Third Quarter 2007 / Volume 12 Issue 1

SRC Insights

Federal Reserve Bank of Philadelphia

Is Your Institution's BSA/AML Risk Assessment Adequate?

by Adina Himes, Manager

Risk assessment is a familiar term in the banking industry. Bank management regularly performs risk assessments for information technology, safeguarding customer information, and audit programs. However, the first release of the Federal Financial Institution Examination Council's (FFIEC) Bank Secrecy Act/Anti-Money Laundering (BSA/AML) Examination Manual on June 30, 2005, was the first document to provide guidance on developing a risk assessment for an institution's BSA/AML program. So while assessing risk is not a new process for bank management, many bankers continue to struggle with developing a detailed and appropriate risk assessment for their bank's BSA/AML program.

Many institutions, particularly community banks, simply do not know where to begin when attempting to develop a BSA/AML risk assessment. An important element to keep in mind throughout the process is that the risk assessment will dictate the institution's overall BSA/AML compliance program, including the content of the institution's policies and procedures, the necessary qualifications and experience of the institution's BSA officer, the comprehensiveness of training and internal controls, the scope of the independent test, and the requirements set forth by the institution's customer identification program.

So, how should bank management determine whether the institution's BSA/AML risk assessment is adequate

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SRC Insights is published quarterly and is distributed to institutions supervised by the Federal Reserve Bank of Philadelphia. The current and prior issues of *SRC Insights* are available at the Federal Reserve Bank of Philadelphia's website at www.philadelphiafed.org. Suggestions, comments, and requests for back issues are welcome in writing, by telephone (215-574-3769), or by e-mail (joanne.branigan@phil.frb.org). Please address all correspondence to: Joanne Branigan, Federal Reserve Bank of Philadelphia, SRC - 7th Floor, Ten Independence Mall, Philadelphia, PA 19106-1574.

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Federal Reserve Bank of Philadelphia

Supervision Spotlight

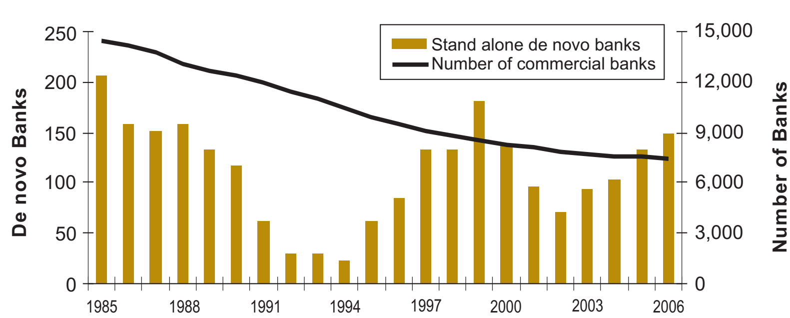
Trends in De Novo Formation

by Michael E. Collins, Senior Vice President

The banking industry is in the midst of an upswing in new bank or "de novo" formations. In 2006, 148 stand-alone de novo banks were chartered across the nation—the highest level since 1999 when 181 stand-alone de novo banks were formed and the third highest level since 1985 when 206 de novos were formed. In the Third District, four de novos formed last year, but seven have formed so far in 2007, and more are in the pipeline. It may seem counterintuitive that as the universe of banks steadily declines, particularly among the ranks of community banks, de novos continue to form and even proliferate during certain periods, as they are now. Why is this, and what are the implications of the current trend for established banks, especially those that experience the entry of de novos into their markets?

While the current upward trend in de novo formations appears to run contrary to common wisdom as seasoned industry players exit the scene, a closer look reveals that certain financial and market characteristics play an important role in influencing the entry of newcomers into local markets. As evidenced in the chart below, on a macro level, peaks in de novo formations have historically followed deregulation, repeals, and relaxation of state-level banking laws—which happened in the mid-1980s—and periods of economic expansion like the late 1990s.

Number of De Novo Banks & Commercial Banks Nationwide

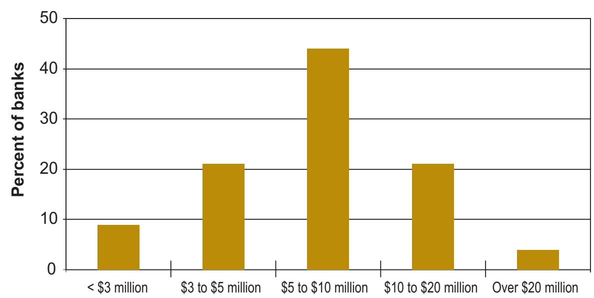


Research also supports a direct connection between merger and acquisition activity and the formation of de novos in specific markets. This connection is strongest where the merger replaces a small, local bank with a large, regional, or super-regional bank.[1] This makes sense, given that small banks typically lend to small, local businesses and others who value personalized attention. As smaller banks (the frequent targets of merger and acquisition activity) are acquired and replaced by larger banks, former customers who value the traditional, relationship-focused banking provided by smaller banks will look for that attention elsewhere. In these markets, de novos are also more likely to find a ready supply of skilled, experienced staff displaced from the merger and acquisition activity.

