

Best Practices for Addressing Elusive AML/BSA, UDAAAP and Fair Lending Standards

Eric M. Marion

Silver, Freedman, Taff & Tiernan LLP

Agenda

- ▶ Overview
- ▶ Bank Secrecy Act/Anti-Money Laundering (BSA/AML)
- ▶ Fair Lending
- ▶ Unfair, Deceptive, or Abusive Act or Practice ("UDAAP")
- ▶ Best Practices for Addressing Compliance Issues
- ▶ Case Studies



Key Risks Facing Community and Midsize Banks

- ▶ Management succession and retention of key staff.
- ▶ Increasing BSA/AML risk because controls have not kept pace with higher risk services and customer relationships.
- ▶ Increasing reliance on third parties to perform operational and business functions.



Contextualizing BSA/AML Regulations

- ▶ Enacted in 1970, the Bank Secrecy Act's primary purpose was to combat drug trafficking.
- ▶ Regulations focused on the domestic banking system and on cash transactions, most often conducted face-to-face.
- ▶ The USA PATRIOT Act, enacted in 2001, significantly changed the AML framework and the BSA itself.
- ▶ BSA/AML regulatory requirements were expanded to address a broader set of criminal activities, including terrorist financing.

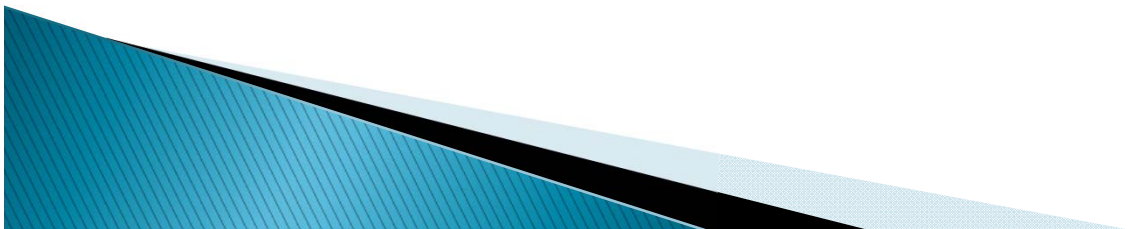
OCC Assessment from Semiannual Risk Perspective

- ▶ BSA/AML risks remain high as innovative technology is vulnerable to criminals who continue to exploit it.
- ▶ BSA/AML programs at some banks have failed to develop or incorporate appropriate controls as products and services have evolved.
- ▶ Insufficient resources and expertise have been devoted to BSA/AML compliance.
- ▶ Banks must properly manage risks associated with customers with higher BSA/AML risk by assessing customers on a case-by-case basis.



Compliance with the Bank Secrecy Act

- ▶ Every community bank faces some degree of inherent Bank Secrecy Act/Anti-Money Laundering (BSA/AML) risk.
- ▶ First step – Accurately assess inherent BSA/AML risks.
- ▶ Inherent BSA/AML risk falls into three main categories:
 - Products and services;
 - Customers and entities; and
 - Geographic locations in which the institution and its customers operate.



Four pillars of BSA compliance

- ▶ BSA/AML programs must include the following minimum requirements (also known as the four pillars):

System of
internal
controls

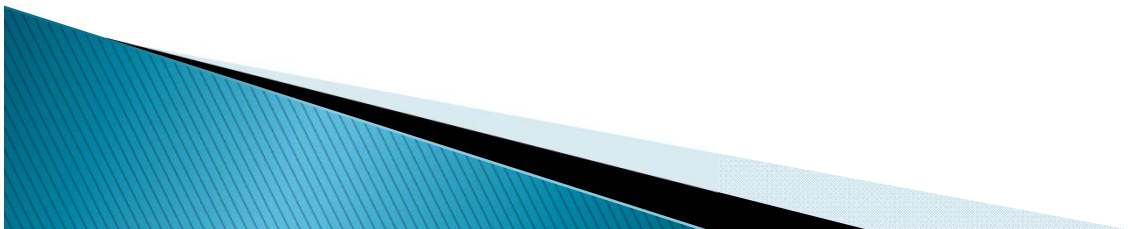
Independent
testing of
BSA/AML
compliance

Designation
of an
individual or
individuals
responsible
for managing
BSA
compliance

Training for
appropriate
personnel

(1) Higher-Risk Products and Services

- ▶ Are there new products and services where the bank has little prior experience?
- ▶ Are there significant volumes of electronic payments, such as wire transfers, ACH, prepaid cards, and remittances?
- ▶ Do your customers actively engage in, or have you recently implemented, electronic banking services, such as remote deposit capture, online account opening, and/or permit Internet transactions?
- ▶ Do you provide services to third-party payment processors or senders?



