Preface

Journal of Community Bank Case Studies

Volume 5

The Journal of Community Bank Case Studies is an independent, adjudicated journal of case studies authored by undergraduate college students. The goal of this journal is to showcase the work of the top undergraduate student teams that participate in the annual Community Bank Case Study Competition, a national competition facilitated by the Conference of State Bank Supervisors. The competition partners undergraduate student teams with community banks to conduct original case studies focused on various topics. This year’s competition focuses on the impact of the Bank Secrecy Act and Anti-Money Laundering (BSA-AML) requirements on community banks.

This fifth volume of the Journal of Community Bank Case Studies includes the top three written submissions from the 2020 Community Bank Case Study Competition. The authors of the papers represent student teams from Mississippi State University, James Madison University, and Mansfield University of Pennsylvania.

About

Conference of State Bank Supervisors

The Conference of State Bank Supervisors (CSBS) is the nationwide organization of banking and financial regulators from all 50 states, the District of Columbia, American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands.

Established in 1902 as the National Association of Supervisors of State Banks, CSBS is uniquely positioned as the only national organization dedicated to protecting and advancing the nation’s dual-banking system.

For more than a century, CSBS has given state supervisors a national forum to coordinate supervision and develop policy related to their regulated entities. CSBS also provides training to state banking and financial regulators.
On behalf of the Conference of State Bank Supervisors, I am pleased to present the *Journal of Community Bank Case Studies, Volume V.*

The publication showcases the work of the top three student teams in the 2020 Community Bank Case Study Competition. This is the sixth year of the annual competition, which is open to undergraduate students in all fields of study as an opportunity to gain valuable first-hand knowledge of the banking industry.

Despite a global pandemic, 37 teams representing 33 colleges and universities entered the competition and examined the impact of the Bank Secrecy Act and Anti-Money Laundering (BSA-AML) requirements on community banks. They partnered with a local bank to examine compliance challenges, associated time and costs and identify potential regulatory reforms.

Our competition serves multiple purposes. Students have an educational opportunity that allows them to network with local banks. And the community banking industry and policy makers benefit from their research. These case studies will be incredibly useful contributions to the policy discussions on the impact of BSA-AML on community banks.

I am grateful to these students for persevering in a challenging year. And I am very pleased to present their papers in this Journal of Community Bank Case Studies.

Sincerely,

John W. Ryan
President and CEO
Conference of State Bank Supervisors
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Authors: Juan Benavides, Liam Benson, Byron McClendon, Jake Mlsna, Kirk Wright
Advisor: Matthew Whitledge, Ph.D.

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The Bank Secrecy Act in the 21st Century: A Study of Farmers and Merchants Bank
Authors: Manushree Bhatt, Homer Eliades, Henry Haas, Daniel Horowitz, Alexis Kakar
Advisor: Dr. Carl Larsson

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Authors: Seungho Lee, Anthony Mastroianni, Abi Welch, Sarah Hart
Advisor: Dr. Atika Benaddi
Co-Advisors: Dr. Xiaoxuan Ji, Dr. Xia Zhou
Citizens National Bank (CNB) was founded in Meridian, MS in 1888, and has faced years of economic turmoil while remaining dependable in its communities. CNB fought hard to remain open during the Great Depression and was one of only six banks in Mississippi to immediately resume serving the public following the federally imposed “bank holiday.” CNB has grown organically through the years and has not needed mergers or acquisitions to grow and maintain its respect in its community. Today, CNB has grown to have nearly $1.5 Billion in total assets and has increased its net income by over 60% in the last five years.

This case reviews how the Bank Secrecy Act of 1970 (BSA) affects community banks, and how much time, money, and resources are needed to comply with regulations. Many smaller, community banks are concerned that the Bank Secrecy Act and the Anti-Money Laundering requirements outweigh the benefits. BSA was originally intended to aid investigations into criminal activity such as income tax evasion and money laundering. The USA Patriot Act of 2001 was passed in response to the terrorist attacks on September 11, 2001 and is primarily focused on stopping money laundering and terrorist financing. BSA and AML regulations have required banks to report any suspicious activity that may be linked to money laundering, tax evasion, or other illicit activities.

Our findings suggest that although BSA/AML regulations are pricey for community banks, CNB has been able to lower the costs associated with it. By educating all employees on measures needed to stop fraud and having a top team of BSA specialists, the bank as a whole has done an excellent job finding and reporting suspicious activity. By fulfilling the needs of customers across Mississippi, CNB has gained the trust of its members and is in a position to become the top community bank in Mississippi.
The U.S. Government created the Bank Secrecy Act (BSA) in 1970 to combat fraudulent activity such as money laundering and drug trafficking ("§ 5311"). The world has since changed, but the BSA has remained largely the same ("BSA Timeline"). This case study examines how a specific community bank, Farmers and Merchants Bank (F&M Bank), is affected by the current framework of the BSA.

F&M Bank is a community bank located in the Shenandoah Valley region of Virginia. It is headquartered in Timberville, Virginia, a small town of about 2,600 residents. It opened in 1908 and has proudly served the area for over 100 years. The bank now has fourteen branches located throughout the region. Mark Hanna is the current President and Chief Executive Officer (CEO) of F&M Bank. Similar to other community banks, F&M Bank’s goal is to grow the bank prudently and develop relationships for the benefit of the bank and its clients.

Although F&M is a small bank, the challenges it faces are pressing to financial institutions of all sizes. Our findings reveal that one of the main issues with BSA is the lack of coordination between involved parties such as the Financial Crimes Enforcement Network (FinCEN), law enforcement, and regulators. Moreover, we discover that BSA does not take advantage of modern technology. F&M Bank also engages in a common practice called de-risking. This limits the services that the bank is willing to provide to customers. Solving these issues would benefit not only F&M Bank but thousands of community banks in the United States.

Our methodology is as follows. In Section 1: Financial Analysis, we begin by reviewing F&M’s financials. We look primarily at data from its Uniform Bank Performance Report (UBPR) and 2019 Form 10-K filing. Our conversation with CEO Mark Hanna provides us insight into F&M Bank’s operations and financial goals. In Section 2: Bank Secrecy Act Compliance, we discuss F&M Bank’s ability to address the BSA protocol. The majority of this information comes from in-person interviews with the three staff members on the BSA team. In Section 3: Technology and Innovation, we investigate F&M Bank’s current BSA software. Moreover, we witness a demonstration of its software, YellowHammer, and gather information from team members about their experiences using it. Finally, in Section 4: Policy Recommendations and The Future of BSA/AML Reform, we consider legislation, which we believe would remedy F&M Bank’s BSA concerns. Additionally, we interview a Capitol Hill staff member who is working on legislation to reform the outdated policies of the BSA.

Our findings are as follows. In Section 1, we determine F&M Bank generates more revenues
than its peer group through its productive loan portfolio. Further, strategic asset allocation drives its portfolio’s value, and management seeks additional exposure by expanding its agricultural loan base. F&M Bank has historically exercised a values-driven credit philosophy (Strischek); however, recently they have created policy to bank hemp farmers, which is legal under the 2018 Farm Bill legislation. In Section 2, we find that although anti-money laundering policies are tedious for F&M Bank’s three-person BSA/AML team, they are useful in combating most instances of fraud. In Section 3, we discover that F&M Bank’s YellowHammer software, while not the latest software available, cost-effectively serves its needs. To reduce BSA compliance costs, they dictate when and which employees to send to BSA school. Additionally, the BSA/AML staff collaborates with local banks to discuss practical, cost-saving strategies. In Section 4, we recommend the recent Illicit Cash Act legislation. This legislation would transfer beneficial ownership liability away from F&M Bank, as well as update provisions of the BSA. In addition, the Act’s allowance for experimentation with newer and more affordable software could lead to cheaper and more accessible BSA software for smaller financial institutions.