While some industry analysts worry about the possible saturation of markets during periods of heavy de novo formation, studies indicate that de novos are aware of their vulnerability to intense competition and imperfect economic conditions. De novos typically target markets with a scarcity of small business lending, high population growth, a strong local economy, and under-representation by smaller banks.[2]

One phenomenon that has been garnering significant attention recently is the increasingly large amounts of capital that de novos have been raising. In 2006, the average amount of capital raised by de novos was $17.2 million, up 69 percent from the 2003 level of $10.2 million. Banks that start with higher amounts of capital can compete more effectively with established banks and are better positioned to lure away customers by offering better rates and more competitive pricing. The prevalence of highly capitalized de novos, however, has raised concerns among some market watchers that newcomers who have raised enormous amounts of capital are growing too fast and may overreach by booking too many risky loans, opening too many branches, and offering overly aggressive prices on loans and assets.[3]

Initial Real Capital Levels of Commercial De Novo Banks Nationwide, 1985-2006



There is also evidence that institutional investors are fueling the current trend in de novo formations and playing a role in the large amounts of capital being raised. Investors risking huge sums of cash in de novos are taking their cues from others who have benefited enormously from the trend of larger banks acquiring smaller banks at substantial premiums.[4] While many de novos open with the expectation of meeting community needs, it's not unheard of, for in-

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Michael E. Collins, Senior Vice President

[1] Keeton, William, "Are Mergers Responsible for the Surge in New Bank Charters?," *Federal Reserve Bank of Kansas City, Economic Review*, First Quarter 2000, pp. 21–41. Available online at <www.kc.frb.org/publicat/econrev/PDF/1q00keet.pdf>.

[2] Moore, Robert R. and Edward C. Skelton, "New Banks: Why Enter When Others Exit?," *Federal Reserve Bank of Dallas, Financial Industry Issues*, First Quarter 1998, pp. 1–7. Available online at <www.dallasfed.org/banking/fii/fii9801.pdf>.

[3] Kuehner-Herbert, Katie, "Can You Start with Too Much Capital? (Some See Risks)," *American Banker*, December 12, 2006. Available online at <www.americanbanker.com>.

[4] Bauerlein, Valerie, "Bank Start-Ups Rush In Despite Profit, Loan Woes," *Wall Street Journal*, January 25, 2007.

New Bank Products: Health Savings Accounts

by Becky Goodwin, Assistant Examiner

While the cost of healthcare continues to rise, more employers are transferring this burden to their employees. Meanwhile, families and individuals wrestle with affordability in the face of rising healthcare costs. In an attempt to address growing concerns related to healthcare costs, health savings accounts (HSAs) were created by the Medicare Prescription Drug Improvement and Modernization Act of 2003, which was signed by President Bush on December 8, 2003. HSAs are designed to help individuals save for future qualified medical and retiree health expenses on a tax-free basis.[1] This article uses the most recent literature issued by the United States Department of the Treasury to define the HSA, focusing on eligibility, contribution requirements, and restrictions, and will also examine the role banks play in offering the HSA as a new product, since banks are qualified to serve as the custodian or trustee of HSAs.

An HSA is a special account owned by an individual to pay for current and future medical expenses, and it is used in conjunction with a High Deductible Health Plan.

What Is an HSA?

An HSA is a special account owned by an individual to pay for current and future medical expenses, and it is used in conjunction with a High Deductible Health Plan (HDHP). For 2007, an HDHP is defined as a health insurance plan with a minimum deductible of $1,100 for self coverage and $2,200 for family coverage. Annual out-of pocket expenses, which include deductibles and co-pays, cannot exceed $5,500 for self coverage and $11,000 for family coverage during 2007. The aforementioned amounts are all annually indexed for inflation.

[1] See <www.ustreas.gov/offices/public-affairs/hsa/>.

Eligibility

Eligibility to establish an HSA is not determined by income levels, nor are qualifying individuals required to have earned income to contribute to an HSA. They must be covered by an HDHP, must not be covered by other health insurance, must not be enrolled in Medicare, and cannot be claimed as a dependent on someone else's tax return.[2] Qualifying individuals may have additional health care coverage in the following forms: insurance covering specific diseases or illnesses; accident and long-term care insurance; and dental, vision, or disability coverage.