(2) Higher-Risk Customers and Entities

- ▶ Do you have a significant portfolio of cash-intensive business customers, such as privately owned ATMs or convenience, liquor or retail stores?
- ▶ Does your customer base include foreign entities, such as financial institutions, corporations and/or individuals?
- ▶ Do you have significant business related to nonbank financial institutions, including MSBs and casinos?
- ▶ Do you have a significant number of professional service provider customers, including attorneys, accountants, real estate brokers, etc.?
- ▶ Does your customer base include a significant number of politically exposed persons?

(3) Higher-Risk Geographic Locations

- ▶ Do your customers engage in or process transactions involving international locations identified by the U.S. State and/or Treasury Departments, the Financial Action Task Force, or other international bodies, and/or geographic locations outside of your normal business area?
- ▶ Are any of your customers located in, or do they conduct transactions with, offshore financial centers?
- ▶ Do you maintain branches in or have significant customer populations located within domestic locales designated as High Intensity Drug Trafficking Areas and/or High Intensity Financial Crimes Areas?



The Fair Housing Act

- ▶ The Fair Housing Act makes it unlawful “to refuse to sell or rent after the making of a bona fide offer, or to refuse to negotiate for the sale or rental of, or ***otherwise make unavailable or deny***, a dwelling to any person because of race, color, religion, sex, familial status, or national origin.” 42 U.S.C. § 3604(a) (emphasis added).
- ▶ There is a view today that much discrimination is not intentional, but there are subtle effects resulting from the implementation of neutral policies.



Fair Lending – Disparate Impact Analysis

The *Inclusive Communities Project* Decision

- ▶ Question at the center of the case is whether the phrase “otherwise make unavailable” contemplated disparate impact claims under the FHA. The Supreme Court established that:
 - Statistical imbalance is not enough to establish a *prima facie* case;
 - Plaintiff must satisfy a “robust causality requirement;”
 - Valid business or policy purpose rebuts a *prima facie* case; and
 - Before rejecting a business justification, the court must find that the plaintiff has demonstrated that there is an “available alternative ... practice that has less disparate impact and serves the [entity’s] legitimate needs.”

Auto Lending

- ▶ While clearly not within FHA, the DOJ and CFPB have looked to the Equal Credit Opportunity Act (“ECOA”) to enforce fair lending for auto loans.
- ▶ ECOA §701(a)(1) states that it is unlawful “for any creditor to discriminate against any applicant . . . on the basis of race, color, religion, national origin, sex or marital status, or age” or other protected characteristic.



USING PUBLICLY AVAILABLE INFORMATION AS PROXY FOR UNIDENTIFIED RACE AND ETHNICITY

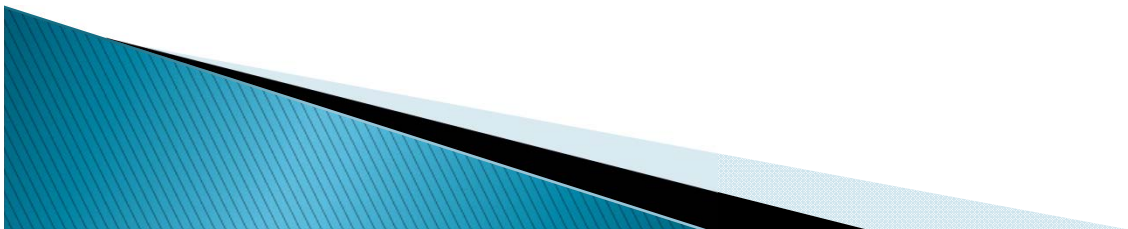
- ▶ Unlike mortgage lending, auto finance forms do not collect racial information. There is no HMDA equivalent in auto finance.
- ▶ As a result, the CFPB's Office of Research and Division of Supervision, Enforcement, and Fair Lending rely on a "Bayesian Improved Surname Geocoding" (BISG) proxy method.
- ▶ The CFPB's analysis in its simplest form is using a borrower's last name tied to domicile and percentage of dealer markup.