The Bank Secrecy Act legislation is crucial for safeguarding our financial system. In an increasingly digital world, the threat of fraudsters to financial institutions is ever-present. This is especially important to study in community banks as they make up 92% of banks in the U.S. (Wooten). Alleviating the burdens that the BSA causes community banks has the potential to vastly increase the efficiency of the American financial system. This case study explores the methods and legislation available to minimize the cost of BSA compliance and streamline communication channels to foster an environment of shared resources.

1. De-risking is, “the practice of banks limiting certain services or ending their relationships with customers to, among other things, avoid perceived regulatory concerns about facilitating money laundering” (U.S. Government Accountability Office).
The Bank Secrecy Act (BSA) and anti-money laundering (AML) regulations affect all community banks in the country. The regulations exist to promote financial transparency to defer and detect criminals from committing crimes such as money laundering and terrorist financing. However, community banks often find that many BSA/AML policies are outdated, extremely costly, and labor-intensive. Citizens & Northern Bank (known as and hereinafter referred to as C&N), a community bank located in Wellsboro, Pennsylvania, is one of those institutions that diligently comply with BSA/AML yet feels there is a need for certain pieces of legislation to accommodate community banks. In this case study, we will examine how C&N manages its resources to account for BSA/AML compliance and identify potential political reforms that would benefit community banks.

Although Congress passed the Bank Secrecy Act in 1970, it has vastly evolved in the past 50 years. At the time, the act was a monumental bill for financial institutions that laid the framework for the requirements regarding record-keeping and reporting. BSA not only affected banks, but other institutions such as money service businesses, loan companies, and investment firms. They also had to report all cash transactions, using a Currency Transaction Report (CTR), that exceed $10,000; identify the persons conducting the transactions; and keep records of the financial transactions.

In 1990, Congress established the Financial Crimes Enforcement Network (FinCEN) as a bureau in the U.S. Department of the Treasury to safeguard the financial system. This became a separate entity to administer the Bank Secrecy Act and collect and analyze data related to financial crimes. However, BSA developed most significantly after the passage...
of the USA Patriot Act in 2001. This legislation expanded the regulatory requirements for all banks to combat money laundering and block all terrorist financing. In addition, the Patriot Act gave financial institutions an outline on how to organize their compliance programs most effectively.

There are five main pillars that all banks and credit unions must adhere to regarding BSA/AML requirements: maintaining a formal written policy, having dedicated compliance personnel, using independent testing of the institution’s BSA/AML program, and ensuring that all appropriate employees of the bank receive proper training, and maintaining customer due diligence (CDD). The fifth pillar became effective July 2016 and deemed that all financial institutions comply by May 2018 ("FinCEN Adds"). Part II and III of this case study will further examine how C&N complies with BSA/AML requirements by explaining the processes the bank uses to conduct its risk assessment and how it structured its compliance function.

One commonly accepted definition of community banks is that they have less than $10 billion in assets. There are just above 5,000 of them in the country. Between 2014 and 2018, they collectively spent $4.9 billion in regulatory costs (Reosti). In addition, many community banks do not have the capability of using expensive BSA software to address the growing complexities of the regulations and, consequently, rely on manual processes. Many community banks feel the outdated framework is more of an exercise in completing the reports, rather than an efficacious process to limit financial crimes.

Reports are labor-intensive to complete, and most do not result in criminal indictments. Community banks, such as C&N, believe policy reform should work toward modernizing BSA/AML regulations to accommodate banks that do not have the sizable resources to spend on regulatory costs. Part VI of this report will explore more closely what other legislative measures C&N feels would benefit the bank most effectively.
Mississippi State University

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Juan Benavides
Liam Benson
Byron McClendon
Jake Mlsna
Kirk Wright

**Faculty Advisor:**
Matthew Whitledge, Ph.D.

**Citizens National Bank and the Bank Secrecy Act and Anti-Money Laundering Act**

**Bank Background**

Citizens National Bank of Meridian, MS (CNB) was founded in 1888 by a group of businessmen and farmers with one goal in mind, “to be an economic engine that creates growth and development in the Mississippi” (yourcnb.com). This “engine” is built upon a foundation of trust with its customers and their communities. CNB acts as a partner to the growth of its communities by providing what large one-size-fits-all banks cannot: flexible and responsive banking tailored to each business’s and individual’s needs.

This competitive advantage provided by CNB is becoming increasingly valuable today. Since 1980, the number of bank organizations has decreased from 15,000 to approximately 4,500, approximately a 70% decrease (FRED). Today the top five banking institutions hold...
approximately $7,843 billion in assets, 42% of the baking industry assets (fdic.gov). As these large corporations continue to consume the competition, community banks become rarer and more valuable. CNB has made it a focus to grow to regional size despite this trend of acquisitions throughout banking institutions. CNBs determination and ability to be a key member of their community sets them apart from these larger banks.

Citizens National Bank has done an excellent job by making their primary focus to serve its community and to remain a community bank. CNB started with only $50,000 and a small store on a dirt road; today, CNB manages around $1.432 billion in assets and has grown into 15 communities with 28 branches. There is a high-risk of mergers and acquisitions for community banks across the nation. However, CNB successfully stuck to their mission and vision statement stated within their “Declaration of Independence” (yourcnb.com). This “Declaration” portrays that CNB will continue to build the trust of its customers by focusing on Mississippi’s future and encouraging personal, business, and community development that “finances the dreams of Mississippians.”

Part I: Financial Analysis

Discussion of Peer Group

The peer group we have selected for Citizens National Bank (CNB) is comprised of 176 banks in 41 different states. A peer group (PG) that is likely to be the most accurate would be based on asset size, in which we gave a range of about $500 million. This includes institutions from about $1.18 billion to about $1.685 billion at the end of 2019. We wanted to include a large enough sample of institutions around the nation without including institutions that are either too large, or too small, to be accurately compared to CNB. A detailed summary of both CNB and the peer group can be found in Appendix A.

Earnings Performance

After a thorough review of Citizens National Bank’s financial data and performance, it is apparent that the bank has seen strong growth in earnings over the last five years. Net income has increased from $16.3 million in 2015 to $26.4 million in 2019. CNB’s growth has come organically, without acquisitions, and is due to its relationships within the community. CNB has an excellent relationship with the members in its community and uses their relationships in part to fuel their growth in Mississippi. Due to the bank’s leadership and financially sound decision making, CNB was able to outperform its peers (PG) over the last 5 years in both net income and total revenue.

<table>
<thead>
<tr>
<th>Date</th>
<th>Net Income CNB</th>
<th>Average Net Income PG</th>
<th>Total Revenue CNB</th>
<th>Average Total Revenue PG</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/15</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>12/31/16</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12/31/17</td>
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<td></td>
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</tr>
<tr>
<td>12/31/18</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>12/31/19</td>
<td></td>
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</tbody>
</table>
The net income growth of 61% over the last 5 years has outperformed its peer group. Chief Financial Officer of CNB, Mr. Jeremy Stringer, has attributed this rapid increase in part to its “large increase in loans and its effect on interest income.” Although the costs of compliance for BSA and AML legislation can be expensive for community banks, Mr. Stringer said that “these costs have not had a considerable influence on net income or earnings performance.” CNB’s net income has had a more consistent growth rate than its peers, and has grown at a quicker rate, growing 8% more than its peers over a 5-year period.

On average, CNB has outperformed its peers in controlling its income and expenses by having a larger percentage of interest and non-interest income relative to its total assets and a smaller percentage of interest expenses. The higher percentage of interest income is partly due to the bank’s increase in loans. CNB’s percentage of non-interest income is relatively low because community banks are less reliant on non-interest income and have a smaller amount of fees than larger banks. The top management at CNB has been very efficient in managing its costs, which has led to a low expense and high-income percentage of total assets resulting in CNB outperforming their peers. CNB wants a lower efficiency ratio because it indicates that the bank is earning more than it is spending. In a five-year period, CNB has lowered its efficiency ratio from 69% to 60% from 2015 to 2019 and is moving closer to the optimal 50%. CNB has outperformed its peer group in having a better average efficiency ratio and is more profitable than its peers.
Loan Portfolio Composition

Citizens National Bank’s loan portfolio is largely comprised of real estate loans. In 2019, real estate loans consist of 55.92% of the loan portfolio and is the bread and butter of the lending process for CNB. Mortgage lending covers 20.46% and has been a focus for CNB to pursue in lending. Commercial and Industrial loans are the second largest category of loans for CNB at 9.77%. CNB has maintained a trend of very similar loan composition over the last several years.