Likewise, participation in employee assistance, disease management, and wellness programs is permitted, based on the condition that the programs do not provide significant medical care or treatment. Furthermore, the use of drug discount cards is permitted in conjunction with HSAs. Individuals eligible for an HSA may also be eligible for VA benefits, unless benefits have been received within the three months prior to opening an HSA.

[2] See <www.ustreas.gov/offices/public-affairs/hsa/pdf/all-about-HSAs_051807.pdf>.

Contributions

Employers, individuals, and families are permitted to contribute to an HSA. Moreover, as of this year, individuals are permitted to make a one-time transfer from their Individual Retirement Account (IRA) to an HSA, in accordance with the contribution limits for the appropriate year of the transfer. The 2007 maximum that can be contributed to a HSA from all sources is $2,850 for self coverage and $5,650 for family coverage. These amounts are indexed annually. However, individuals who are aged 55 years or older are allowed "catch-up" contributions to an HSA in amounts totaling $800, $900, and $1,000 for the years 2007, 2008, and 2009, respectively. Enrolling in Medicare would prohibit further contributions. Any contributions exceeding the existing limits are subject to excise tax unless withdrawn by the individual. On the other hand, if the HSA limit is not reached for the year and a withdrawal occurs that is not qualified for medical expenses, the withdrawal will be subject to both income tax and a 10 percent penalty. The additional 10 percent penalty is not applicable if the individual dies, becomes disabled, or is over age 65. More details outlining the 2007 applicable rules for HSAs can be found in Internal Revenue Service Publication 969, "Health Savings Accounts and Other Tax Favored Health Plans."[3]

Banks and credit unions are automatically qualified to offer HSAs to their respective customers in the form of trust or custodial accounts.

Banks as Trustees and Custodians

Banks and credit unions are automatically qualified to offer HSAs to their respective customers in the form of trust or custodial accounts. Additionally, insurance companies and other entities that are already approved trustees or custodians of individual retirement accounts (IRAs) qualify. Other entities that want to become approved trustees or custodians of HSA accounts must contact the IRS directly. While trustees may exercise some level of discretionary fiduciary authority over the assets of the fund within the best interest of the beneficiary, the custodian has no fiduciary obligation to the owner of the funds.

Like IRAs, HSAs have many investment options, yet trustees do not have to offer all investment options to account holders. The individual is responsible for determining what to contribute, how much to use for medical expenses, whether to use the account for current or future medical expenses, which company will hold the account, and which type of investments will be used to grow the account. However, custodians and trustees can impose reasonable limits on fund accessibility through the frequency and size of distributions to the account. The fees for such accounts can be paid directly by the beneficiary without being added to the contribution itself or paid directly from the HSA account without taxes or penalties being imposed.

Banks and credit unions are in a unique position to benefit from offering a product like the HSA. The benefits for banks include the generation of fee income and opportunities to cross-sell and broaden their customer base, although the number of community banks within the Third District offering HSAs is very limited right now.

HSA trustees are required to report all distributions annually to the individual through form 1099 SA, and HSA account holders are required to file a form 8889 with their annual tax returns. Trustees or custodians are not required to ascertain whether HSA distributions are used for qualified medical expenses, but the individual HSA account holders are required to maintain records of their medical expenses for such purposes.

[3] "Health Savings Accounts and Other Tax-Favored Health Plans" is available online at <www.irs.gov/pub/irs-pdf/p969.pdf>.

A Growing Business

HSAs are considered a growing business line and an avenue for cross-selling banking products. The Aite Group, a leading independent research and advisory firm focused on business, technology, and regulatory issues, forecasts that large and specialty banks will be the winners in the health savings account (HSA) market, as they will see significant growth in the number of HSAs they provide. By 2010, large banks will likely support 40 percent of HSAs (up from 20 percent in 2006), and specialty banks will likely support 35 percent of HSAs (up from 30 percent in 2006).[4]

As banks continue to look for ways to expand their customer base and generate additional fee income, products like the HSA can become very attractive. Banks must be prepared to properly and adequately educate consumers and potential customers about new products or service offerings. According to Joe Donlan, vice president at Subimo, an informational healthcare resource and website, banks will find HSAs difficult to market if they don't provide customers with the tools necessary to make intelligent decisions about their health care savings requirements.[5] As with any new product offering, a bank's board of directors and senior management must perform due diligence and ensure that the bank has the appropriate infrastructure and expertise to offer and manage these newer products. Failure to do so could potentially expose the bank to unwarranted operational, legal, and reputational risk.

As consumers become more familiar with the benefits offered by HSA ownership, the demand for such product offerings is expected to increase.