UDAAP/UDAP

- ▶ Unfair, deceptive, or abusive act or practice ("UDAAP") and Unfair or Deceptive Acts and Practices ("UDAP").
- ▶ UDAAP did not exist prior to enactment of the Dodd-Frank Act (the "Act").
- ▶ The Act specifically excludes from the definition of Federal consumer financial law the Federal Trade Commission Act's separate but similar prohibition on UDAP.
- ▶ The CFPB's UDAAP authority, unlike its authority under the enumerated consumer protection statutes, does not have a pre-existing statutory basis.

How Do You Ensure that Your Bank is Adequately Assessing Inherent Risk?

- ▶ Take a dynamic approach to risk assessment, rather than viewing it as a static exercise.
- ▶ Involve the compliance officer in any new product discussion.
- ▶ Set the right compliance tone from the top by demonstrating the importance of understanding, monitoring and controlling risk.



New Product or Service Development

Consider the following questions:

- ▶ How does the new product or service affect your risk profile?
- ▶ What steps need to be taken to appropriately mitigate the risks?
- ▶ Do you have the expertise, capacity, and compliance resources to take on the new product or service and/or the various associated service providers?



Culture of Compliance

- ▶ Strong commitment to compliance from the board of directors and senior management.
- ▶ Conduct discussions about risk at all levels of the organization.
- ▶ Invest in compliance talent and resources.
- ▶ Empower compliance officers with authority to resolve identified issues.
- ▶ Formal mechanism for reporting on risks and issues.



Collaboration

Potential Areas of Opportunity for Collaboration

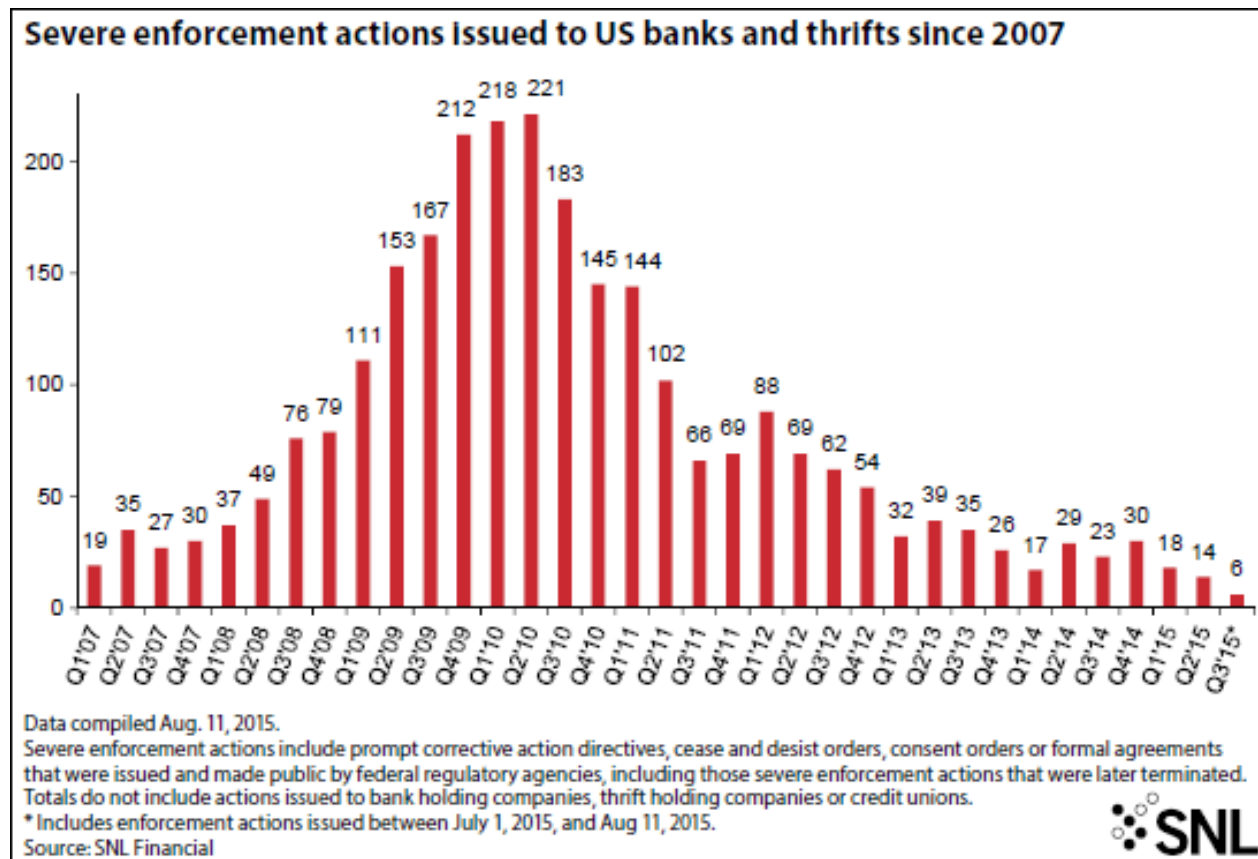
Administrative and back-office operations	<ul style="list-style-type: none">• Accounting• Advertising• Clerical support• Data processing• Internal audit• Marketing• Procurement (office supplies, furniture, equipment)• Records management and data storage• Research studies and surveys
Human resources management	<ul style="list-style-type: none">• Employee benefit development and administration• Health insurance• Payroll processing• Recruiting• Training and education
Regulatory compliance	<ul style="list-style-type: none">• Bank Secrecy Act and Anti-Money Laundering• Mortgage rules