Over the last several years, CNB has focused on increasing their commercial lending and SBA lending. SBA loans can guarantee up to 85% of the loan, allowing banks to mitigate their risk through the SBA loan process. The breakdown of the loan portfolio table below portrays the

<table>
<thead>
<tr>
<th></th>
<th>2015 (Sm)</th>
<th>2016 (%)</th>
<th>2016 (Sm)</th>
<th>2017 (%)</th>
<th>2017 (Sm)</th>
<th>2018 (%)</th>
<th>2018 (Sm)</th>
<th>2019 (%)</th>
<th>2019 (Sm)</th>
<th>Total Growth (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>All real estate</td>
<td>649.03</td>
<td>8.10%</td>
<td>706.27</td>
<td>6.87%</td>
<td>758.35</td>
<td>5.24%</td>
<td>800.27</td>
<td>0.81%</td>
<td>806.84</td>
<td>23.42%</td>
</tr>
<tr>
<td>Farm loans</td>
<td>0.48</td>
<td>2.04%</td>
<td>0.49</td>
<td>28.99%</td>
<td>0.69</td>
<td>-72.50%</td>
<td>0.4</td>
<td>79.06%</td>
<td>1.91</td>
<td>294.01%</td>
</tr>
<tr>
<td>Commercial and</td>
<td>123.23</td>
<td>-1.59%</td>
<td>121.3</td>
<td>8.46%</td>
<td>132.51</td>
<td>-0.51%</td>
<td>131.84</td>
<td>3.61%</td>
<td>136.78</td>
<td>13.57%</td>
</tr>
<tr>
<td>Industrial loans</td>
<td>28.20</td>
<td>5.62%</td>
<td>29.88</td>
<td>-3.07%</td>
<td>28.99</td>
<td>-3.42%</td>
<td>28.03</td>
<td>-5.77%</td>
<td>26.5</td>
<td>-8.83%</td>
</tr>
<tr>
<td>Loans to individuals</td>
<td>15.27</td>
<td>28.51%</td>
<td>21.36</td>
<td>9.34%</td>
<td>23.56</td>
<td>-4.80%</td>
<td>22.48</td>
<td>-4.51%</td>
<td>21.51</td>
<td>38.94%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>2015 (PG)</th>
<th>2016 (PG)</th>
<th>2017 (PG)</th>
<th>2018 (PG)</th>
<th>2019 (PG)</th>
<th>2019 (PG)</th>
</tr>
</thead>
<tbody>
<tr>
<td>All real estate</td>
<td>54.17%</td>
<td>51.60%</td>
<td>53.69%</td>
<td>53.01%</td>
<td>56.95%</td>
<td>53.84%</td>
</tr>
<tr>
<td>Farm loans</td>
<td>1.62%</td>
<td>2.27%</td>
<td>10.29%</td>
<td>1.04%</td>
<td>3.35%</td>
<td>1.48%</td>
</tr>
<tr>
<td>Commercial and</td>
<td>1.57%</td>
<td>1.04%</td>
<td>10.29%</td>
<td>10.29%</td>
<td>1.05%</td>
<td>1.05%</td>
</tr>
<tr>
<td>Industrial loans</td>
<td>1.57%</td>
<td>1.72%</td>
<td>1.72%</td>
<td>1.72%</td>
<td>1.72%</td>
<td>1.05%</td>
</tr>
<tr>
<td>Loans to individuals</td>
<td>1.57%</td>
<td>1.04%</td>
<td>1.04%</td>
<td>1.04%</td>
<td>1.04%</td>
<td>1.04%</td>
</tr>
<tr>
<td>Total other loans</td>
<td>1.57%</td>
<td>1.04%</td>
<td>1.04%</td>
<td>1.04%</td>
<td>1.04%</td>
<td>1.04%</td>
</tr>
</tbody>
</table>
growth over the last several years in dollar terms regarding lending in the past five years. Since 2015, real estate lending has grown 23.42% and has shown to be a significant portion of the overall growth of CNB.

The peer group consisted of financial institutions ranging from $1.18 billion to $1.68 billion in assets. Providing a range of $500 million allowed for accurate comparison and evaluation of the loan portfolio of similar size banks, which is particularly important for portfolio composition. The portfolio breakdown of the peer group is very similar to Citizens National Bank. After further analysis, we see the growing trend in real estate lending. According to Freddie Mac, since 2018, the average fixed 30-year and fixed 15-year mortgage rates have steadily been declining. The cost of borrowing for customers has steadily declined, and you can see they are utilizing this time to continue to borrow.

**Asset Growth**

Between 2015 and 2019, the bank saw a 19.56% growth in their total assets from $1.198 billion to $1.432 billion. This translates to a year-over-year growth of about 4.63% for the bank. Its growth in assets was completely organic, meaning that it was done so without any mergers or acquisitions. We can compare the growth rate of CNB to that of the peer group which grew total assets by 35.61%, but 70 of the 176 institutions grew with at least one acquisition.

The growth in total assets of CNB was similar to the trend in the growth of earning assets (Net Loans and Leases plus Investment Securities) which grew 19.71%, about $221 million, over the same period. The bank’s growth in earning assets contributed to just over 94% of all asset growth over the 5-year period. This was slightly larger than that of the peer group, whose earning assets contributed to just under 92% of asset growth between 2015 and 2019.

As Mr. Stringer (CFO) said, this growth can be broken down into two timeframes. The first

<table>
<thead>
<tr>
<th>Year</th>
<th>PG Growth %</th>
<th>CNB Growth %</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016</td>
<td>7.79%</td>
<td>9.80%</td>
</tr>
<tr>
<td>2017</td>
<td>1.22%</td>
<td>7.99%</td>
</tr>
<tr>
<td>2018</td>
<td>8.37%</td>
<td>7.50%</td>
</tr>
<tr>
<td>2019</td>
<td>6.17%</td>
<td>6.17%</td>
</tr>
</tbody>
</table>

**CNB Asset Growth vs. Peer Group**

<table>
<thead>
<tr>
<th>Year</th>
<th>PG Growth %</th>
<th>CNB Growth %</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>$1,122,819</td>
<td>$1,238,475</td>
</tr>
<tr>
<td>2016</td>
<td>$1,238,475</td>
<td>$1,254,119</td>
</tr>
<tr>
<td>2017</td>
<td>$1,254,119</td>
<td>$1,273,125</td>
</tr>
<tr>
<td>2018</td>
<td>$1,273,125</td>
<td>$1,344,124</td>
</tr>
<tr>
<td>2019</td>
<td>$1,344,124</td>
<td>$1,344,124</td>
</tr>
</tbody>
</table>

**CNB Earning Assets vs. Non-Earning Assets ($ in 000’s)**

<table>
<thead>
<tr>
<th></th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earning Assets</td>
<td>$1,122,819</td>
<td>$1,238,475</td>
<td>$1,254,119</td>
<td>$1,273,125</td>
<td>$1,344,124</td>
</tr>
<tr>
<td>Non-Earning Assets</td>
<td>$75,260</td>
<td>$76,992</td>
<td>$77,374</td>
<td>$76,036</td>
<td>$88,323</td>
</tr>
</tbody>
</table>
major period of growth, from 2015 to early 2018, was driven by a growth of about $165 million in the bank’s net loans and leases. According to Mr. Stringer the second stage of growth, from early 2018 to late 2019, a large jump in deposits fueled the growth which is reflected in the increased investment in securities of about $40 million. According to the 2019 CSBS National Survey of Community Banks, which consisted of 571 institutions in the sample, 22.8 percent stated that the “single greatest challenge” their bank is facing presently is growing core deposits (CSBS 25). With this second stage of growth in CNB, we can see that it is staying ahead of the curve with this challenge.