The board of directors is ultimately responsible for the overall level of risk taken by the institution, and business strategies related to new products (e.g., HSAs) should be approved by the board. While significant policies governing any new products should be documented properly, senior management should also be capable of managing the activities and risk associated with new products. In any event, risk should be identified, measured, monitored, and controlled.

Ongoing risk monitoring and management information systems should be established to provide directors and senior management with a concise understanding of the banking organization's related performance and risk exposure. Management should also establish and maintain an effective system of controls governing the new product offering, which should be reviewed and tested by an independent internal auditor. The results of the review should subsequently be documented and reported directly to the board or audit committee for any needed response or required action.

Third District Perspective

Although there are not many Third District community banks offering HSAs, regulators anticipate that the flattening yield curve may prompt bank management to explore additional opportunities to increase their fee income through new or expanded products. As consumers become more familiar with the benefits offered by HSA ownership, the demand for such product offerings is expected to increase. The HSA may soon become a household name, just like the IRA. Even so, any new product offering embodies risk and the potential to negatively impact an institution if the board and senior management fail to exercise due diligence or do not have full knowledge of a product and its potential risk to the organization.

For more information about HSAs, visit the United States Department of the Treasury's discussion of HSAs at <www.ustreas.gov/offices/public-affairs/hsa/>. ☐

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[4] "Health Savings Accounts: A Bounty for Banks?" is available online at <www.aitegroup.com/reports/200608211.php>.

[5] "Introducing HSAs: Planning Tools May Help Acceptance" is available online at <www.bai.org/nl/v1/n5/articles/1hsa.asp>.

Don't Take that 2 for Granted!

by Jim DePowell, Manager

The scene is pretty familiar. An examiner-in-charge meets with a bank's board of directors and recites the CAMELS exam ratings assigned to the bank at its recent examination.[1] Management breathes a sigh of relief, and board members bravely take in the maze of acronyms and ratios inherent to the examination process. Because examiners are trained to refrain from laudatory comments, these meetings with examiners may be considered anti-climatic, yet banks may not fully realize how important achieving an overall "satisfactory" assessment is and how it supports management's ability to execute the bank's strategic plan.

Through their ratings, examiners potentially pre-qualify institutions to receive a variety of supervisory benefits.

Today's supervisory process is tailored to the risk profile of the supervised institution. Through their ratings, examiners potentially pre-qualify institutions to receive a variety of supervisory benefits. This article will discuss some of the benefits of receiving a satisfactory (2) composite rating, which range from reduced examination and regulatory application burden to very tangible benefits, such as lower deposit insurance premiums and discount window availability. The downside of examinations (i.e., when a rating is poor) and how to avoid such a situation will also be discussed.

Before delving into the benefits of a 2 rating, it is worthwhile to touch upon a common question asked by many bankers: What do I have to do to receive a strong (1) composite rating? Bankers may strive to attain a 1 rating, but it may not always be the most desirable goal. Although examiners focus on safety and soundness, bankers must strive to satisfy other stakeholders, such as shareholders and market analysts. And while examiners take comfort in high levels of capital and liquidity, earnings may suffer if levels are too high. Similarly, asset quality that reflects nominal levels of problem loans may be indicative of an overly conservative credit culture. However, in regard to earnings and management, both examiners and bankers typically agree that ample earnings, in conjunction with sound risk management practices, represent the ideal situation.

Reduced Examination Burden

The frequency of safety and soundness, compliance, and CRA examinations is tailored to the size and risk profile of financial institutions. The banking industry has been consistently strong in recent years, and Congress has gradually reduced examination burden. All but the largest institutions are examined less frequently if they are rated at least satisfactory, thereby reducing burden on banks.

The Financial Services Regulatory Relief Act of 2006 increased the asset threshold to $500 million for well-capitalized and well-managed banks to qualify for an extended 18-month safety and soundness examination cycle. The term "well managed" is generally based on satisfactory CAMELS composite and management component ratings. Another example is the Gramm-Leach-Bliley Act (GLBA), which reduced the frequency of consumer compliance examinations to either four or five years for banks with $250 million or less in assets if they achieve satisfactory or outstanding CRA ratings, respectively.

Expedited Applications

Examination ratings have a great impact on a bank or bank holding company's ability to expand. Although most of the Federal Reserve's supervisory process-

[1] SR Letter 96-38, *Uniform Financial Institution Rating System*, is available on the Board of Governors' website at <www.federalreserve.gov/boarddocs/srletters/1996/sr9638.htm>.

es take place through off-site surveillance and periodic on-site examinations, state and federal banking regulations identify certain events that require prior regulatory approval. Most revolve around expansion events like branch formations, mergers and acquisitions, and the conduct of certain activities.

