19309 Winmeade Drive, #110 • Lansdowne, Virginia 20176
571.333.0300 • www.dmlassociatesllc.com
Getting to the root of the matter.
DML ASSOCIATES, LLC

Corporate Culture: The Driving Force Behind Regulatory Actions Against Financial Institutions

By Dennis M. Lormel 11/10/2013

You Can't Fix Stupid

Greed blurs the senses. It can influence the thought process and make otherwise intelligent people make stupid decisions. In the case of financial institutions, the allure of short term profitability often trumps long term sustainability. There is an interesting saying, ***"you can't fix stupid."*** In the past few years, we have seen time and again throughout the financial services industry where business executives have been overcome by greed and have made stupid decisions. Most stupid business decisions result in significant consequences, to include enforcement actions. Not only has there been a trend toward massive fines and penalties, the damage to the reputations of financial institutions have been significant. The list of bank indiscretions goes on and on, giving the industry a black eye.

If business executives were more responsible and less influenced by greed, they would be less inclined to make stupid decisions. To overcome corporate greed, there must be a strong corporate culture. There must be a strong culture of compliance that includes corporate accountability. Without a strong culture of compliance, greed will permeate and business executives will continue to make stupid decisions. Remember, ***"you can't fix stupid."***

Considerations for Executive Management

There have been a growing number of enforcement actions that have drawn more costly fines and penalties. With that backdrop, the role of Bank Secrecy Act (BSA) anti-money laundering (AML) compliance has become expansive and more costly. Increased compliance responsibilities have been challenged by the war on talent, wherein financial institutions have experienced problems retaining AML compliance staff. Because of the greed and stupidity of business executives, regulators have gotten more aggressive. In addition, the courts and the public have become less sympathetic toward financial institutions. Consequently, there has been a mounting cry for criminal prosecutions of bank executives.

Weaknesses in corporate culture have driven regulatory actions. Recent enforcement actions highlight significant AML compliance inadequacies and failures. In most instances, such AML compliance inadequacies were caused by the business side of the house. In many institutions there is a business versus compliance culture and business wins out. Business generates profits while compliance is considered a cost center, which gives business entities leverage. Hence, the risk appetite of an institution is dictated by business with little regard for compliance.

To change this type of culture, business entities cannot be permitted to circumvent or marginalize the compliance function. There must be consequences and accountability for business executives driven by greed to make stupid decisions. The business culture in financial institutions must become more compliance oriented. This will require training. More importantly, if business executive compensation was tied directly to adherence with compliance requirements, business greed would diminish.

Establishing a culture of compliance must be driven by the tone at the top of a company beginning with the Board of Directors and executive management. Without their buy in and participation, it is unlikely that an institution can develop a viable culture of compliance. It is important to understand that corporate culture does not change overnight. It is an incremental process that can take considerable time to accomplish. In establishing a culture of compliance, the AML compliance process must be given the capacity to perform. That translates to resources in terms of personnel and technology. The Chief Compliance Officer should be independent and have direct access to the board of directors. As noted earlier, business compensation must be tied to adherence to AML compliance requirements.

In addition to visibly supporting the culture of compliance, executive management should ensure that AML compliance executives are included in making business decisions; that compliance is viewed not merely as a cost center but as a revenue protector; that compliance has adequate resources to perform its functions effectively; that executive management understand the importance of the suspicious activity reporting (SAR) process; that they participate in the risk assessment process; and that they understand the consequences of non-compliance in terms of reputational risk, liability (both personal and professional to themselves) and the risk of litigation.

Executive management should also ensure that they, and other employees, avoid being willfully blind. Willful blindness is the deliberate avoidance of knowledge of facts or purposeful indifference. Greed can make it is easy to fall into the trap of willful blindness and lead to stupid decisions, or in the case of willful blindness, stupid non-decisions.

Compliance as a Risk Deterrent

All financial institutions, regardless of size, location and product offerings are vulnerable to servicing individual criminals, groups of criminals, and criminal organizations. All financial institutions, regardless of size, location and product offerings are vulnerable to facilitating terrorist financing. The back office has evolved into the frontline in the fight against money laundering and terrorist financing. Compliance professionals not only play an important role in defending the economic threat posed by criminal enterprises but also play a role in safeguarding national security from terrorist groups.

Embedding a compliance culture must be dictated from the top of the institution and be followed by the staff. Senior compliance management should communicate compliance expectations to staff; insist on being informed about compliance efforts; establish and oversee the compliance program, including procedures, processes and controls; and including compliance in job descriptions and performance appraisals across the entire institution.

Components of an effective corporate culture should include:

- Vision: An effective culture starts with a vision or mission statement.
- Values: A company's values are the core of its culture.
- Practices: A company's values must be reinforced and followed.
- People: A company's people must share its core values.
- Narrative: A company's history must be told in a narrative.
- Place: Whether geography, architecture, or aesthetic, design impacts the values and behaviors of people in a workplace.

