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A D V I S O R

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SHOULD YOUR BANK OUTSOURCE ITS INTERNAL AUDIT PROGRAM?

For community banks, a strong internal audit program is a critical tool for ensuring regulatory compliance, managing risk, maintaining operational efficiency, and inspiring confidence in their financial and reporting practices. It also can help prevent and detect fraud. According to the Association of Certified Fraud Examiners' most recent report on occupational fraud, though tips are by far the most common way frauds are exposed, internal audits are the second most common method. The report found that internal audits are associated with significant reductions in the magnitude and duration of frauds.

Internal audits aren't the same as external audits, which focus on ensuring that financial statements are free from material misstatement and comply with Generally Accepted Accounting Principles or other relevant frameworks. Both types of audits are essential for a bank's financial health, providing a robust framework for accountability and transparency. However, internal audits involve different procedures, are usually broader in scope, and can be tailored to fit your bank's risk-management, operational and governance needs.

One question many banks face is whether to conduct internal audits in-house or to outsource the internal

audit function. The answer to that question depends on your bank's circumstances. Let's look at some factors to consider.

PROS OF OUTSOURCING

Outsourcing internal audits offers several important advantages over conducting them in-house, including:

Improved independence and objectivity.

Outsourced internal auditors are usually independent, objective and less susceptible to influence from bank management, providing a fresh look at the bank's operations and internal controls. Outsourcing also makes it easier to rotate internal auditors, which can be a challenge with an in-house internal auditing department.

Access to expertise. Outsourced internal auditors possess specialized expertise and skills that would be challenging or cost-prohibitive to maintain in-house. This is particularly true for banks in smaller communities as well as those that plan to offer new products and services or expand into new markets.

Access to technology. Outsourced internal auditors often have access to sophisticated technology tools that would be impractical for a bank to purchase in-house.

Reduced costs. By allowing banks to avoid overhead and fixed labor costs associated with an in-house staff, outsourcing can reduce costs. It also gives banks the flexibility to quickly scale their internal audit programs up or down as their needs change or special projects arise.

If your bank's management concludes that the pros of outsourcing the internal audit function outweigh the cons, it's critical to handle outsourcing relationships with care.



CONS OF OUTSOURCING

Perhaps the biggest disadvantage of outsourcing is that outsourced internal auditors may initially lack an in-house auditor's deep and broad familiarity with the bank's operations. This creates a learning curve that may counteract the cost-effectiveness of an outsourced audit. One option is to outsource the internal audit function to the bank's external auditor. But be sure to weigh the potential impact of such an arrangement on the external auditor's independence when considering this approach.

Outsourcing arrangements may result in conflicts of interest, mistakes or misaligned goals if not carefully managed. For instance, outsourced internal auditors might recommend additional auditing activities to increase their fees, or their perceived goals might not be aligned with the bank's goals for the internal audit function. To avoid these issues, it's important to 1) prepare a comprehensive engagement letter or contract that spells out the audit's scope and the parties' expectations regarding the auditing firm's activities and advice, 2) promote open and ongoing communication, and 3) monitor the auditor's activities closely.

CO-SOURCING: THE BEST OF BOTH WORLDS?

Co-sourcing — that is, splitting internal audit activities between in-house and outsourced auditors — may offer the best of both worlds. For example, it allows a short-staffed bank to maintain the advantages of in-house auditors while gaining access to the additional human resources.

And co-sourcing can be a good way to conduct special-purpose audits, such as anti-money laundering/countering the financing of terrorism (AML/CFT) audits or IT audits. These require specialized skills that the in-house auditing team might not possess.