The good news is that the applications process has been retooled to provide expedited processing to institutions that are well managed and well capitalized. The benefits range from reduced processing timeframes and streamlined information requests to full exemption from the application requirement. The concept of pre-qualification through examination ratings and capital levels was an integral part of GLBA, which authorized expanded activities through financial holding companies and financial subsidiaries.

The good news is that the applications process has been retooled to provide expedited processing to institutions that are well managed and well capitalized.

Management's proven ability to effectively oversee existing activities as evidenced by satisfactory examination ratings provides comfort to regulators that new activities will also be well managed. Therefore, new activities, to include insurance and securities activities, are available to qualified banking institutions without prior notice to their regulators.

An institution's capital levels also play an important part in qualifying for expansionary proposals. With bank capital levels at historic highs, the well-capitalized threshold established by FDICIA has become relatively standard and should be maintained upon consummation of any expansion that requires regulatory approval. This would apply to proposals by bank holding companies, as well as insured depository institutions (DIs). Also, bank holding companies that are well capitalized and well managed are generally not required to give prior notice when repurchasing their stock.

It is also noteworthy that, with certain exceptions, bank holding companies with consolidated assets of less than $500 million are not subject to the Federal Reserve's capital adequacy guidelines. In these situations, the focus shifts to the impact of the proposal on the capital levels of the subsidiary bank and to any debt burden incurred by the bank holding company, in particular, its ability to service the debt without undue reliance on the bank for cash flow.

Lower Deposit Insurance Premiums

The Federal Deposit Insurance Reform Act of 2006 authorized the FDIC to implement a more risk-sensitive deposit insurance premium. The change is intended to spread the assessment more fairly across institutions. The FDIC adopted a new rule in

November 2006, which became effective January 1, 2007. The rules place each institution into one of four risk categories using a two-step process based first on capital ratios (capital group assignment) and then on other relevant information (supervisory group assignment).

Subgroup A of the supervisory group consists of financially sound institutions with few minor weaknesses and generally corresponds to the primary federal regulator's composite ratings of 1 or 2. Institutions that qualify for the lowest overall Risk Category I will be assessed premium rates based on their CAMELS component ratings, certain financial ratios, and long-term debt issuer ratings, as applicable.

> An institution qualifies for the Discount Window's Primary Credit Program if it is assigned a CAMELS rating of 1, 2, or 3 and is at least adequately capitalized, unless supplementary information indicates that the institution is not generally sound.

Beginning in 2007, rates will range between 5 and 43 cents per $100 in assessable deposits, while institutions in Risk Category I will be charged a rate between 5 and 7 cents. At the maximum end in each range, a bank with $100 million in insured deposits would be assessed $430 thousand, while a bank in Risk Category I would only be assessed $70 thousand.

Availability of Federal Reserve Daylight Credit and Discount Window Programs

Supervisory ratings are confidential and therefore cannot be disclosed by a DI in obtaining credit. An exception to this is the Federal Reserve, where the bank's rating is already known and factored into its ability to access daylight overdraft credit and discount window programs. Generally, any institution that has a composite rating of 1, 2, or 3 will have access to both daylight and overnight credit from the Federal Reserve.

Under the Federal Reserve's Payment System Risk Policy on Daylight Credit, CAMELS ratings of 1, 2, and 3 are highly correlated to the three self-assessed net debit cap categories and are the primary driver in determining an institution's daylight credit capacity.[2] The other factor used to determine daylight overdraft capacity is the institution's capital category. Under normal circumstances, an institution would need to be well or adequately capitalized to qualify for a net debit cap. In extenuating circumstances, an undercapitalized DI with a rating of 1 or 2 may qualify for a net debit cap. Each cap category is assigned a multiple that is applied to the DI's risk-based capital to determine its daylight credit capacity.

Similarly, an institution qualifies for the Discount Window's Primary Credit Program if it is assigned a CAMELS rating of 1, 2, or 3 and is at least adequately capitalized, unless supplementary information indicates that the institution is not generally sound. DIs assigned a CAMELS rating of 4 may be eligible under limited circumstances, while a 5 rating results in ineligibility. DIs that are ineligible for primary credit may borrow under the Secondary Credit Program, when use of such credit is consistent with a timely return to a reliance on market sources of funding or the orderly resolution of a troubled institution, subject to certain limitations.

The Downside

There are multiple consequences to losing a 2 rating, but it is sufficient to note that examination frequency accelerates, the ability to expand through mergers or

[2] The Federal Reserve's *Overview of the Federal Reserve's Payments System Risk Policy on Daylight Credit* is available on the Board of Governors' website at <www.federalreserve.gov/PaymentSystems/PSR/overview.pdf>.

engage in new activities is sharply curtailed, and there is the likelihood of an enforcement action—either formal or informal—until the underlying problems are addressed. On a positive note, institutions do not lose their satisfactory assessments without fair warning from regulators.

