

COMPLIANCE

Is a Storm Front Coming?

2005

With 2005 well underway, compliance professionals are examining what happened last year and what might lie ahead. Through the lenses of leading compliance experts from various types

and sizes of financial institutions, this article forecasts some of the challenges to expect in 2005 and beyond.

There might be a storm front gaining momentum this year, as a high-pressure regulatory system mixes with a compliance community strapped for resources and time.

FORECAST

BY JOSEPH M. KELLY,
SENIOR EDITOR

ACCORDING TO RESULTS of a recent American Bankers Association Center for Regulatory Compliance online survey of 472 bankers, 279 (almost 60 percent) ranked BSA/AML/OFAC as the area that will be the most demanding in 2005. If you factor in the 39 second-place votes that category received, 67 percent of respondents ranked BSA/AML/OFAC as a leading concern. FACTA ranked second with 54 first-place votes and 132 second-place votes, meaning 39 percent of respondents ranked FACTA as one of their top two concerns for 2005.

Several leading compliance professionals interviewed for this article indicated that the following areas are the biggest storms on their radar screens for 2005:

- USA PATRIOT Act: Bank Secrecy Act (BSA), anti-money laundering (AML)—including filing suspicious activity reports (SARs)—and compliance with the Office of Foreign Asset Control (OFAC)
- fair lending, especially the public reaction to the anticipated release of new Home Mortgage Disclosure Act (HMDA) pricing data
- Fair and Accurate Credit Transactions Act (FACTA) of 2003
- governance, particularly the Sarbanes-Oxley Act (SOX) and Basel II

These areas represent major regulatory obstacles that compliance officers must navigate to stave off financial penalties, negative reports from regulators, and public scrutiny. These new turbulent clouds arrive at a time when the role of compliance professionals is becoming more complex. Our group of experts also discussed the biggest compliance management issues facing the profession.

Risk vs. Controls; Governance and Education

When asked about emerging industry-changing trends, bankers said a paradigm shift has occurred, changing compliance from a controls-based function to a risk-based one.

“I think compliance risk management needs to be done in a consistent way,” said First Vice President and Compliance Process Manager Meg Sczyrba, CRCM, of Seattle-based Washington Mutual Bank (WaMu). “Right now, it has many different meanings to many different people. We should all agree on the basic concepts and how to accomplish it.”

According to one compliance vice president at a large southeastern bank, the need for risk-assessment skills—the ability to “sort the wheat from the chaff”—is essential. “With the limited staff and monetary resources that compliance managers and business units have, we must use a risk-based approach. Few things damage a compliance manager’s credibility with line officers more than recommending that a business unit use a sledgehammer to control a mosquito.” She also encourages a true partnership with business unit managers and an understanding on their part that compliance officers “advise” while the business units

“own” compliance execution.

Bonita Jones, principal of the Division of Banking Supervision and Regulation at the Federal Reserve Bank of San Francisco, said regulatory changes and the focus on governance have increased the need for education. She said that the change in focus might also incent banks to increase the resources they dedicate to training. As an example, she noted record attendance at recent American Bankers Association compliance schools and conferences.

Glia Group and BankersOnline Executive Vice President Andy Zavoina, CRCM, also thinks education is critical because, he said, “I think many will be dealing with change and trying to dig out from the blizzard of 2004 changes.”

More with Less


That blizzard of changes is more than an education issue; it also represents an increased workload, yet—in most cases—compliance officers aren’t receiving a corresponding increase in resources or cooperation from upper management.

“In smaller banks, with the increased emphasis on margin and profits, compliance officers wear several hats,” said Anna Rentschler, CRCM, vice president and compliance officer at First National Bank of Audrain County in Mexico, Mo. “When it comes to what directly impacts the bottom line, the loan line or deposit-gathering gets the push. Despite the emphasis by regulators, compliance is still perceived by many as a requirement, not an integral part of the loan or deposit function. In discussions with other smaller financial institutions, senior management often does not see the necessity of including compliance on employee performance appraisals ... more regulations and requirements, but less time and staff.”

Rentschler isn’t alone. According to WaMu’s Sczyrba, getting resources from, and the attention of, senior management can be one of the most difficult aspects of being a compliance officer. Zavoina agrees that one of the toughest challenges is ensuring that compliance officers have management’s buy-in, resources, and the necessary time to manage those resources. “With so many having to do more with less, there just isn’t enough time to do everything, and do it well, when you wear many hats,” he said.

Most of the compliance professionals interviewed for this article indicated they were not getting additional resources to deal with the ever-changing regulatory environment. One went as far as to say, sarcastically, “You are kidding, right?”