Capital Levels and Planning

Seifried and Brew, LLC recognized Citizens National Bank as being ranked in the top 15th percentile of community banks. This achievement gives spotlight to high-performing community bank that have demonstrated “exemplary” understanding of balancing risk and reward by management. CNB, looking to continue to be ranked among the best banks in the country, wants to maintain its capital level in relation to the minimum ratios that were set by Basel III. Basel III requires a minimum of 6% capital ratio. Both the peer group and CNB’s minimum ratios are currently above average. CNB has historically stayed above average dealing with its Tier 1 Risk-based Capital. For the last five years, Tier 1 Capital has maintained a relatively constant level around 10%. According to Basel III, the minimum required Tier 1 Capital ratio is 8%. The bank has a ratio of 10% which implies they are in good capital health. Taking this into consideration, it is safe to consider the bank to be well-capitalized institution.

In the future, CNB is looking to further invest into loans supported by the SBA lending program. During these last five years, there has been a major growth in the company due to loan growth and deposits. Mr. Stringer commented that the bank was placing more focus on loan growth and deposits.

Liquidity

One measure commonly looked at to measure a banks liquidity is their Net Loans and Leases to Deposits Ratio (LDR). LDR measures a banks liquidity by comparing a bank’s loans (assets) to its total deposits (liabilities) within the same time period. A higher LDR indicates that a bank may be taking on additional risk by not have enough liquidity to handle large unexpected expenses,
while a lower LDR may indicate that a bank is not using its cash effectively or that it is in a risk averse position. As shown in the graph, CNB’s Peer Group has steadily increased its Net Loans and Leases to Deposits Ratio from 80% to 86% in the last four years. During this same time period, Citizens National Banks LDR has varied between 74% and 80% which is on the conservative side. This indicates that CNB has a higher liquidity, and thus in a safer position for an economic downturn, than its peers. Although, this could also suggest that CNB could more effectively use this source of funding for higher profitability.

Citizens National Bank has maintained lower Net Loans and Leases to Deposits Ratio, thus higher liquidity, compared to their Peer Group. Mr. Jeremy Stringer, CNB’s CFO, stated that CNB has been able to maintain an acceptable balance of profitability and risk by effectively managing their costs and diversifying their non-interest income through Off-Balance Sheet items, specifically their trust department. CNB’s off-balance sheet items provide revenue outside of the Loans and Leases account. Although this is an advantage, CNB plans to improve margins from their Loans account in the near future. Mr. Stringer mentioned that CNB has plans to increase their Net Loans and Leases to Deposits Ratio up to 85%, better utilizing this source of funding to increase earnings and profitability.

A major advantage that Citizens National Bank has that allows it to obtain these desired profits is its centralized locations and community bank status. Since CNB does not have any branches outside of Mississippi, it is not required to meet the LDR ratios set forth in Section 109 of the Riegle–Neal Interstate Banking and Branching Efficiency Act. This Act requires a bank’s statewide LDR ratio to be at least one-half of the relevant host state LDR ratio. As of 2018, Mississippi’s surrounding states LDR averages 85%. If CNB were to move into these states, it would prohibit the flow of investments CNB is able to provide its current communities. This action would also limit the greater flexibility and control CNB has over its liquidity compared to similar sized inter-state banks.

### Part II: Bank Secrecy Act and Anti-Money Laundering Act (BSA/AML) Compliance Assessment

CNB frequently conducts an overall risk assessment in which those involved with BSA monitor financial information to see how many Suspicious Activity Reports (SARs)
they have that month, and why they might have occurred. CNB’s compliance manager, Ms. Kelly Menard, believes that information is key when trying to better assess the bank’s risk. Ms. Menard assesses several key components such as the type of loan, individual characteristics, sales, number of visits, and type of transaction to name a few. CNB gathers information from compliance software, Verafin, that efficiently and quickly outputs data to the company. CNB then looks for any trends in the data and monitors these trends for further analysis.

After the data is analyzed, CNB reports the SARs and Customer Transaction Reports (CTRs), and tries to find out why they happened and what can be done in the future to prevent them. Verafin notifies CNB of possible suspicious activity and can be programmed to look for certain things. If a SAR is filed, Verafin can notify other banks of the activity as further preventive measures. Verafin uses machine learning, which can help streamline the process in further months by providing more accurate reports on suspicious activity. Through an experienced staff, CNB has been able to fine-tune the software’s parameters to limit the number of false alerts. Prior to Verafin, CNB could have up to 1,000 alerts about suspicious activity, but that number is down to about 300 alerts per month.

Citizens National Bank takes BSA/AML compliance very seriously and has three dedicated employees to its compliance, each with a different focus. With the help of Verafin, they can gather and assess data very quickly and easily. Employees within their BSA department have covered many roles over time with the goal to improve timeliness so CNB can quickly recognize suspicious activity. This has made all their monthly compliance tasks much easier and has greatly shrunk the time on assessing possible suspicious activity. All full-time employees at CNB are required to take annual webinars and classes to stay up to date with their BSA/AML compliance training. New hires must also attend these webinars and classes and must take a test to ensure their readiness to locate suspicious activity. By constantly monitoring activity throughout the bank, CNB ensures that all its employees are complying with BSA/AML regulations and that all suspicious activity is being reported.
CNB views its overall compliance costs for BSA/AML as “scaled fixed costs” which means that as CNB grows, so will the banks compliance costs. These costs are also viewed as an expense that must happen every year. Other than having three employees dedicated to compliance, the most expensive component of complying by BSA/AML guidelines for them is the compliance software, Verafin. That was described as “the Cadillac” of BSA/AML systems by CEO Archie McDonnell. CNB realizes that as the bank grows, the bank’s compliance costs will grow with them. Although Verafin is expensive, costing CNB about $50,000 annually, it is viewed as a necessity for the bank and is very valuable for the bankers. With the help of Verafin, CNB was able to reduce the hours spent by employees for BSA/AML compliance. One employee’s former duties were condensed into a process that is done in just 10 hours per month. Since then, this has given the employee a different workload and allows more time to focus on projects and SAR investigation. CNB, having the ability to reallocate jobs and increase workload since Verafin, has been one of the driving factors behind it reducing costs associated with BSA/AML compliance.

CNB has invested money in employee training and its software to ensure it meets BSA requirements. After a review of available options, CNB reached an agreement to change its software and utilize Verafin as its software around five years ago. In only a short span, Verafin has proven to be a valuable addition to the company. CNB can pinpoint any deviation from compliance by using the skills of their employees along with Verafin, through constant monitoring. Any report of suspicious activity will be alerted to the bank via Verafin. Once the bank receives the alert, the BSA department will investigate and conduct research on the alert. CNB focuses heavily on BSA training and effective communication. The bank cooperates externally by working with an auditor who ensures compliance. CNB has worked hard to enhance due diligence reviews and enjoy successes from it. Efficiency has improved with the implementation of the system and with reorganization of employee duties. In the future, the bank will continue to protect itself.

**Challenges under BSA/AML**

Working under the BSA can be difficult at times. CNB is a relatively small bank and regulations can be more difficult to follow compare to larger banks. Smaller banks usually lack the manpower to keep up with what needs to be
done. More requirements and more reporting standards to follow may leave smaller banks with more paperwork than they can handle. Along with the workload, the communication between banks and the government should be addressed. Banks are required to send their reports to the government, but the government does not relay information back to the banks. After receiving the reports, the government should find a way to utilize that information to assist banks. Mr. Stringer and Ms. Menard both agree that banks are the “eyes and ears” of BSA/AML. They could be better equipped to handle SARs.