The underlying causes do not generally manifest themselves in one examination cycle. In most cases, negative trends are identified and criticized by examiners well in advance of a composite rating downgrade. Bankers should be alert for slippages in asset quality, capital positions that no longer support the bank's risk profile, declining earnings performance and liquidity, and increased exposure to interest rate risk. The satisfactory management assessment is particularly vulnerable to inadequate risk management practices and failure to comply with laws and regulations.

In the past, examiners focused heavily on the financial components. Today's examiners emphasize risk management to a much greater extent and are not hesitant to downgrade the management rating, as well as financial components, if they are not managed in a safe and sound manner. In addition, management should be sensitive to emerging issues. When topics become hot issues or emerging trends, management should be vigilant to ensure that there are appropriate processes and controls in place to avoid criticism. Finally, ratings downgrades can largely be avoided if management addresses examination recommendations in a timely manner and avoids repeat criticism.

In Summary

There are positive and tangible benefits to be derived from a successful examination. Although it may be intrusive and time consuming, an examination that results in a satisfactory or better rating provides a number of benefits and helps to reduce regulatory burden, thus allowing more time to devote to core business activities. □

Trends in De Novo Formation

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stance, for a de novo to explicitly incorporate acquisition by a larger entity into its business strategy. And while a robust capital base may serve as a cushion for operating expenses as a de novo develops and expands, industry experts agree that the more critical component of a startup's success lies in the acumen of its business strategy and the strength and talent of its management team in successfully executing that strategy.

Banks are considered de novo institutions through their fifth year of operation in recognition of the problems that can surface during this period due to inexperienced management, staffing changes (particularly in the management team or directorship), and poor lending practices. The Federal Reserve's supervision standards for de novos are intended to help startups avoid these pitfalls. The standards specify that capital levels for state member bank de novos, for example, must be reasonable in relation to state law, location, business plan, and competitive environment. More information on de novo bank formation and the Federal Reserve's standards for de novos may be found in the Federal Reserve's *Application and Supervision Standards for De Novo State Member Banks*, available on the Board of Governors' website at <www.federalreserve.gov/boarddocs/srletters/1991/SR9117.HTM>.

Both de novos and established banks alike face considerable challenges in today's tough operating environment, which is characterized by a flattened and sometimes inverted yield curve, margin compression, a residential real estate correction, and intense competition. Despite these difficulties, the trend toward increasing the number of de novos demonstrates that banking remains a highly attractive business and that small community banks continue to be valued by the businesses and communities they serve. □

Is Your Institution's BSA/AML Risk Assessment Adequate?

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to identify, measure, monitor, and control BSA/AML risks before the regulators conduct their next examination? Many institutions have used Appendix J in the FFIEC BSA/AML Examination Manual as a template, and while this is definitely a good reference point, Appendix J is only intended for regulators to determine BSA/AML regulatory risk. The following pointers should provide bank management with a better understanding of the overall regulatory expectations.

Think Enterprisewide

One of the most common deficiencies noted by examiners is that the organization's risk assessment does not take into consideration all of the institution's business lines and operating subsidiaries. This is particularly true for companies that administer the BSA/AML compliance program at the holding company level or at the lead bank. Management must consider how the risks of one business line are interrelated with other business lines within the organization.

Some smaller institutions with less complex structures often forget to incorporate trust, broker/dealer, and mortgage activities. However the institution is structured, management must exhibit cross-organizational awareness and reassess risks periodically in order to keep pace with the changing business environment.

> Management must consider how the risks of one business line are interrelated with other business lines within the organization.

Identify Risk Categories

After all business lines and entities that should be included in the risk assessment have been identified, all products, services, customers, and geographic locations that are unique to the institution should be documented. While management should assess AML risks associated with each risk category, there are certain products, services, customers, and geographic locations that are more susceptible to AML risks or have been used historically for illicit means. Management must also consider how the institution interacts with its customers, whether it is face-to-face contact or through an online banking product.

Products and services. Management should identify all of the products and services offered by the bank and the risk that each could be used for money laundering. Special consideration should be given to products or services that may facilitate a higher degree of anonymity or involve the handling of high volumes of cash or cash equivalents. One example would include electronic funds payment services, such as stored value cards, funds transfers, pay upon proper identification transactions, third party payment processors, remittance activity, and automated clearing house transactions. Other examples include automated teller machines, electronic banking, private banking, trust and asset management services, monetary instruments, foreign correspondent accounts, trade finance, special use or concentration accounts, lending activities, and nondeposit account services. This list is not meant to be all-inclusive, and products and services will vary by institution.