However, some financial services companies are investing in their compliance programs. One of the largest banks in the industry, for example, added three positions in 2004 and will add another in 2005 just in one department, creating them primarily to support the bank’s AML and anti-terrorist financing (ATF) activities. Other departments in that same bank are adding positions to tackle AML- and ATF-related issues.



Getting the message through to upper management and boards of directors has been a challenge for compliance officers for many years. However, the raising of the bar with major penalties and regulatory slaps is breaking down those barriers. “Compliance should no longer be viewed as a cost center, but as a cost-reduction center,” said Keith E. Monson, CRCM, senior vice president, and audit and compliance manager at Premier Bank in Jefferson City, Mo. His peers also feel a sense of urgency.

“With [the Sarbanes-Oxley Act] and Enron-like issues, and now the BSA/AML big-dollar penalties, I think the environment has become more serious,” Sczyrba said. “Maybe management will hear what we have been saying all along—you need to take compliance seriously.”

Relationships with Regulators

When it comes to taking compliance seriously, regulators are among the most serious in the business. Their relationships with compliance officers vary widely, from amiable to tolerable to adversarial. While regulators suggest they are working better and communicating better with bankers, the compliance community offers mixed reviews. Some suggest relationships are deteriorating, while others see no change. Still others see a change for the better. Because regulator expectations are not exactly uniform, opinions about relationships are likewise all over the place.

“I think relationships may deteriorate somewhat in the AML area, as regulators come under increasing legislative and political pressure from Congress and the public,” said one compliance officer from a bank in the south, who spoke on condition of anonymity. “Regulator latitude has decreased, and such inflexibility can strain the relationship with the bank. The atmosphere means folks on both the bank and the regulator sides must work even harder to understand each other’s situations, keep each other fully informed.”

WaMu’s Sczyrba agrees. “I think the zero-tolerance for BSA issues could strain the relationship. However, most of the regulators that are higher up in the agency claim to understand our pain. Personally, I haven’t felt a difference with the people I work with.”

Michael D. Maher, CRCM, senior vice president for risk assessment at Wells Fargo Home Mortgage in Minneapolis, Minn., said he wouldn’t say relationships with regulators have deteriorated, but he considers them more strained. “Regulators are under tremendous pressure given situations like the Riggs anti-money laundering issue [in 2004] as well as pressure from state attorneys general and community advocates due to preemption of state laws, especially state consumer protection laws.”

Rentschler sees no direct change in the relationship she has with regulators. However, she remains cautious about what she is hearing from her peers—that there is a push for regulators to find “something.” What regulators expect isn’t consistent, which poses a problem for banks. “Some regulators, especially in smaller banks,” she said, “are still looking at the nitty-gritty details versus the big risk picture.”

Said Zavoina, “While I know examiners are under pressure, I do see them reaching out to banks to assist them. I cite in particular the

FDIC [Federal Deposit Insurance Corporation] in Chicago, which has periodic regulator briefings free of charge.” He said the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board (FRB), and the Office of Thrift Supervision (OTS) also reach out, offering examiners as speakers at banking seminars.

Said Monson, “The communication gap between examiners and bankers was, in part, due to a lack of importance placed on compliance by senior management. Now that compliance has senior management’s attention and more resources are being allocated to compliance, compliance exceptions/violations are becoming less repetitive, which by the nature of the beast, enhances communication.”

As for which major issues could spark storms in 2005 and lead to further tensions between banks and regulators, the short list includes USA PATRIOT Act (BSA/AML/OFAC), fair lending and HMDA, Sarbanes-Oxley and Basel II governance issues, and FACTA. Let’s examine each more closely to see how stormy 2005 might become.

USA PATRIOT Act—BSA/AML/OFAC

Because of the increased regulatory focus on the BSA and other AML efforts, compliance officers are planning to step up efforts in that area as well. According to Rentschler, BSA and implementing the myriad enhancements that examiners seek—and getting the staff, time, and budget levels to do it correctly—is her top concern for 2005. She has plenty of company among her peers.

“Given the recent surge in large penalties and agreements, not to mention the regulators’ consistent call for zero tolerance, BSA/AML looks to me to be the hottest area in the coming year,” Sczyrba said. She added that BSA has “everybody in the industry running scared.”

Another compliance officer said banks must exercise great care with high-risk customers—identifying them when they apply for accounts or where they are already in portfolios, vetting them carefully, and closing down and/or reporting questionable customers. “It’s tough to do too much in this area,” she said. “The expectations bar continues to rise for us, but the consequences of noncompliance or inadequate due diligence almost don’t bear contemplation.”

Fair Lending/HMDA

“Banks will need to ensure 2004 data reported is accurate,” said the Federal Reserve Bank of San Francisco’s Jones. “Bankers will also need to be prepared to manage risk associated with public scrutiny of new data elements disclosed—for example, HOEPA loans, loans exceeding rate triggers, etc.”