**Part III: Technology, Innovation, and Collaboration**

The role of technology has dramatically changed the way that community banks operate. Technology can take tasks that would have required multiple employees and taken extended periods of time to complete and reduce this time tremendously. In CNB’s case with BSA and AML compliance, Verafin is the star of the show when it comes to technology. Verafin considers itself “the industry leader in Financial Crime Management solutions,” and their “software is used by nearly 3000 financial institutions” (Verafin.com). Verafin is a comprehensive financial crime management system that uses artificial intelligence (AI) and machine learning, along with user inputs, to improve efficiency. An example of this is when a customer opens a new account, they would fill out information on their intended use of this account. If there are deviations from these known uses, Verafin will send an alert through the system and the alert will be further investigated. Ms. Menard (CNB’s Compliance Manager) stated that since the bank started using Verafin five years ago, they have been able to reduce the number of alerts per month from about 1,000 to just 300. The reduction of time spent on investigation of false, or low-risk alerts, has allowed the department to prioritize its investigation of suspicious activity. Ms. Menard also stated that it is about finding the “sweet spot” for the system to trigger alerts, where the bank does not have such a wide array of activity which may trigger an alert, but also that the scope is not too narrow where the bank may miss suspicious activity. Ultimately, the more information that is held about customers, the better the system will run for the bank. This is a significant advantage that a community bank has over its larger counterparts in knowing more about its customers.

*The role of technology has dramatically changed the way that community banks operate.*
When asked why CNB chose Verafin for their BSA compliance software, there was a consensus that it had some of the best training and support of their options. Mr. McDonnell (CEO) also added that it is because Verafin “is the Cadillac of BSA software.” While not surprising from the CFO, one thing that could make this better, according to Mr. Stringer (CFO), is the price point. At $50,000 per year, Verafin is one of the more expensive options for software on the market, and it would be beneficial if this price could be scaled better for smaller community banks. Another thing that could make the Verafin software better, from the perspective of CNB, would be its collaboration capacity. Verafin may be collaborative in nature, but where it may lack is that it only uses trends and insight from institutions within its network. The ability to gain insight from sources outside of its network would be a valuable addition.

An October 2018 joint statement from the Financial Crimes Enforcement Network (FinCEN) and its other federal banking regulatory counterparts (Federal Reserve, FDIC, NCUA, OCC) stated that smaller community banks now have the ability to “use collaborative arrangements to pool human, technology, or other resources to reduce costs, increase operational efficiencies, and leverage specialized expertise” (Interagency Statement on Sharing Bank Secrecy Act Resources, fincen.gov). Although this may be viewed as beneficial to small community banks, there are still many hurdles that they must face when collaborating. The first issue comes with customer privacy.

With sharing human, or technological, resources an issue arises of how to conduct collaborative business functions without interfering with customer privacy. One point where Mr. Stringer was critical of this statement was in saying that FinCEN and other agencies may have stated that collaboration is okay for these community banks, but the agencies do not give guidance on how to properly collaborate without violating certain rules and regulations of the industry. This may put an added burden on the side of the smaller community banks.

Most collaboration that is done by the bank for purposes of BSA/AML compliance is being done so through Verafin. Verafin has a collaborative cloud in which it shares current trends of certain “risky” customers and potential offenders. This information and current trends can be entered by banks on the Verafin network and if a risky customer signs up for a new account at a new bank, this new bank will get an alert that the customer has been involved in suspicious activity. The downside of this is that CNB will only see current trends of customers at banks within Verafin’s network, and although it is used by many institutions, it does not supply all info on potentially risky customers. Although they do not get full disclosure on every customer, collaborating through Verafin ensures that they are within federal guidelines and compliant with current regulations.

A suggestion made by the senior management of CNB was that the government could help with collaboration efforts. Since regulation requires banks to send reports of suspicious activity and other such events to the federal
government, it would be beneficial to all financial institutions, especially smaller institutions, if there was a backflow of information from the government or regulators. This backflow of information from them could inform the banks of current regional, and national, trends and certain risky customers from data compiled from institutional reports around the United States.

Citizens National Bank has established a strong, foundational relationship with local law enforcement as well as the attorney general’s office. Through this relationship, CNB has developed an effective way of reporting to the proper authorities. The measures over the recent years that CNB has been implementing has allowed CNB to provide accurate reporting to authorities of all levels. Local law enforcement helps financial institutions through these reporting through successful prosecutions. In addition, investigators from the attorney general’s office will reach out to CNB and ask for certain accounts that have been reported regarding certain issues. This aid gives CNB assistance with their own practices.

In 2019, CNB partnered with Zelle to offer person-to-person payments. This allowed customer a convenient avenue to make payments or send money to each other without sharing personal account information. Zelle is widely used in the financial industry and has proven to be a more reliable alternative for financial institutions to track BSA compliance methods. CNB expressed their concerns with customers using other applications means to deposit into their accounts. It is very difficult for financial institutions to track where transactions are coming from when customers use these other methods of transferring money.

Mr. Stringer expressed the idea of a backflow from the government and regulators to the bank on preventing fraud, implementing a clear two-way street that will allow smaller banks to gain additional insight regarding fraud and money laundering. This will allow banks to better prepare and protect themselves from potential future damage. The government has many resources that could be provided to community banks and assist with BSA compliances.

Part IV: Policy Recommendation & The Future of BSA/AML Reform

Clarification of Key Components and Compliance Expectations

Citizens National Bank has taken extensive measures to meet, and exceed, regulations set by the Financial Crimes Enforcement Network.
Citizens National Bank has taken extensive measures to meet, and exceed, regulations set by the Financial Crimes Enforcement Network (FinCEN) concerning the Bank Secrecy Act and the Anti-Money Laundering Act.

Citizens National Bank has taken extensive measures to meet, and exceed, regulations set by the Financial Crimes Enforcement Network (FinCEN) concerning the Bank Secrecy Act and the Anti-Money Laundering Act. These measures include extensive employee training, costly systems for customer identification, and creating vital relationships that directly improve their ability to comply. Despite these measures, CNB rigorously works to continue meeting BSA and AML requirements as technology improves and regulations increase. Senior Management at CNB believes that the BSA and AML are black and white in terms of conditions surrounding SARs, such as types of transactions and the amount and reoccurrence of transactions, but there is a lack of information directing banks on how to implement these regulations in a real-world environment. Top management at CNB recommends that clarifying the timing and process of how to perform these regulatory activities is necessary to ensure proper compliance.

Senior management at CNB also stated that requirements for Customer Identification Programs (CIP) are very broad, and better descriptions of the information needed would be beneficial. One area needing improvement is the documentation required for individuals to open accounts and be entered into the CIP. Different banks may require different information from customers. Some require a birth certificate or passport, while others want Social Security Card or other types of national IDs and driving licenses. This lack of consistency between institutions allows individuals to open various accounts with different banks, and thus creates a higher risk for cleaning cash by depositing multiple small amounts into these accounts.

Modernization of BSA and AML

Financial technology (FinTech) has advanced significantly over the recent years. One major area Senior Management at CNB spoke extensively about is electronic payments platforms. Platforms like Venmo and CashApp allow individuals to pay other individuals and transfer money seamlessly. Once a user of these systems uploads their banking information, they are free to use this money as they choose with a significant loss of tracking potential criminal activity. Banks that these accounts are connected to have no monitoring system for these transactions, as they do if a transfer or deposit was completed using the bank’s website or through another federally regulated
Banks have no access to what the payments are used for or where they come from. Individuals using these apps can also easily misrepresent what they are using the money for by using misleading short statements and descriptions connected with each payment. Although most of these platforms’ “User Agreements” state that cash transactions for illegal drugs and activities are prohibited, they are unable to effectively verify those restrictions. A survey done by LendEDU, an online marketplace for financial products, showed that 32.6% of Venmo users have performed transactions on its platform to pay for some type of drug (LendEDU). These platforms allow individuals to more easily launder and use cash for nefarious activities.

This regulatory burden should not fall on banks, but instead fall on these electronic payment platforms. As these electronic payment platforms fail to restrict their users from illicit activities, and the transfer and use of these funds are done through their platform, these companies should be held to the same standard and expectations as banks to prevent such activities. These platforms should meet similar regulations and requirements that banks meet to ensure that money laundering is fully prohibited. They should also face similar penalties for failing to meet these requirements as banks do. In addition, these platforms should provide and share information concerning illicit and suspicious activities to the banks their users’ accounts are connected with. These actions would further reduce money laundering activities and show the progression of regulations in conjunction with progressing technology.

