 pandemic has had a significant impact on community banks and their customers, but one area that is often overlooked is the potential impact on a bank's Community Reinvestment Act (CRA) rating. If the pandemic has negatively affected your bank's ability to reinvest funds into its community, it's important to document the factors that have contributed to the decline. For example, demonstrating to regulators that the pandemic's impact on the economy or customer behavior is responsible for reduced community lending activity may help you avoid a poor CRA rating.

PURPOSE OF THE CRA

The CRA is designed to encourage banks to help meet the credit needs of the communities in which they operate, including low- and moderate-income neighborhoods, consistent with safe and sound banking operations. To monitor compliance, the federal banking agencies periodically evaluate banks' records in meeting their communities' credit needs and make their performance evaluations and CRA ratings available to the public. The agencies take a bank's CRA rating into account when considering requests to approve bank mergers or acquisitions, charters, branch openings, and deposit facilities. CRA ratings also may affect a bank's reputation in the community.

CRA EVALUATION STANDARDS VARY SOMEWHAT DEPENDING ON A BANK'S SIZE AND ITS SUPERVISORY FEDERAL AGENCY.

CRA evaluation standards vary somewhat depending on a bank's size and its supervisory federal agency. Generally, "small" and "intermediate small" banks enjoy streamlined CRA evaluations and avoid specific reporting obligations imposed on larger banks. For banks regulated by the Federal Deposit Insurance Corporation (FDIC) or Federal Reserve, small or intermediate small banks are currently defined as those with less than $1.322 billion in assets, while the threshold for Office of the Comptroller of the Currency (OCC)-regulated banks is $2.5 billion in assets.

According to FDIC guidelines, regulators examine the following performance criteria when evaluating a small bank:

- The bank's loan-to-deposit ratio, adjusted for seasonal variation and, as appropriate, other lending-related activities such as secondary market participation, community development loans or qualified investments,
- The percentage of loans and other lending-related activities located in the bank's assessment area or areas,
- The distribution of lending among borrowers of different income levels and businesses of different sizes,
- The distribution of lending among geographies of different income levels, and
- The institution's record of taking action, if warranted, in response to written complaints about its CRA performance.

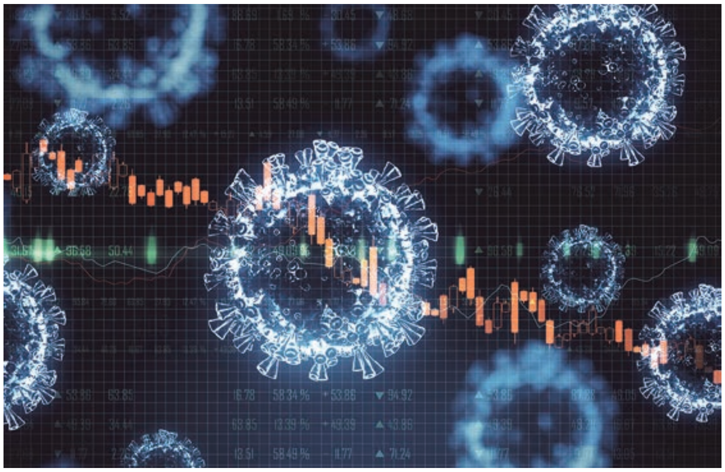
Banks may receive a rating of "outstanding," "satisfactory," "needs to improve," or "substantial noncompliance." Banks that operate in more than one assessment area generally receive separate ratings for each area. Assessment areas are based on states or multi-state metropolitan areas in which a bank has branches.

COVID-19 IMPACT

The pandemic has changed the behavior of many bank customers. A trend toward less consumer spending and greater consumer savings has led many banks to experience a substantial increase in deposits together with a sharp decrease in lending activity. The resulting decline in a bank's loan-to-deposit ratio may have a negative impact on its CRA rating.

To determine whether a bank's loan-to-deposit ratio is adequate, regulators consider the "performance context," such as:

- The bank's capacity to lend,
- The lending capacity of other similarly situated banks in the assessment area,
- Demographic and economic factors present in the assessment area, and
- Lending opportunities in the assessment area.



To mitigate the risk of receiving a poor CRA rating, banks should identify and document the various factors — both bank-specific and community-specific — that influence their lending ability.

HOW DO YOU RATE?

All community banks should look into the impact of the pandemic on their loan-to-deposit ratios and other performance areas regulators assess in determining CRA ratings. Being prepared to explain these can help you avoid a negative evaluation. ■

BANK WIRE

FED PROVIDES LIBOR TRANSITION GUIDANCE

After 2021, the London Interbank Offered Rate (LIBOR) will no longer be used as a reference interest rate for loans and other financial instruments. Recently, the Federal Reserve issued guidance for assessing a financial institution's progress in preparing for the transition, noting that entering into new contracts that reference LIBOR after December 31, 2021, would create safety and soundness risks. Supervision and Regulation Letter 21-7 provides separate guidance for smaller and larger institutions, in both cases focusing on six key transition areas: 1) transition planning, 2) financial exposure measurement and risk assessment, 3) operational preparedness and controls, 4) legal contract preparedness, 5) communication, and 6) oversight. To avoid regulatory scrutiny and potential supervisory action, banks should ensure that they will be ready to stop issuing LIBOR-based contracts by the end of this year. ■

SAFE BANKING ACT REINTRODUCED IN CONGRESS

With wide bipartisan support in both the House and Senate, the SAFE Banking Act has been reintroduced in Congress, after being passed by the House three times. At this writing, the House had again passed the bill, but its fate in the Senate was uncertain. If passed, the act would provide liability protection to banks and other financial institutions that serve legitimate, cannabis-related businesses. ■

GET READY FOR NEW CONSUMER PROTECTIONS

In early 2020, the Consumer Financial Protection Bureau (CFPB) established the Taskforce on Federal Consumer Financial Law. A year later, in January 2021, the task force released its report. According to the report, agencies should identify opportunities to coordinate regulatory efforts. For example, the CFPB and prudential regulators should eliminate overlapping examination subject areas and reconcile inconsistent examination standards that unnecessarily expend multiple resources and can cause confusion.

A few other examples of the task force's 100 or so recommendations are that agencies should:

- Research consumer reporting issues that arise in connection with a consumer's bankruptcy,
- Work with other agencies to create a unified regulatory regime for new and innovative technologies providing services similar to banks, and
- Exercise caution in restricting the use of nonfinancial alternative data, which can be useful indicators of creditworthiness.

The report has no legal effect, but you can be sure that Congress, the CFPB, and federal and state regulators will take its recommendations seriously. ■

BANKING REGULATORS GATHERING INTELLIGENCE ON AI

Increasingly, banks are exploring the use of artificial intelligence (AI), and federal banking regulators have taken notice. Recently, in a joint request for information and comment, the federal banking agencies (Federal Reserve, Consumer Financial Protection Bureau, Federal Deposit Insurance Corporation, National Credit Union Administration and Office of the Comptroller of the Currency) announced that they're seeking information about how financial institutions are using AI in their businesses, including fraud prevention, personalization of customer services and credit underwriting. ■

acxell ("acxell") has been meeting the specific risk management needs of community banks of all sizes since 1991. As a high quality and affordable alternative to other firms, acxell provides internal audit, regulatory compliance, BSA/AML, information technology, SOX/FDICIA and enterprise risk management review services and software. acxell 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.

acxell'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.

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