That scrutiny has bankers concerned about the fallout from the new HMDA data. They fear public outcry and negative media attention that can damage a bank’s reputation—a hit that can cost more than a one-time fine. “The release of the new HMDA data will provide more data but still not the whole picture, potentially causing consumer advocacy groups to charge the industry with illegal discrimination,” said Wells Fargo’s Maher. “We will need to be prepared.”

Maher isn’t alone in his concern about HMDA data. “I agree that

“Given the recent surge in large penalties and agreements, not to mention the regulators’ consistent call for zero tolerance, BSA/AML looks to me to be the hottest area in the coming year.”

—Meg Sczyrba

HMDA results will create a lot of fair lending issues as there will be new categories of data that the press will misinterpret and read into,” Zavoina said. “Bankers need to know their data, understand what it means, and compare themselves to peers. The latter can’t be done until the data is released. Knowing their own data, that should begin in March or April.”

Sczyrba is likewise concerned about the public perception of banks’ lending practices. “The new HMDA data will be difficult to manage in terms of how we slice and dice it and how consumer groups choose to interpret it.”

Governance

According to Maher, governance is a top priority for 2005; he will dedicate more energy toward true risk management to fully understand and candidly evaluate risk and controls. “Compliance ties directly to operational risk management, which is covered by both SOX and Basel II,” he said.

Editor’s Note: ABA Bank Compliance will continue to tackle governance issues—particularly Sarbanes-Oxley and Basel II—with a dedicated column written by Paul Osborne of Crowe Chizek and Company LLC. His “Governance” column is slated for the March/April, July/August, and November/December 2005 issues.

FACTA

Possible changes related to FACTA and Fair Credit Reporting Act (FCRA) compliance also loom large in 2005. Effective December 1, FCRA rules with which compliance officers should already be complying include the following:

- credit score disclosures
- fraud and active duty alerts
- blocking of identity theft information
- prevention of repollution
- notices about negative reports

However, several final rules will determine the effective dates on a host of other issues, which include the following:

- risk-based pricing notices
- affiliate marketing
- medical information sharing
- red flag guidelines and regulations
- notice of opt-out
- accuracy and integrity guidelines
- ability to dispute with furnisher
- reconciling addresses

The recommendation is to stay tuned for the final rules later this year and frequently visit www.aba.com for the latest information. In addition, expect future coverage in this magazine after the final rules are published. A series of articles have been slated to cover this complicated piece of legislation.

Strengthening and Adapting

With so many looming changes, compliance officers are fortifying their efforts to thwart a downpour of problems in 2005. For some, the goal is to institutionalize and strengthen the entire compliance program. Others’ goals are more specific. For example, Rentschler’s goal is to change the focus of her compliance program to a risk-based approach throughout the bank, while still keeping abreast of the details and controls. Her quest is also to “apply a risk/reality focus when dealing with the varying issues,” because “spending excessive time dealing with minute details is not effective when bigger issues hang in the balance.” She advises her peers to document well, so regulators will move on to more-important items.

Training Approaches

One way to strengthen the way banks handle compliance is to adopt an integrated training approach. According to Maher, individual employees at all levels of the company fulfill most regulatory and legal compliance requirements. While Wells Fargo does “cultural” training (ethics, fair lending, privacy, etc.) and training on specific regulations, the best strategy is to integrate compliance into procedural training to help employees perform their overall jobs. “Compliance is just a part of their job and it’s integrated into many of the things they do every day,” he said.

Rentschler relies on intranet training and face-to-face follow-up to tie procedures to compliance. She monitors performance and follows up with training on issues not properly understood. “Training often and training deep is important,” she said. “We rely heavily on our staff to give us a heads-up when a concern is raised. To be compliant with the numerous regulations and requirements, we have to work as a team and bring important issues to the table—training assures this is done.”

“I agree that HMDA results will create a lot of fair lending issues as there will be new categories of data that the press will misinterpret and read into.”

—Andy Zavoina

“Training is primarily ‘job-based’—that is, compliance/legal requirements are woven seamlessly, as much as possible, into job procedures, and then staff are trained on procedures,” said a compliance veteran from one major bank. “For our line staff, training is tailored to the job. When we do separate compliance training, it’s on issues with widespread impact, such as fair lending/fair treatment, privacy, AML/ATF, etc.” She noted that while training is important across all lines of business, it’s important for compliance officers to seek training

as well. "Take time to 'sharpen the saw'—be sure you get the training you need," she said.

Glia Group's Zavoina believes many banks use tiers of in-house training, Web-based training, teleconferences, and conferences/schools. "This is like a pyramid moving from the larger bottom (in-house) to the point (conferences and schools). This is for effectiveness and cost."