Customers and entities. A very important part of a strong risk assessment is knowing your customer. Management must understand the relationship between its institution's Customer Identification Program (CIP) and the institution's overall customer risk. Management is expected to assess the risk of the institution's customer base. This process was introduced in October 2003, with the implementation of Section 326 of the U.S.A. PATRIOT Act, which requires institutions to establish a CIP.[1] According to the CIP, management must ensure that a customer's risk is determined at account opening. In order to get

a full understanding of the risks posed by the institution's customers, institutions were expected to review all existing customer relationships.

An important point to remember, which is something frequently noted by examiners, is that the prescribed list of businesses ineligible for exemption under 31 C.F.R. 103.22 (d)(6)(viii) is not sufficient for determining the level of risk associated with each customer.[2] Management is expected to take certain factors into consideration when making the determination, including which types of customers have been historically associated with money laundering or illicit activities. However, management must make the final determination based on factors unique to the specific customer and take actual transaction volumes into consideration.

The analysis of the customer base for risk assessment purposes should be granular. For example, the FFIEC BSA/AML Examination Manual discusses various groups of customers and entities that are considered to be high risk for money laundering, such as professional service providers, cash-intensive businesses, nonbank financial institutions, non-resident aliens, etc. However, management may narrow the list even further and identify the risk associated with each customer or entity type. An example of this is lawyers, who are a type of professional service provider. Some concerns with lawyers include the layer of anonymity between the client and the lawyer and the potential for commingled funds in interest on lawyers' trust accounts. Simply stating that the institution has several customers that are professional service providers is not acceptable.

Geographic locations. Examiners often note that bank management has only listed the geographic areas where the institution operates within the risk assessment. However, bank management should also determine the areas that all of the institution's branches, entities, customers, and transactions reach. The next step is to determine which areas, both foreign and domestic, bank management considers to be high risk.

Management should give special consideration to locations with a higher level of perceived risk, including:

- High intensity drug trafficking areas
- Countries subject to Office of Foreign Asset Control (OFAC) sanctions
- Countries identified as supporting international terrorism under section 6(j) of the Export Administration Act of 1979, as determined by the Secretary of State
- Jurisdictions determined to be "of primary money laundering concern" by the Secretary of the Treasury
- Jurisdictions subject to special measures imposed by the Secretary of the Treasury, through FinCEN, pursuant to section 311 of the PATRIOT Act
- Jurisdictions or countries identified as non-cooperative by the Financial Action Task Force on Money Laundering
- Major money laundering countries and jurisdictions identified in the U.S. Department of State's annual International Narcotics Control Strategy Report

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[1] The full text of the USA Patriot Act of 2001 is available at <www.fincen.gov/hr3162.pdf>.

[2] Describes businesses ineligible for a Currency Transaction Reporting exemption.

- Offshore financial centers as identified by the U.S. Department of State
- Countries considered high risk for human trafficking identified in the U.S. Department of State's annual Trafficking in Persons Report
- Other countries identified by the institution as high risk based on experience or other factors

Be Specific

The more detailed information provided in the risk assessment, the better the quality of the overall product. After management identifies all risk categories, it should quantify the risk for each category. This may require some research.

Management should quantify risk using actual numbers. Some examples include volume of wire transfer activity and cash, percentages of customers in certain geographies, number of customers by customer type, etc. However, sometimes nonfinancial indicators are more appropriate. For example, the institution may be in the position to determine the risk associated with a customer that is a nonbank financial institution, such as a money services business (MSB). Management should understand specifically which products and services the MSB offers, as well as the extent of the MSB's operations, whether they are foreign or domestic.

Finally, management should make an overall evaluation of the institution's BSA/AML risk. Is the level of risk low, moderate, or high? The evaluation should be based on the various risk categories included in the institution's risk assessment. The overall risk profile and the level of risk in the various risk categories should assist management with establishing risk mitigants when designing an appropriate BSA/AML compliance program.

Update Often and Seek Approval

Similar to other risk assessments management may prepare, the BSA/AML risk assessment should be approved by the board of directors and updated at least every 12 to 18 months. Furthermore, the risk assessment should be considered a living document and should be updated and approved on an as-needed basis. Bank management with proactive risk management programs always evaluate BSA/AML risk upon the development of new products or services.

> The risk assessment should be considered a living document and should be updated and approved on an as-needed basis.

Don't Forget About OFAC

Even though OFAC compliance is separate and distinct from BSA/AML compliance, the regulatory expectation is that management should evaluate the institution's OFAC risk by developing a risk assessment that evaluates the institution's OFAC risks. This could be prepared as part of the same document as the BSA/AML risk assessment, or it can be a stand-alone document. However, consistent with the BSA/AML risk assessment, the expectation is that the bank's OFAC compliance program should be dictated by management's assessment of overall OFAC risk.