Third Party Oversight

- ▶ The use of third parties to conduct all or a portion of consumer credit-related product development, implementation, and fulfillment can substantially increase the risk of unfair or deceptive practices.
- ▶ Fair lending risk also may increase when banks engage a third party to conduct all or a portion of the application or underwriting processes or make decisions regarding terms or pricing.
- ▶ The integrated mortgage disclosure requirements are expected to pose significant operational and compliance challenges for some banks and should include, as necessary, revisions to policies and processes, technological changes, training, testing, and effective third-party risk management.



Case Studies



- ❖ SNL defines severe enforcement actions as cease and desist orders, prompt corrective action directives and formal agreements/consent orders handed to a bank or thrift by a federal regulator. This analysis does not include severe enforcement actions issued to holding companies or credit unions.

High Stakes for Compliance Failures

- ▶ Requirements to add more compliance oversight, programs, policies, testing and assessment.
- ▶ Enforcement actions have resulted in significant fines and penalties.
- ▶ Weak programs, even in the absence of a formal enforcement action, can also stall expansionary plans.
- ▶ After the enforcement action, banks continue to incur significant expenses associated with remediation as well as related professional fees.



Federal Reserve Semiannual Report on Banking Applications Activity

- ▶ For the second half of 2014, seventeen M&A proposals were withdrawn after consultation with Federal Reserve staff.
- ▶ Three of those withdrawn raised BSA/AML compliance program issues.

Merger and acquisition proposals, dispositions and processing times of approved proposals, 2011-14 and 2013:H2 and 2014:H2						
Mergers and acquisitions	2011	2012	2013	2014	2013:H2	2014:H2
Dispositions						
Approved	194	226	190	248	118	133
Withdrawn	43	43	40	25	18	17
M&A as a percentage of total approved proposals	15%	17%	15%	20%	18%	21%
Processing time of approved proposals (days)						
Average	71	66	56	60	59	62
Median	41	41	40	41	39	41

Burke & Herbert Bank & Trust Company, Alexandria, Virginia

Consent Order dated August 29, 2014, required among other things:

- ▶ Implement a BSA Compliance Program.
- ▶ Develop a system of BSA Internal Controls.
- ▶ Adopt effective training programs.
- ▶ Implement a BSA Staffing Plan and designate BSA Officer.
- ▶ Conduct a “look back review” by independent firm.
- ▶ Establish BSA Directors Committee.
- ▶ Fully describe Order in communication to shareholders.



Citizens Bank of Pennsylvania, Philadelphia, Pennsylvania

Monetary Penalties

- ▶ Coordinated action between the FDIC, CFPB and OCC for unfair and deceptive practices in violation of Section 5 of the Federal Trade Commission Act.
- ▶ The FDIC Order requires CBPA to pay a civil money penalty of \$3.0 million and provide restitution of approximately \$5.8 million to consumers and businesses who held more than 475,000 accounts affected by the violations.

