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Financial Institutions Insights

A timely information and idea statement

Is your internal audit of BSA/AML doing all it should?—The internal audit should provide an independent and comprehensive review of your BSA/AML program and related risks

By: Rob Farling, Sonja Kriegsmann, and Nick Mustafa

For your financial institution, the internal audit is your third line of defense and should provide an objective review of your Bank Secrecy Act/Anti-Money Laundering (BSA/AML) and Office of Foreign Assets Control (OFAC) programs, including policies, procedures, systems, processes and internal controls. How can you be sure your internal audit function is appropriately testing your BSA/AML activities?

Focus on five key themes when evaluating how the internal audit is addressing your BSA/AML concerns:

- Does your internal audit program have foundational components that are consistent with key elements of the Federal Financial Institutions Examination Council (FFIEC) BSA/AML Examination Manual to build upon? For instance, the BSA/AML independent review should be risk-based and cover the core examination areas outlined in the manual.
- Does the internal audit adequately review AML risk during the internal audit planning process? The level and intensity of testing for each of the core BSA/AML areas should be risk driven, and for larger and more complex financial institutions, the internal audit may conduct its own BSA/AML risk assessment independent of the first and second lines of defense.
- Is the internal audit taking a holistic view of your overall BSA/AML environment or is it following a rote, check-the-box approach? Inexperienced internal audit staff too often focus on transactional testing instead of taking an overall look at processes and internal controls. The internal audit should start with design assessments of the core BSA/AML areas and processes before testing transactional results. The evaluation of transactions should include testing of controls as well.
- Does your internal audit staff have the skills and experience to evaluate the numerous qualitative factors necessary for a successful BSA/AML program? And are they periodically trained? For example, do they know what to look at to evaluate the adequacy of your processes and control activities based upon the risk profile of your institution and an understanding of leading industry practices? Do they effectively evaluate your culture of compliance?
- Is the internal audit keeping up with the constantly evolving regulatory expectations surrounding BSA/AML? If there haven't been any significant changes in your audit plan and approach in recent years, odds are your internal audit approach is not keeping up with regulatory demands.

Five steps to an effective internal audit

Be sure the internal audit is focusing on the following key issues and includes these five steps when assessing your BSA/AML program and activities:

- Do you have a strong culture of compliance? Assessing your culture of compliance sounds very subjective, but there are measureable aspects to consider. Are findings and deficiencies addressed appropriately and timely by management? Does BSA/AML staff receive regular training? Does your BSA/AML officer have access to your board, and are BSA/AML issues reported to the board when appropriate? Is BSA/AML compliance integrated into compensation and evaluation decisions?
- Do you have experienced and sufficient BSA/AML management and staff? It can be difficult to attract and retain strong BSA/AML staff, especially at community banks. Therefore, consideration of the strength of your BSA/AML staff should be a vital part of your internal audit effort. Look for backlogs in suspicious activity monitoring and reporting. Review the quality of investigations, SARs and other issues. Take a close look at your BSA/AML training program—is it keeping up with the evolving BSA/AML landscape and tailored to your risk environment, or is it generic?
- Is management's BSA/AML risk assessment effectively tailored to your environment? Evaluating the risk assessment can be one of the most difficult parts of your internal audit because there is limited formal regulatory guidance and a heavy reliance on industry practices in this area. Regulators are increasingly focused on whether your

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Structuring IT staff to encourage innovation and support growth

By: Beth Johnson

For senior executives at banking and credit unions, growth is by far their top priority.[1] Yet numerous surveys and reports examining the utilization of information technology in a range of industries indicate a discrepancy between IT budgeting and company goals. Most companies dedicate much of their IT resources to simply "keeping the lights on" rather than to innovation.

The role of the IT professional has never been more important than it is today—and that level of importance will rise as new technologies are developed and security needs increase.

As a financial institution grows, its IT staff should keep pace in order to provide adequate services. While many institutions understand the need for innovation, bank executives may not have an in-depth understanding of its staff's capabilities—or how best to utilize them.

Identifying the need

On average, the banking and financial services industry is second only to Internet service providers and software publishers in IT spending as a percentage of revenue—about 6.3 percent. How the money is allocated is another matter.

[1] "Market & Technology Trends in Banking, NA, 2015" Gartner

An institution's leadership may see the writing on the wall—a competitor's mobile application, the increasing number of transactions being completed—and may conclude that their bank's IT environment needs improvement. Is the bank ready to establish a chief information officer role? The answer depends on a number of factors:

- Level of institutional complexity
- Size of the institution's IT footprint
- Level of innovation to attain
- Cultural comfort with new technology
- Level of scrutiny by examiners

Once these factors are examined and the future IT state of the bank is identified, management will want to turn to examining the current state, including the number of existing IT staff and the experience level of its individual members. Management may find that the experience level of the staff is not adequate to meet its goals; it may also find that the bank is not leveraging the staff's talent in a way best suited for the needs of the institution. The institution may also feel stronger leadership is needed for IT to evolve.

To read more, go to: http://rsmus.com/our-insights/newsletters/financial-institutions-insights/structuring-it-staff-to-encourage-innovation-and-support-growth.html

Bank-owned life insurance—Time to rethink conventional wisdom?

By: Charlie Ratner

Many banks have chosen to invest in bank-owned life insurance (BOLI) to fund a variety of obligations to their current and retired employees. BOLI's status as a preferred funding vehicle is largely attributable to the inherent investment characteristics of cash value life insurance as well as to its often interrelated income tax and financial statement advantages.

