

# Financial Services Regulatory Update



**August 2018**

*This communication is designed to provide you with quick snapshots and timely perspectives on recent regulatory developments.*

## **Land Mines: The Compliance Side of M&A**

### **Background**

According to recent industry reports and analyses, merger and acquisition activity in the financial sector is on pace to match or exceed numbers posted since 2014. Stock prices among U.S. banks have increased steadily since 2016, and with anticipated roll-backs of Dodd-Frank Act rules for systemically important financial institutions (with assets between \$50 billion and \$250 billion), larger institutions are poised to gain market share through acquisition. Smaller institutions – those with assets between \$500 million and \$1 billion, whose balance sheets reflect excess capital – find themselves in a great position to sell at a premium, or to acquire smaller institutions to extend their service areas and gain market share. And while the accountants and Boards weigh the financial factors to determine the most beneficial moves for stockholders, industry best practices dictate one more consideration: compliance risk in acquisition targets. Whether an institution plans to acquire an entire organization or a portion of a loan portfolio or something in between, compliance risk is no small factor.

### **Know What You're Getting Into**

Bank and portfolio acquisitions historically have involved financial, human resources, market share and community impact concerns, but compliance risk has not been a significant factor considered in merger and acquisition deliberations. Even when an acquiring institution does take compliance risk into account, the approach tends to focus on low-hanging fruit such as enforcement action items or consumer harm issues that have become public. While these areas are important, compliance risk can lurk beneath the surface and come to light after the ink on agreements dries. When this happens, the acquiring or surviving institution can face significant regulatory scrutiny, enforcement actions, negative press, and material financial loss due to reimbursements or restitution payments.

Taking appropriate precautions, such as involving the Compliance Officer in initial M&A discussions can be helpful for several reasons. First, the Compliance Officer can better assess a target's compliance culture during face-to-face meetings, rather than trying to piece the picture together based on a handful of documents and conversation summaries from those who were more focused on financial or human resources concerns. Second, the Compliance Officer can ask clarifying questions about things like information and core systems, the extent to which manual processes have been used to manage compliance when systems fall short, and the likelihood of human error in consumer transactions where business line staff are over-burdened, under-trained, or new to the business. Finally, the Compliance Officer is in the best position to assess the potential for compliance violations based on how well the target's three lines of defense are aligned and coordinated. In short, the Compliance Officer has the expertise to proactively manage compliance risk through the process of acquisition and going forward.

### **How to Know**

The old saying goes, "the best defense is a good offense," and compliance risk management is no exception. Simply having a seat at the M&A table from the beginning of negotiations and throughout the process does not mean the Compliance Officer's work is done, or that compliance risk is known, much less managed. Consistently following protocol for M&A compliance due diligence will give the Board and executive management better assurance that compliance risk is being effectively managed, and that the chance of a regulatory enforcement action or other negative



impact event will arise following the acquisition. Industry experts shared best practices at a 2018 regulatory compliance conference that included establishing a solid due diligence methodology specific to compliance risk, tying the review back to the acquirer’s compliance risk assessment and adjusting as necessary based on the target’s risk assessment, and focusing due diligence transaction testing on areas with the highest risks. Depending on such factors as compliance risk ratings, whether the entire organization is subject to acquisition or if just portions of portfolios will be acquired and the types of assets to be acquired (e.g., higher risk consumer mortgages, commercial or small business loans, etc.) a good compliance due diligence review would include some or all of the following areas:

Compliance Component	What to Look For
Compliance Management System	Formal, written Program based on comprehensive Compliance Risk Assessment; Reasonable alignment among three lines of defense; Board and Executive Management oversight; Expressly addresses the Five Pillars of the compliance program (Board/Management oversight; Compliance Officer and Function; Training Program; Three Lines of Defense; and Compliance Risk Assessment); and Specific to the organization.
Controls Specific to UDAAP	Policy clarifying management expectations; Third party and vendor risk management controls, as appropriate; Debt collection practices; Default servicing and foreclosure controls; Products/services targeting at-risk groups (financially non-literate, non-English speaking persons, etc.); and Inherently higher-risk products, services or practices such as overdraft programs, credit reporting controls.
BSA/AML/OFAC/USA PATRIOT Act Program	Expressly addresses the Five Pillars of the Program; Provides for training and communication, including the Board; Clarifies management expectations for banking higher risk businesses or persons; Alignment of processes and controls for balance of efficiency and effectiveness (e.g., minimal manual controls for SAR and CTR monitoring); and Program-specific, comprehensive risk assessment.
Community Reinvestment and Community-related Risk	Designated CRA Officer; Regulatory Reporting (i.e., CRA Loan Application Register), if applicable; Controls and processes reasonably designed to identify covered transactions and validate data; Culture that encourages community development loans and activities, practices innovation in meeting community needs, and welcomes community input/feedback; Technical compliance controls including identifying and periodically amending the Assessment Area, updating the Public File and lobby notices, and analyzing data; and Leveraging data analysis to manage Fair Lending risk.



Compliance Component	What to Look For
Technical Compliance	Track record of effective compliance risk management, especially in consumer protection areas; Positive relationship with primary regulator; Comprehensive and regularly conducted Internal Compliance Audits with effective issue remediation and related tracking; Effective second line of defense monitoring that includes issue tracking and reporting; and Reasonable reliance on core systems, with effective change management for updates and upgrades.

The chart above is not exhaustive, but rather is intended to guide Compliance Professionals in considering areas that are likely to involve the greatest compliance risk in connection with an acquisition. Whatever the acquiring institution’s compliance due diligence protocol includes, it will serve as a roadmap, not just for assessing compliance risk related to the acquisition, but also for conducting a comparative review to quantify how the acquisition is likely to affect the surviving institution’s compliance risk profile.

**How Experis can help**

Experis Finance offers industry experience in all aspects of Financial Services, including:

- Performing Fair Lending, Compliance Management Program and Compliance Risk Management assessments
- Assessing the adequacy of your organization’s compliance control environment
- Developing compliance due diligence programs to address unique risks
- Developing data-based analysis and related Board reporting
- Evaluating processes and practices and developing program enhancements to address weaknesses

Our Risk Advisory Services practice can evaluate your compliance management program, provide comprehensive recommendations for improvement and help you address those recommendations.

Our team of professionals has extensive experience working with clients to address these issues to help them avoid costly fines and penalties. If you have any questions about or concerns around your implementation of these steps, contact an Experis representative at [financialservicesindustry@experis.com](mailto:financialservicesindustry@experis.com) or visit our website [Experis Finance](http://Experis Finance).