BancorpSouth Bank, Tupelo, MS

- ▶ FDIC cease and desist order dated September 4, 2014 for weaknesses in BSA/AML risk assessment program.
- ▶ Third-quarter 2014 earnings release, BancorpSouth Inc., the Bank's parent company, reported a pre-tax one-time cost of \$3.1 million for BSA/AML compliance remediation.
- ▶ Form 10-Q for September 30, 2014, noted that the CFPB was considering enforcement action and a referral to the U.S. Department of Justice for alleged violations of the Equal Credit Opportunity Act of 1974.
- ▶ As of June 9, 2015, BancorpSouth Chairman and CEO James Rollins III stated there is "not a whole lot of clarity" as to how the bank would resolve any potential violations and "virtually no communication" from the CFPB.

BancorpSouth Inc.

- ▶ Merger applications to acquire Ouachita Bancshares Corp. (“OIB”), Monroe, LA and Central Community Corp. (“CCC”), Temple, TX withdrawn in August 2014 after FDIC examination identified weaknesses in BSA/AML program.
- ▶ Applications refiled in February 2015.
- ▶ Termination date for merger agreements extended until December 31, 2015 (originally announced on January 8, 2014 (OIB) and January 22, 2014 (CCC)).



Hudson City, Paramus, NJ and M&T Bank, Buffalo, NY

- ▶ Merger agreement amended four times after it was announced in August 2012.
- ▶ April 17, 2015, announced extension to October 31, 2015 (Federal Reserve expressed intention to act by September 30th.)
- ▶ Delay largely understood to be due to a written agreement with the Federal Reserve regarding M&T's firm-wide BSA/AML compliance risk management.
- ▶ Form 10-Q filed May 8, 2015, Hudson City disclosed DOJ investigation of compliance with various fair lending laws, including ECOA and the Fair Housing Act.
- ▶ September 24, 2015, Hudson City announced a settlement agreement with the CFPB and DOJ.

M&T Bank Written Agreement

- ▶ June 17, 2013, the Federal Reserve Board entered into a written agreement with M&T.
- ▶ Identified deficiencies in M&T's firm-wide compliance risk management program with respect BSA/AML Requirements, the Bank's internal controls, customer due diligence procedures and transaction monitoring.
- ▶ July 2014 second quarter earnings call, M&T stated that it had more than 500 employees devoting a majority of their time to BSA/AML activity.
- ▶ Anticipated more than \$150 million in BSA/AML compliance-related spending during 2014.



Hudson City Consent Order

- ▶ CFPB and DOJ alleged violations of the Fair Housing Act and Equal Credit Opportunity Act.
- ▶ Consent order, subject to court approval, requires Hudson City to take remedial measures to provide access to credit to the Black and Hispanic neighborhoods that it allegedly redlined.
- ▶ If approved, Hudson City will pay \$25 million in direct loan subsidies, \$2.25 million in community programs and outreach and a \$5.5 million penalty.
- ▶ Represents the largest redlining settlement in history to provide direct subsidies.



Questions?

Eric M. Marion, Esq.
Silver, Freedman, Taff & Tiernan LLP
3299 K Street, N.W., Suite 100
Washington, DC 20007-4444
Phone: (202) 295-4500
Fax: (202) 337-5502
Website: <http://www.sfttlaw.com>

Sources

- ▶ "Considerations When Introducing a New Product or Service at a Community Bank," Community Banking Connections, First Quarter 2013 at www.cbcbfrs.org/articles/2013/Q1/Considerations-When-Introducing-A-New-Product
- ▶ SR Letter 02-8, "Implementation of Section 327 of the USA Patriot Act in the Applications Process," March 20, 2002, at www.federalreserve.gov/boarddocs/srletters/2002/sr0208.htm
- ▶ "An Opportunity for Community Banks: Working Together Collaboratively" at OCC.gov <http://www.occ.gov/publications/publications-by-type/other-publications-reports/pub-other-community-banks-working-collaborately.PDF>
- ▶ Semiannual Report on Banking Applications Activity, at <http://www.federalreserve.gov/bankinfo/reg/201504-semiannual-report-on-banking-applications-activity.htm>
- ▶ Assessing Inherent BSA/AML Risk at Community Banks, at <https://www.communitybankingconnections.org/articles/2013/q3/assessing-inherent-bsa-aml-risk-at-community-banks>