THE BUCK STOPS HERE

Outsourcing the internal audit doesn't absolve your bank's management or board from responsibility

REVIEW OUTSOURCING AGREEMENTS CAREFULLY

When managing relationships with outsourced vendors and other third parties, scrutinize the contract or engagement letter. Under banking agency guidance, an agreement should, among other things:

- ▶ Define the parties' expectations and responsibilities,
- ▶ Establish the fees and scope of the work,
- ▶ Set responsibilities for providing and receiving reports and other information,
- ▶ Outline the process for changing the agreement's terms or terminating it,
- ▶ Provide that internal audit reports are the bank's property,
- ▶ Specify how long the vendor must retain workpapers,
- ▶ Acknowledge that vendor-provided internal audit services are subject to regulatory review and provide that examiners will be granted full, timely access to reports and workpapers,
- ▶ Prescribe a process for resolving disputes and allocating the cost of damages arising from errors, omissions or negligence, and
- ▶ State that the vendor will comply with any applicable regulations or professional standards.

for it. Among other things, understand and follow the federal agencies' guidance on managing third-party risks, including the Federal Deposit Insurance Corporation's "Interagency Policy Statement on the Internal Audit Function and Its Outsourcing." Failure to properly manage these risks can hurt your bank's reputation, and weaknesses in the internal audit process may lead regulators to conclude that your bank isn't operating in a safe and sound manner. ■

Assessing asset concentration

MAINTAIN THE RIGHT BALANCE

One advantage of community banks is the business relationships they're typically able to develop within their local communities. This includes providing loans to local industries and businesses that may have a strong impact on the bank's profitability — for better or worse. Asset concentration in local industries can be a strength. However, it's important to manage those assets carefully to avoid the downsides, including the risk of heavy concentration in an industry that's losing ground.

DETERMINE THE RISKS AND REWARDS

Asset concentrations increase a bank's risk by exposing it to 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. So, you should weigh the risks against the benefits — and implement measures to mitigate potential risks.

ASSET CONCENTRATIONS ENABLE BANKS TO BETTER SERVE THEIR COMMUNITIES BY TAKING ADVANTAGE OF LOCAL INDUSTRY EXPERTISE AND MARKET KNOWLEDGE.

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 sector could make it harder for *businesses* in the industry to repay their commercial loans and 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.

Also 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 loan concentration in a particular industry, market or loan type, consider the relationships among these loans when evaluating the sufficiency of your capital and determining an appropriate allowance for loan and lease losses (ALLL).

USE DIVERSIFICATION STRATEGIES WISELY

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 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.

STAY ON TOP OF THE LOCAL ECONOMY

A superficial understanding of the industries in which your customers operate may lead to bad decisions. Your bank's lending officers need to be conversant with the many factors involved in the local business environment in order to analyze, and react to, its fluctuating risks and rewards. ■

BOLI: A POWERFUL EMPLOYEE BENEFIT TOOL

Community banks continue to deal with a shortage of skilled labor and rising employee benefit costs. So many are turning to bank-owned life insurance (BOLI). BOLI is a highly tax-efficient long-term investment option. It also can be a powerful tool for funding benefits for executives and other key employees, enhancing a bank's appeal to prospective workers. For example, a bank may use BOLI to fund retiree health benefits, nonqualified deferred compensation plans and supplemental executive retirement plans. Here's a brief introduction.

HOW DOES IT WORK?

To take advantage of BOLI, a bank purchases life insurance policies — either directly or through an insurance trust — on the lives of executives or other highly compensated employees who consent in writing

to be insured. The bank owns the policies, pays the premiums and is the designated beneficiary. Typically, the bank uses the proceeds of these policies to offset or underwrite various benefits for key employees. However, some banks elect to share some of the proceeds with the insured's family.

Banks are allowed to use BOLI for specific purposes. Examples include funding employee benefit and compensation plans, providing key person insurance, and recovering some employee benefit costs. Banks can't purchase BOLI for rank-and-file employees — the policies are limited to employees the bank has an "insurable interest" in. Generally, that means the loss of the insured employee would have a significant negative financial impact on the bank, or the insurance proceeds will be used to fund benefits promised to the employee or his or her beneficiaries.

WHAT ARE THE PROS AND CONS?

One advantage is that BOLI can be an attractive investment and benefit-funding strategy, often outperforming the after-tax returns of other traditional bank investments. A policy's cash value grows on a tax-deferred basis. If the policy is held until the insured's death, the death benefits are also generally tax-free to the bank.

BOLI CAN BE AN ATTRACTIVE INVESTMENT AND BENEFIT-FUNDING STRATEGY, OFTEN OUTPERFORMING THE AFTER-TAX RETURNS OF OTHER TRADITIONAL BANK INVESTMENTS.