The many advantages of BOLI notwithstanding, its purchase involves a rigorous due care process whereby the bank demonstrates to its regulators that it recognized and addressed the range of risks associated with owning such a long-term, potentially illiquid investment. One element of that risk analysis is the tax implications of owning BOLI, a topic that can have more bearing on other, seemingly unrelated risks than first meets the eye. That's why any bank, whether buying BOLI for the first time or adding to its existing portfolio, should understand that the very tax characteristics of BOLI that can make it today's solution can just as easily make it tomorrow's problem.

Taxation of cash value life insurance and its subset, corporate or bank-owned life insurance, is an expansive topic, replete with its own acronyms and jargon. That said, there are actually just a few fundamentals that a bank needs to know to make informed decisions about whether to buy BOLI and, if so, how to design, fund and deploy it.

The key tax fundamentals

The bank is the owner and beneficiary of the policy on the insured employee. The premiums paid by the bank, which is typically just one premium, are not deductible because the bank is the beneficiary of the policy that insures the life of an employee.[1](section 264(a)(1)). Assuming the BOLI policy qualifies as life insurance under section 7702, something the carrier should represent, the build-up of the cash value is deferred for regular tax purposes as long as it stays in the policy. If the policy is surrendered, the excess of cash surrender value over premiums paid is ordinary income (not capital gain). So long as the bank complies with section 101(j), discussed below, the death benefit from the policy is received income tax free. The opportunity for long-term tax deferral on the "inside build-up" of the cash value and a tax-free death benefit are among BOLI's strongest selling points versus competing and often lower yielding, taxable investment or funding vehicles.

To read more, go to: http://rsmus.com/what-we-do/services/tax/lead-tax/bank-owned-life-insurancetime-to-rethink-conventional-wisdom.html

FASB delays effective date of pending ASU on credit losses by one year

During its meeting on April 27, 2016, the Financial Accounting Standards Board (FASB) decided to delay the effective date of its forthcoming Accounting Standards Update (ASU) on the impairment of financial instruments. This ASU will result in estimating the impairment of financial assets measured at amortized cost using the current expected credit loss (CECL) model, which will entail day-one recognition of life-of-asset expected losses. The revised effective dates decided upon by the FASB are as follows:

- *SEC filers (as defined):* Fiscal years beginning after December 15, 2019, including interim periods within those years
- *Public business entities (as defined) other than SEC filers:* Fiscal years beginning after December 15, 2020, including interim periods within those years
- *All other entities:* Fiscal years beginning after December 15, 2020 and interim periods thereafter

All entities will be able to adopt the new guidance as early as the beginning of their first fiscal year beginning after December 15, 2018.

The FASB also discussed the applicability of what are commonly referred to as the vintage disclosure requirements that will be in the forthcoming ASU. To satisfy these disclosure requirements, an entity will be required to provide the amortized cost basis of its financing receivables and net investments in leases (with certain exceptions) within each credit quality indicator by year of origination.

To read more, go to: http://rsmus.com/our-insights/newsletters/financial-reporting-insights/fasb-delays-effective-date-of-pending-asu-on-credit-losses-by-on.html

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risk assessment adequately addresses and quantifies your unique risk profile. Be sure that your risk assessment covers your products, services, customers and geographies, as well as how each contributes to your overall BSA/AML risk exposure. Don't just look at the reasonableness of the ratings, dig into the details of the methodology—and make sure it's documented. Do the statistics and data analysis support the results? And has the data been validated for completeness and accuracy, and is this validation documented? For more complex financial institutions, risk assessments should be conducted at the subsidiary or business line level, and then consolidated across the enterprise.

- Do you have the right BSA/AML systems, and are the models working appropriately and as intended? There are typically three models within the BSA/AML area, including suspicious activity monitoring, customer risk scoring and sanctions screening. Review and evaluate the process and system owners, roles and responsibilities, change management procedures, user access controls, management's initial and ongoing validation of both data integrity and model assumptions, and independent model validations. Additionally, internal audit should play an appropriate role in implementation and user acceptance testing within your organization.
- Are your customer due diligence (CDD) and enhanced due diligence (EDD) practices appropriate to your risk profile? Understanding your customers and how they relate to your products and services is vital to an effective BSA/AML function. Your internal audit should take a close look at CDD and EDD practices as part of the approach. The following customers and business areas deserve special attention:
  - Nonresident aliens, foreign nationals and politically exposed persons
  - Foreign correspondent banks
  - Trade finance
  - Marijuana businesses
  - Payment processors
  - Money service businesses
  - Online and mobile banking operations
- CDD activities should include a risk-based collection of customer information, which may include beneficial ownership so that you "know your customer," as well as ongoing monitoring of customer risk. EDD activities should provide for periodic reviews of higher-risk customers to update information, conduct screenings and review aggregate transactional activity for reasonableness. EDD procedures should be tailored for the aforementioned business types if they are part of your customer base.

Don't forget the basic

Be sure the scope and documentation of the internal audit covering your BSA/AML function is appropriate. Your internal audit and its scope should:

- Include assessments for both design adequacy and operational effectiveness of key processes consistent with the FFIEC BSA/AML Examination Manual
- Include all applicable subsidiaries and lines of business
- Confirm findings with management, and provide timely final reports
- State conclusions clearly
- Make clear recommendations that address the root cause of any issues within the final reports

To read more, go to: http://rsmus.com/our-insights/newsletters/financial-institutions-insights/is-your-internal-audit-of-bsa-aml-doing-all-it-should.html

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