**Burdens of BSA/AML Reporting**

Top management at CNB recognizes that a major issue facing community banks is the difficulty to meet the same rules and regulations that are also required for larger banks. Larger banks, with the ability to spread costs over larger pools of capital, are better suited to handle the increased costs and heightened regulatory burdens set by BSA and AML compliance. Community banks, such as CNB, have to follow these same laws with a vastly smaller budgets and less staff. CNB designates $50,000 annually for their compliance system, Verafin, along with a dedicated department of multiple staff members to effectively meet BSA and AML requirements. Many small institutions are unable to dedicate staff to these duties and must resort to allocating the duties among several employees with other primary responsibilities.

FDIC-insured community banks undergo the same examination as their larger counterparts, which takes valuable time and extensive resources to comply. These expenses account for a larger percent of income in community banks than larger banks, thus restricting a larger percent of investment into profitable areas. Research presented at the jointly sponsored conference by the Federal Reserve Bank (FRB), the FDIC, and the Conference of State Banks Supervisors at the FRB of St. Louis and replicated below, displays the higher percent of spending that compliance cost fills in smaller
banking institutions compared to larger banking institutions (Dahl et al). The survey by the Conference of State Bank Supervisors found that compliance as a percent of spending decreases from 17.7% for banks with under $100 million in assets to 9.7% for banks with assets between $1 million and $10 million, showing that an increase in asset size decreases the total monetary impact of compliance costs. CNBs total assets in 2019 were $1,432 million putting them in a category where compliance expenses are 9.70% of spending. When this assumption is applied to CNB, we can infer that CNB spent approximately $2.88 million on compliance costs alone in 2019.

Information Quality and SAR/CTR Submission

CNB currently uses Verafin, a sophisticated Artificial Intelligence (AI) system that records and recognizes customer trends. Trends that show potential threats are then shared with other banks within the Verafin network. Many variables, including those set by BSA/AML requirements, are input by CNB and then suspicious trends based on these variables are learned by Verafin. A potential course of action to improve the flow and quality of information would be to implement a similar system to Verafin across all banks or establish protocols for sharing data among similar systems that various banks use.

While banks report SARs, CTRs, and other information to show they are effectively meeting these regulations and help prevent fraud, no information is returned to the banks. This essentially causes an information barrier and prohibits banks from effectively protecting themselves. If this reported information was redistributed back to the banks, the in-house reporting systems would better recognize suspicious trends and potential fraud. This information would also help banks recognize individuals who have already set dangerous trends at other banks. The implantation of this type of system would be a major step toward ending illicit activities within and through banks, instead of mitigating these activities.
## Appendix A

### Figure 1. Citizens National Bank (Meridian, MS) Selected Data

<table>
<thead>
<tr>
<th>CNB Selected Data</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
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<tbody>
<tr>
<td>Employees ($ in 000's)</td>
<td>320</td>
<td>325</td>
<td>321</td>
<td>322</td>
<td>320</td>
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<tr>
<td>Total Assets</td>
<td>$1,198,079</td>
<td>$1,315,467</td>
<td>$1,331,493</td>
<td>$1,349,161</td>
<td>$1,432,447</td>
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<td>Total Assets (Growth)</td>
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<td>9.80%</td>
<td>1.22%</td>
<td>1.33%</td>
<td>6.17%</td>
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<td>Earning Assets</td>
<td>$1,122,819</td>
<td>$1,238,475</td>
<td>$1,254,119</td>
<td>$1,273,125</td>
<td>$1,344,124</td>
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<tr>
<td>Earning Assets (Growth)</td>
<td>---</td>
<td>10.30%</td>
<td>1.26%</td>
<td>1.52%</td>
<td>5.58%</td>
</tr>
<tr>
<td>Tier 1 Capital</td>
<td>$128,249</td>
<td>$129,324</td>
<td>$133,119</td>
<td>$138,114</td>
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<td>Tier 1 Capital (Growth)</td>
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<td>0.84%</td>
<td>2.93%</td>
<td>3.75%</td>
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<td>Revenue</td>
<td>$48,684</td>
<td>$52,527</td>
<td>$59,595</td>
<td>$65,238</td>
<td>$71,973</td>
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<td>Revenue (Growth)</td>
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<td>7.89%</td>
<td>13.46%</td>
<td>9.47%</td>
<td>10.32%</td>
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<td>Interest Income</td>
<td>$41,916</td>
<td>$44,995</td>
<td>$49,255</td>
<td>$54,423</td>
<td>$60,352</td>
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<td>Interest Income (Growth)</td>
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<td>7.35%</td>
<td>9.47%</td>
<td>10.49%</td>
<td>10.89%</td>
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<tr>
<td>Non-Interest Income</td>
<td>$13,664</td>
<td>$14,681</td>
<td>$17,707</td>
<td>$18,377</td>
<td>$19,143</td>
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<td>Non-Interest Income (Growth)</td>
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<td>7.44%</td>
<td>20.61%</td>
<td>3.78%</td>
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<td>Interest Expense</td>
<td>$2,962</td>
<td>$3,760</td>
<td>$4,572</td>
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<td>Interest Expense (Growth)</td>
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<td>26.94%</td>
<td>21.60%</td>
<td>63.95%</td>
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<td>Non-Interest Expense</td>
<td>$35,906</td>
<td>$36,371</td>
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<td>Non-Interest Expense (Growth)</td>
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<td>1.30%</td>
<td>2.74%</td>
<td>4.42%</td>
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<tr>
<td>Net Income</td>
<td>$16,373</td>
<td>$18,883</td>
<td>$23,398</td>
<td>$25,088</td>
<td>$26,461</td>
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<tr>
<td>Net Income (Growth)</td>
<td>---</td>
<td>15.33%</td>
<td>23.91%</td>
<td>7.22%</td>
<td>5.47%</td>
</tr>
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### Figure 2. Peer Group Selected Data

<table>
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</tr>
</thead>
<tbody>
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<td>($ in 000's)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Employees</td>
<td>222</td>
<td>232</td>
<td>242</td>
<td>249</td>
<td>266</td>
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<tr>
<td>Total Assets</td>
<td>$1,035,849</td>
<td>$1,116,585</td>
<td>$1,205,802</td>
<td>$1,296,253</td>
<td>$1,404,734</td>
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<tr>
<td>Total Assets (Growth)</td>
<td>---</td>
<td>7.79%</td>
<td>7.99%</td>
<td>7.50%</td>
<td>8.37%</td>
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<tr>
<td>Earning Assets</td>
<td>$957,198</td>
<td>$1,032,075</td>
<td>$1,115,745</td>
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<td>$1,296,099</td>
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<td>Earning Assets (Growth)</td>
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<td>7.82%</td>
<td>8.11%</td>
<td>7.53%</td>
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<td>Tier 1 Capital</td>
<td>$115,234</td>
<td>$123,884</td>
<td>$131,683</td>
<td>$140,736</td>
<td>$152,472</td>
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<tr>
<td>Tier 1 Capital (Growth)</td>
<td>---</td>
<td>7.51%</td>
<td>6.30%</td>
<td>6.87%</td>
<td>8.34%</td>
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<tr>
<td>Revenue</td>
<td>$50,201</td>
<td>$54,832</td>
<td>$60,941</td>
<td>$69,929</td>
<td>$70,731</td>
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<tr>
<td>Revenue (Growth)</td>
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<td>9.22%</td>
<td>11.14%</td>
<td>14.75%</td>
<td>1.15%</td>
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<tr>
<td>Interest Income</td>
<td>$38,271</td>
<td>$41,449</td>
<td>$46,676</td>
<td>$54,580</td>
<td>$58,662</td>
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<tr>
<td>Interest Income (Growth)</td>
<td>---</td>
<td>8.30%</td>
<td>12.61%</td>
<td>16.93%</td>
<td>7.48%</td>
</tr>
<tr>
<td>Non-Interest Income</td>
<td>$16,541</td>
<td>$18,101</td>
<td>$19,164</td>
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<td>$16,958</td>
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<td>Non-Interest Income (Growth)</td>
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<td>9.43%</td>
<td>5.87%</td>
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<td>Interest Expense</td>
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<td>$4,418</td>
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<td>Interest Expense (Growth)</td>
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<td>20.89%</td>
<td>53.48%</td>
<td>36.85%</td>
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<tr>
<td>Non-Interest Expense</td>
<td>$34,763</td>
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<td>Non-Interest Expense (Growth)</td>
<td>---</td>
<td>6.57%</td>
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<td>Net Income</td>
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<td>3.13%</td>
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<tr>
<td>Number of Institutions</td>
<td></td>
<td></td>
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<td>176</td>
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The Bank Secrecy Act in the 21st Century: A Study of Farmers and Merchants Bank

Financial Analysis

1.1 Section Overview

In this section, we conduct a financial analysis of F&M Bank ($813 million in total assets). To do this, we analyze data from its Uniform Bank Performance Report and 2019 Form 10-K filing. Additionally, we present details from our discussion with the executive management team. Our findings suggest that F&M Bank’s active loan portfolio and effective working capital management offset high BSA compliance costs. We now present these findings in more detail.