In addition, BOLI can help banks reduce the risks of losing key employees. So, it can be a highly effective tool for providing valuable benefits to key employees while managing risk.

One big disadvantage is that if the bank surrenders a BOLI policy, the surrender charges, taxes and penalties can be costly. Also, BOLI policies are illiquid assets, which can expose a bank to liquidity risk. This is a major concern today, in light of recent bank failures due to liquidity issues.

HOW DO BANKING REGULATORS VIEW BOLI?

The federal banking agencies have given their blessing to BOLI, provided banks have a comprehensive risk management process for purchasing and holding it. This includes effective senior management and board oversight. "Bank-Owned Life Insurance: Inter-agency Statement on the Purchase and Risk Management of Life Insurance" provides guidance from the federal banking agencies on using BOLI.

For example, the statement directs banks to establish internal policies and procedures governing their BOLI holdings, including guidelines that limit the aggregate cash surrender value (CSV) of policies from any insurance company and from all insurance companies.

According to the statement, "It is generally not prudent for an institution to hold BOLI with an aggregate CSV that exceeds 25% of its Tier 1 capital." It also advises bank management to conduct a thorough pre-purchase analysis to help understand the risks, rewards and characteristics of BOLI.

WORTH A LOOK

Implementing a BOLI program can be complex. But in today's environment, it may be worthwhile for banks seeking a competitive edge in the battle to attract and retain quality talent. ■



CYBERSECURITY TESTING IS MORE IMPORTANT THAN EVER

Rapidly increasing cyber risks make it essential for banks to conduct regular tests of their cybersecurity preparedness, including vulnerability and penetration testing. According to IBM's "Cost of a Data Breach Report 2024," the average breach cost \$6.08 million in the financial industry (defined as banking, insurance and investment companies). That's second only to health care. To help prevent cyberattacks, banks must develop effective information security programs and test them regularly to ensure that they're operating as expected.

According to the Federal Financial Institutions Examination Council's (FFIEC's) Information Technology Examination Handbook, the primary testing tools include self-assessments, penetration tests, vulnerability assessments and audits. Penetration testing is particularly important, given the speed with which hackers' techniques are evolving. It involves subjecting a system to real-world attacks selected and conducted by the testers to identify weaknesses in business processes and technical controls. ■

FFIEC TO RETIRE CYBERSECURITY ASSESSMENT TOOL

The FFIEC will "sunset" its Cybersecurity Assessment Tool (CAT) at the end of August 2025. First made available nearly 10 years ago, the CAT is a voluntary tool banks can use to identify their cybersecurity risks and determine their preparedness. The FFIEC notes that while "fundamental security controls addressed throughout the maturity levels of the CAT are sound, several new and updated government and industry resources are available that financial institutions can leverage to better manage cybersecurity risks."



Government resources include:

- ▶ The National Institute of Standards and Technology (NIST) Cybersecurity Framework 2.0 (go to www.nist.gov and search for cyber framework), and
- ▶ The Cybersecurity and Infrastructure Security Agency's (CISA) Cybersecurity Performance Goals (go to www.cisa.gov and search for cybersecurity performance goals).

Industry resources include:

- ▶ The Cyber Risk Institute's (CRI) Cyber Profile (go to <http://www.cyberriskinstitute.org> and search for "the profile,") and
- ▶ The Center for Internet Security Critical Security Controls (go to www.cisecurity.org and search for controls.)

The FFIEC doesn't endorse any particular tool, but says that these standardized tools can assist banks in their self-assessment activities. ■

CFPB TARGETING IMPROPER OVERDRAFT OPT-IN PRACTICES

In a recent Consumer Financial Protection Circular (2024-05), the Consumer Financial Protection Bureau (CFPB) explained how to tell if a bank is violating the Electronic Fund Transfer Act and Regulation E. A violation may happen if the bank lacks proof that it has obtained consumers' affirmative consent before levying overdraft fees for ATM and one-time debit card transactions.

Regulation E's overdraft provisions establish an "opt-in" regime. The CFPB clarifies that banks are prohibited from charging such fees unless consumers affirmatively consent to enrollment. The form of records that demonstrate consent may vary depending on which channel the consumer uses to opt in to covered overdraft services. ■



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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