The culture of compliance requires:

- Leadership and oversight of top managers
- Written policies and procedures
- Enterprise-wide risk recognition and management
- Strategic planning and product development
- Training
- Lines of communication
- Monitoring and auditing
- Disciplinary actions
- Investigations and corrective actions
- Compensation tied to adherence to AML compliance requirements

Key Risk Areas and Corresponding Actions

Bill Fox, Managing Director, Global Financial Crimes Compliance Executive for Bank of America, was interviewed by ACAMS Today, which is published by the Association of Certified Anti-Money Laundering Specialists (ACAMS). The interview appeared in the magazine's December 2012 – February 2013 edition. In the interview, Bill stated: "Understanding your risk is a key to building an effective program: understand your business model, your products, your clients and the geographies where you operate. Then you design your control environment to address those risks, ensuring that you have a fundamentally sound overall program. I believe you also must make your program and processes as efficient as you possibly can, while still ensuring they are effective."

On September 12, 2012, at an ACAMS conference in New York City, and again during the ACAMS Today interview, Bill discussed how he reviewed every enforcement action between 2001 and 2012, as well as every report published by the Senate Permanent Subcommittee on Investigations (PSI) relating to money laundering. Based on his extensive review, Bill determined that the government was consistent about the risks they really care about. Bill boiled the risks down to seven buckets, as follows:

1. Correspondent Banking
2. Cash/Currency
3. Private Banking

4. Embassy (Foreign Mission) Banking/Mission Personnel/Senior Political Figures or Politically Exposed Persons (PEPs)
5. Non-Bank Financial Institutions
6. Non-Transparent Entities
7. Economic Sanctions/Stripping

During the September 2012 ACAM conference, Bill also addressed corresponding actions financial institutions should take to address the seven key risk areas he identified above. They include:

- Enterprise-wide risk assessment of key risk areas – with a deep assessment of internal controls
- Senior leader engagement – meetings with key leaders to ensure they are aware of environment
- Proactive engagement with business lines with key risk – focus on key risk areas to ensure strong controls across the enterprise
- Proactive engagement with government regulators, law enforcement and policy makers – proactive engagement with government stakeholders

Risk Recognition and Assessment

On September 23, 2013, while participating in a panel discussion, during the ACAMS annual AML conference in Las Vegas, Dan Stipano, Deputy Chief Counsel, Office of the Comptroller of the Currency (OCC), made the following statement:

"The two major compliance problems that lead to OCC enforcement actions are failure to assess certain areas for risk and failure to accurately assess risk…Risk assessment has to be dynamic, never static…The key thing is that it's revisited often enough so that the risk assessment remains accurate."

The cornerstone of every AML compliance program is a risk assessment. Bank regulators expect financial institutions they supervise to conduct a business line risk assessment, customer risk assessment, Office of Foreign Assets Control (OFAC) risk assessment and an enterprise-wide risk assessment. The risk assessment should be developed to identify and mitigate institutional risk. The starting point is to identify inherent risk, which is the risk to an entity in the absence of any actions to alter either the risk's likelihood or impact. The next step is to design and implement control processes to mitigate inherent risk. The risk remaining after all controls have been applied to reduce inherent risk is residual risk. An acceptable level of residual risk is determined by the risk appetite or tolerance of the financial institution.

The risk assessment should be a two-step process comprised of the identification of risk categories and the analysis of those risk categories. Risk assessments should be considered non-static. They should not be placed on the shelf but should be treated as a living process requiring periodic updates. The results should be communicated and shared with management, the board of directors and appropriate staff. An effective risk assessment enables a risk-based program that is structured to control risk and to be modified as risk changes.

Customer Identification Program

The know your customer (KYC) program is an important element of an AML compliance program. A KYC program should have a sound process that includes verification and documentation. Customer due diligence (CDD) should be the process of obtaining information from all customers that enables a financial institution to verify the identity of a customer and assess risks associated with that customer. Clients deemed to be high risk will require additional due diligence steps, which is known as enhanced due diligence (EDD). CDD requires a sense of vigilance and should be an ongoing process.

Conclusion

There are a number of training tools available to enhance risk recognition and mitigation. They include:

- Enforcement actions that delineate and highlight BSA/AML compliance breakdowns;
- Criminal and civil case court filings that contain statements of fact outlining schemes and scenarios used for illicit purposes;
- SAR analysis which identifies patterns of activities and emerging trends;
- Case typologies that demonstrate how bad guys identify and exploit systemic vulnerabilities;
- Grass roots working groups that informally exchange information regarding mutual threats and concerns.

In furtherance of a culture of compliance, financial institutions should interact with law enforcement. Institutional management should understand the differing perspectives between law enforcement and their organization. Financial institution personnel should participate in grass roots working groups and maintain contact with their local SAR review team. The roles of executive management, AML officers and legal counsel should be defined when it comes to dealing with law enforcement in terms of responding to requests for information by law enforcement and in responding to the media regarding law enforcement activity involving the institution.

Keys to success in establishing a culture of compliance start with the tone at the top. Without executive buy in, the culture of compliance will not succeed. Executive management must support the compliance program and afford compliance the capacity to function effectively; they must understand the consequences to reputational risk, risk of liability and the potential of litigation for non-compliance; they should cooperate with law enforcement; and executive management should develop business growth smartly and responsibly.

Financial institutions should be proactive about dealing with risk. Institutions should engage risk. They should not sit back and let the environment engage them. To counter risk, an institution needs a vibrant culture of compliance. To develop a strong culture of compliance, a business must limit corporate greed. Greed leads to stupid decisions. Stupid decisions lead to serious consequences such as enforcement actions. Limiting greed will minimize stupid decisions. Remember, "***you can't fix stupid.***"