1.2 Earnings Performance

Our analysis of F&M Bank’s income statement reveals sound profitability defined by a 2.36% average Year-Over-Year (Y.O.Y) growth.
rate in earnings over the time interval 2015-2018. Following another strong year of profits in 2018 just north of $9 million, earnings fell in 2019 to $4.5 million. This decline in net income stems from several non-recurring items reported in its 2019 fourth-quarter earnings statement. First, in 2018, multiple upper-level executives announced their retirement. These retirements involved pension costs and severance benefits accruing to an estimated value of $1.5 million. In addition, management discovered an accounting error in November 2019 (Hanna). This accounting error brought forth additional expenses on the year. Above all, in 2019, management injected nearly $7.5 million in provisions to its Allowance for Loan & Lease Losses. This tactic intends to cover expected loan losses due to impairments on substandard loans and problem credits, as well as its forecast of the health and direction of the economy. Next, in Table 1, we outline key line-items from F&M Bank’s income statement to help us recognize its standard profitability.

As Table 1 shows, when measured against Peer Group 5 (PG5), F&M Bank returns a greater share of interest income and net interest income.

![Figure 1: F&M Bank’s Net Income from 2015-2019](Image)

This table depicts net income in $1,000s. Data source: UBPR, FFIEC

<table>
<thead>
<tr>
<th>Year</th>
<th>F&amp;M PG5</th>
<th>F&amp;M PG5</th>
<th>F&amp;M PG5</th>
<th>F&amp;M PG5</th>
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<tbody>
<tr>
<td>2015</td>
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<td>1.04</td>
<td>1.32</td>
<td>1.05</td>
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<td>2016</td>
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<td>4,541</td>
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<td>2017</td>
<td>2018</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>2019</td>
<td></td>
<td></td>
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</table>

Table 1: Income Statement Analysis for F&M Bank & Peer Group 5 from 2015-2019

This table provides a brief overview of income statement line-items as a percentage of average assets during the year for F&M Bank and PG5. Source: UBPR, FFIEC.
as a percentage of average assets. This spread is accomplished through robust growth in its loans held for investment. Further, F&M Bank continues to see a steady increase in both its noninterest income and noninterest expense. Its primary source of noninterest income is derived from investments made for businesses and individuals. Additionally, its noninterest expense covers personnel and various operating expenses, with personnel expenses making up the majority (58% in 2019) of total noninterest expenses. The last item in Table 1 depicts returns as a percentage of average assets, or ROAA. In Figure 2, we graph F&M Bank’s ROAA against PG5 to get a better visual.

As Figure 2 illustrates, aside from 2019, F&M Bank is generating healthy returns from its assets. Transitioning into 2020, management is certain that its proactive measures to cover loan losses will put F&M Bank back in position to yield strong returns at the start of the new decade.

1.3 Loan Portfolio Composition

Farmers and Merchants Bank has diversified its loan portfolio over its history through organic loan growth and expansion of local branches. In Figure 3, we examine its loan portfolio composition and find that real estate loans deliver about three quarters (75%) of its total value annually.

Given the history of F&M Bank, we expected agricultural loans to represent a larger share of its portfolio than illustrated. Moreover, F&M Bank branches sit beside two of the highest agricultural-producing counties in Virginia: Rockingham County and Augusta County (“Virginia”). This being said, management
has a renewed focus on developing this loan class. To elaborate, management is targeting an expansion in agricultural loans from 1% to 15-20% of its total portfolio value. Also, management recently hired an employee who specializes in the procurement and development of agricultural loans. In 2019, F&M Bank’s agricultural loans grew approximately $5 million. Further, during the first quarter of 2020, F&M Bank has added $5 million in agricultural-related loans (Hanna).

1.4 Asset Growth

Our survey of asset growth for F&M Bank suggests total assets increase yearly supported by its mature loan portfolio. In Figure 4, we see that F&M Bank has experienced routine growth in assets covering the last 5 years. In fact, the year 2019 marks its seventh consecutive year of positive total asset growth.

Next, we collect data from F&M Bank’s 2019 Form 10-K filing and summarize the major components of Net Loans & Leases in Table 2.

As reflected in Table 2, growth in loans held for investment is the core driver behind net loans and leases development. In 2019, net loans and leases declined led by a decrease in loans held for investment. This 2019 decline in loans held for investment is a result of management’s decision to partially write down a large problem asset. Lastly, we compare F&M Bank’s net loans and leases growth to PG5. As Figure 5 illustrates, since 2017, F&M Bank’s growth in net loans and leases has been volatile. This volatility exists because management is working to remove...
non-performing assets from its portfolio. Still, total assets are on track to grow for the eighth successive year.

1.5 Capital Levels

A new amendment to Basel III calls for a schedule of increasing “capital conversion buffers” to ensure banks have sufficient capital levels during periods of economic recession (“Capital”). As of 2019, this buffer totaled 2.5% above the minimum regulatory capital ratios. Effectively, the minimum requirements for a “well-capitalized” bank are as follows: Total Capital Ratio > 10.5%, Tier One Capital Ratio > 8.5%, Common Equity Tier One Ratio > 7.0%, Tier One Leverage Ratio > 5.0%.

After analysis of its capital levels, we find that F&M Bank exceeds the minimum requirements for a “well-capitalized” bank. As such, it is not restricted in terms of capital distributions and payments. In Figure 6, we notice that F&M Bank is currently over-capitalized as depicted by its high tier one leverage ratio. This equity cushion has permitted F&M Bank to repurchase shares on the open market and retain these shares as treasury stock. Though this operation reduces its capital levels, it benefits existing shareholders in the form of greater earnings per share. Another fact we uncover from Figure 6 is that F&M Bank has a smaller proportion of core capital to risk-weighted assets than PG5. Its lower tier one capital ratio is tied to the greater amount of non-performing assets on its balance sheet that carry a high credit risk.

1.6 Liquidity

Management actively monitors its liquidity position and trusts its Loans Held for Sale are a safe source of liquidity. Loans Held for Sale are
mortgage loans originated by F&M Bank and purchased by a mortgage aggregator. These loans are liquid because they are converted to cash within 5-10 days. The large amount of Loans Held for Sale in F&M Bank’s portfolio, however, inflates its loan-to-deposit ratio. In 2019, F&M Bank’s Loans Held for Sale as a percentage of average assets totaled 8.19%. In contrast, Peer Group 5’s figure was only 0.13%. In Figure 7, we compare F&M Bank’s loan-to-deposit ratio to its major competitors headquartered in Virginia. Based on this measure, F&M Bank has lower liquidity levels than its rivals in PG5. Despite this, management is confident it can meet both short and long-term obligations through its origination of individual mortgage notes and reliable business with its mortgage aggregator.

1.7 Section Summary
Following our financial analysis, we reaffirm F&M Bank’s capacity to bear the present high costs of BSA compliance through its revenue-generating portfolio of assets and growth in its net loans and leases. Further, we estimate that improved BSA compliance measures could relieve resources and stimulate a more productive workforce in the form of lower noninterest expenses.