Said Sczyrba, "Training should be risk managed like any other aspect of compliance. At WaMu, we attempt to make it seamless with the line's responsibilities. It is not nearly as important for them to know which reg is which or when it was written. What is important is for employees to know what is expected of them in their jobs."

According to Premier Bank's Monson, "Ineffective training is a double-edged sword," because "the lack of training increases compliance exceptions/violations, which in turn, increases the risk to the institution, which then increases the compliance monitoring in a risk-based program." He added that ineffective training represents more work for the already understaffed compliance program. He suggests that compliance professionals "take the time to develop an effective training program."

Keys to Success: Words of Advice

While agendas are being set, priorities identified, and training efforts mapped out, compliance officers must take a step back to evaluate their compliance programs in their entirety. They know what works

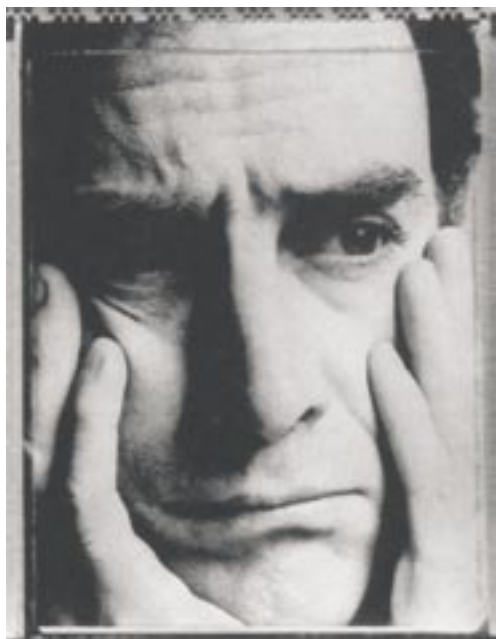
and what has the potential for failure. So what are the keys to being successful? What advice can they give to their peers?

For Maher, the key to success is "an ability to influence others to do what needs to be done to have a strong compliance program. We rely far more on influence than direct authority, comforting the afflicted and afflicting the comfortable when necessary."

According to First National Bank-Audrain County's Rentschler, the key to her bank's success lies in management support and the communication demonstrated throughout the bank—from the top down. "Management and the board's commitment in time, staff, and yes, dollars," she said, are critical to success. Having the proper authority to do what needs to be done is likewise essential, she added.

The ability to take a risk-based approach to laws and regulations, so that compliance and business unit resources are appropriately used, is a critical key to success, according to several sources. A vice president of compliance also cited the "ability to offer practical solutions to compliance gaps/hurdles," and "the ability to build strong relationships with business unit management, to work as a partner, not as a policeman, with them." She further recommends that compliance officers "take time to do strategic thinking, planning—it may save you hours and even days later."

For Zavoina, the key to a successful compliance program is the ability to lead. "A leader guides others and influences change where necessary," he said. "Today's regulatory environment is more about



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change management than auditing, with 2004 behind us, Reg. B, Reg. C, FCRA, and Check 21, to highlight events.”

On the Lighter Side

When it comes to dealing with the difficulties of being a compliance officer, perspective is also necessary. “Don’t work yourself into illness—no job is worth losing your health,” a wise compliance officer said. “Keep things in perspective: (1) Where human beings are concerned, things will never be perfect—no matter how hard you try to make it so. (2) Don’t take all problems on your own shoulders. When gaps/problems arise, differentiate between what you as a compliance risk manager and the business units are responsible for.”

While compliance officers want upper management to take compliance more seriously, maintaining a sense of humor prevents them from heading toward the brink of insanity. Compliance officers suggest that their peers have some fun with a business that is fundamentally serious. “Take time to have fun,” said Maher. “Maintain perspective. We deal with important stuff but, by-and-large, we don’t usually have lives or souls hanging in the balance.”

Said another, “Be sure you get at least one laugh a day; if you don’t, you’re in the wrong job.”

Conclusion

When compliance professionals examine their programs, they must set

the agenda based on the ever-changing regulatory scene. With more responsibility weighing them down, coupled with regulatory pressure and the ever-present potential for reputational damage, theirs is a difficult task. Without support in terms of resources—money, personnel, and time—added to compliance efforts, compliance officers will trek along doing the best they can with what they have.

However, smart boards of directors and upper management are starting to take notice. All they have to do is check the headlines to read about a major bank paying millions of dollars in penalties. With stormy weather looming on the compliance horizon in 2005, it’s curious that compliance hasn’t reached the radar screens at a larger number of financial institutions.

In the overall scheme of things, veteran compliance managers must champion the concept, within their institutions, that compliance is everyone’s responsibility, not just that of the compliance officer. Let’s hope it doesn’t take a scolding from a regulator, a major fine, or public outcry to crystallize that point in the boardroom. By then, it’d be too late. BC

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