Conclusion

Developing an appropriate BSA/AML risk assessment for your institution does require a significant time and resource commitment, especially for more complex organizations. However, the quality of the institution's risk assessment often dictates management's ability to develop appropriate risk mitigants and administer an effective BSA/AML compliance program.

For more information about BSA/AML compliance, please visit <www.ffiec.gov/bsa_aml_infobase/default.htm> (the FFIEC's BSA/AML Infobase) or contact Manager Adina Himes (adina.himes@phil.frb.org) at (215) 574-6443. ☐

Financial Institution Access to Homeland Security National Communications Programs

The Department of Homeland Security's National Communications System (NCS) administers the following programs to ensure that critical functions of the government can continue to communicate during times of national emergencies and natural disasters. Financial institutions' participation in the programs requires sponsorship from their respective federal regulator.

The Government Emergency Telecommunications Service (GETS) is a White House-directed emergency phone service provided by the NCS. GETS provides emergency access and priority processing in the local and long distance segments of the Public Switched Telephone Network (PSTN). It is intended to be used in an emergency or crisis when the PSTN is congested and the probability of completing a call over normal or other telecommunications means has significantly decreased. The GETS program is maintained in a constant state of readiness to overcome network outages through such methods as enhanced routing and priority treatment.

The Telecommunications Service Priority (TSP) Program provides national security and emergency preparedness (NS/EP) users priority authorization of telecommunications services that are vital to coordinating and responding to crises. The program resulted from an FCC order requiring telecommunications service providers to prioritize service requests for identified National Security/Emergency Preparedness (NS/EP) functions. A telecommunications circuit with a TSP assignment is assured of receiving full attention by the service vendor before a non-TSP circuit.

The Wireless Priority Service (WPS) is the wireless component to the GETS program, providing priority cell phone tower access when placing calls during periods of congestion. The FCC also issued guidelines for NS/EP use of wireless networks, directing that only NS/EP leadership and key personnel should be approved to use WPS. WPS users are authorized and encouraged to use GETS via their cellular phones to better their probability of completing their NS/EP calls during periods of congestion.

For more information on any of these programs, including eligibility requirements, please visit the Department of Homeland Security's National Communications System website at <www.ncs.gov/services.html>.

The Financial and Banking Information Infrastructure Committee (FBIIC) and the Board of Governors (the Board) have established specific criteria for sponsorship. The Board's sponsorship criteria are posted on the Board's public website at: <www.federalreserve.gov/paymentsystems/telecomservice/default.htm>.

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By completing the survey, you will help us make *SRC Insights/Compliance Corner* even better. We appreciate your help and value your feedback.

Who to Call

Your institution may need to contact an officer, manager, or staff member in the Supervision, Regulation, and Credit Department, but you may not know whom to call. The following list should help you find the correct contact person to call. Financial institutions that have an appointed central point of contact should generally contact that individual directly.

Contact names appearing in bold are the primary contacts for their areas.

Community, Regional, and Global Supervision

John J. Deibel, VP	574-4141
Elisabeth V. Levins, AVP	574-3438
Joseph J. Willcox, Manager	**574-4327**
Stephen J. Harter, Manager	**574-4385**
Eric A. Sonnheim, AVP	574-4116
Glenn A. Fuir, Manager	**574-7286**
Adina A. Himes, Manager	**574-6443**
H. Robert Tillman, Special Advisor	574-4155

Capital Markets

John J. Deibel, VP	574-4141
Elisabeth V. Levins, AVP	574-3438
Avi Peled, Manager	**574-6268**

Consumer Compliance & CRA Examinations

John J. Deibel, VP	574-4141
Constance H. Wallgren, AVP	574-6217
Robin P. Myers, Manager	**574-4182**
David A. Center, Manager	**574-3457**

Consumer Complaints

John J. Deibel, VP	574-4141
Constance H. Wallgren, AVP	574-6217
John D. Fields	574-6044
Denise E. Mosley	**574-3729**

Regulations Assistance

Regulations Assistance Line	**574-6568**

Enforcement

A. Reed Raymond, VP	574-6483
Cynthia L. Course, AVP	**574-3760**

Regulatory Applications

A. Reed Raymond, VP	574-6483
William L. Gaunt, AVP	574-6167
James D. DePowell, Manager	**574-4153**

Retail Risk Analysis

William W. Lang, VP	574-7225
Todd Vermilyea, AVP	574-4125
Christopher C. Henderson, Special Advisor	574-4139

Discount Window and Reserve Analysis

Vish P. Viswanathan, VP	574-6403
Gail L. Todd, Manager	**574-3886**

NOTE: All phone numbers have the area code (215).

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OF PHILADELPHIA

Supervision, Regulation and Credit Department
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Philadelphia, PA 19106

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