2. Bank Secrecy Act Compliance

2.1: Section Overview
In this section, we examine F&M Bank’s techniques for complying with the Bank Secrecy Act. We look primarily at its current processes and assess the opinions of staff members on the effectiveness of compliance processes. Our overall findings reveal F&M Bank combats fraud effectively and utilizes all available resources to minimize operating costs. During our team’s conversation with the three-person BSA compliance team, there were few complaints about its anti-money laundering and fraud framework. Instead, there is pride in the bank’s ability to save money and bank higher-risk businesses.

2.2: F&M Anti-Money Laundering and Fraud Team Structure
F&M has three dedicated specialists who work on anti-money laundering compliance. They focus primarily on regular operations along with the technology associated with BSA. The Senior Vice President (SVP) of Deposit Operations and BSA officer heads the team. The most recent addition to the team works primarily with the day-to-day aspect of BSA, focusing on

Figure 7: Loan-To-Deposit Ratios for F&M Bank and its Rivals in PG5
This figure depicts loan-to-deposit ratios in percentage terms. Source: UBPR, FFIEC

<table>
<thead>
<tr>
<th>Bank</th>
<th>Ratio</th>
</tr>
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<tbody>
<tr>
<td>F&amp;M Bank</td>
<td>103%</td>
</tr>
<tr>
<td>Village Bank</td>
<td>99%</td>
</tr>
<tr>
<td>Bank of the James</td>
<td>89%</td>
</tr>
<tr>
<td>Virginia National Bank</td>
<td>86%</td>
</tr>
<tr>
<td>Peer Group 5</td>
<td>82%</td>
</tr>
<tr>
<td>Farmers Bank</td>
<td>68%</td>
</tr>
</tbody>
</table>
daily transactions. The other, more senior team member looks at things on more of an aggregate level, analyzing statistics and searching for patterns.

F&M Bank’s BSA compliance team does not work under its compliance department. Instead, its BSA compliance team is housed within F&M Bank’s deposit operations department due to the BSA expertise of the SVP of Deposit Operations. This arrangement allows for the compliance team to be in close proximity to deposit operations and improves communication between the groups.

2.3 F&M Risk Assessment

Risk parameters are the settings the bank inputs into its systems to determine which transactions are automatically flagged for further review. When setting risk parameters, F&M works primarily with a third-party processor who provides standards for similarly sized community banks. These standards are altered for common transactions such as check kiting and elder exploitation to decrease false-positive rates. Check kiting occurs when a person has multiple checking accounts with different banks and takes advantage of unprocessed funds or “float” by moving it back and forth (Walsh). This action creates the effect that the individual has more money in their account than they should. Further, elder exploitation is a type of fraud that tricks elders into spending resources on scams. By covering these common transactions, F&M Bank often does not have to change its parameters. In fact, during the twelve years the SVP has been with the bank, it has only changed them once. That change occurred in 2012 with the introduction of remote deposit transactions. These parameters are set with the objective of catching all instances of fraud. However, F&M Bank’s systems often flag legitimate transactions. These transactions are known as false positives. Despite the false positive rate, the system accomplishes its goal, which permits the BSA compliance team to examine flagged transactions.

F&M conducts annual risk assessments in March, which differ from the daily control associated with risk parameters and individual transaction monitoring. This assessment allows F&M to analyze emerging transaction trends and identify abnormal wire transfer patterns.

2.4 Recent Changes in F&M BSA Policy

One of the primary consequences of the Bank Secrecy Act on community banks is de-risking.
De-risking is, “the practice of banks limiting certain services or ending their relationships with customers to, among other things, avoid perceived regulatory concerns about facilitating money laundering” (U.S. Government Accountability Office). F&M has traditionally had to de-risk and remain selective in what kinds of businesses it provides with banking services. For example, they choose not to bank money service businesses as they are another risky category.

F&M recently created policy geared towards new legislation, The Farm Bill (2018), which legalizes hemp farming. Hemp-related businesses are considered high-risk by the banking industry due to their close association with marijuana (“Industrial”). FinCEN requires specific regulations and inspections, including checking that hemp crops are less than the 0.3% THC concentration level (Rowe). F&M was one of the first banks in the area to take advantage of the development of this newly legal business. A lack of direction from FinCEN makes it difficult for F&M to know what to do in unique situations such as hemp agriculture. F&M hopes to get more clarity regarding the banking services that it can provide for these farmers.

2.5 Cost of F&M BSA Compliance

F&M does not explicitly have a line item in its financial statements for the cost of BSA compliance. In our conversations with the team, they said they were not able to quantify compliance costs specifically. However, the bank’s BSA cost centers consist of the two day-to-day BSA operations’ employee salaries, the cost of YellowHammer software, and the cost of training. This is significant as all of the bank’s branches, including its corporate office, have about 170 staff members with three of these staff members dedicated almost entirely to BSA compliance (“Annual Report”). That equates to about 1.76% of the bank’s manpower going just to complying with this legislation.

All three members of the BSA compliance team were sent to BSA school, a significant expense for F&M. They continue to attend new training sessions and educate themselves as legislation changes. They utilize networking to save on costs and find out about other best practices. Along with five or six other local banks in the area, they meet with professionals from Adult Protective Services (APS) and law enforcement to talk about common types of fraud and how to combat them as efficiently as possible.

F&M has traditionally had to de-risk and remain selective in what kinds of businesses it provides with banking services.
unique opportunity is crucial because it is a cost-efficient way to reduce costs for all the community banks in the area.

2.6 BSA Challenges and Future Outlook
Proving Beneficial ownership is a significant challenge for F&M as it leaves the responsibility of proving individual and corporate identity on the team. Beneficial ownership is defined as, “a person who enjoys the benefits of ownership even though the title to some form of property is in another name” (Chen). Banks must create policies for how they will verify the identity of the corporate account holder. F&M’s policy implements I.D. checks and a series of questions to verify an individual’s identity. This process has proven to be time-consuming and inefficient as reputable customers repeatedly answer the same questions. F&M would like to see the responsibility for this shifted back over to the State Corporate Commission who previously had this responsibility.

2.7 Section Summary
F&M Bank is currently operating as best it can given the current guidelines and its limited set of resources. F&M is unique in that it was quick to get on board with hemp legislation, despite generally avoiding riskier businesses. Its small team works diligently and prudently to ensure optimal performance. There are challenges, but hard work helps the team to push through.

3. Technology & Innovation
3.1 Section Overview
This section addresses the effectiveness of F&M’s current BSA monitoring platforms and how the bank suggests BSA compliance could be more efficient. In a meeting with the BSA compliance team at F&M, the team suggested several changes to the current BSA framework. To get a better understanding of universal concerns regarding the BSA, we researched issues that plague community banks’ BSA compliance through interviews and case studies. Finally, to understand how these changes may be implemented at the legislative level, we met with a Capitol Hill staff member who is working on updating the compliance requirements for the BSA.

Overall, we find that F&M Bank’s compliance team is satisfied with its current software, but it acknowledges that additional improvements could benefit the bank. Our discussion with a Capitol Hill staffer illuminated the fact that Capitol Hill is aware of the outdated nature of the BSA. This awareness led to Capitol Hill’s introduction of legislation aimed at improving
the BSA compliance processes and cutting costs for all financial institutions.

3.2 F&M’s Use of New and Existing Technology

The current platform that F&M Bank uses is YellowHammer Fraud Detection, which is a program provided by Jack Henry & Associates. Jack Henry & Associates advertises YellowHammer as a program that fully automates and centralizes compliance with the Bank Secrecy Act. It does this by providing “data monitoring, recordkeeping, and reporting to eliminate the time-consuming and error-prone manual compliance process and mitigates the risks associated with BSA compliance” (“YellowHammer”). YellowHammer assists F&M Bank by reviewing transactions and assigning transactions a risk score. This helps the team direct their attention to transactions more likely to violate BSA standards. Transactions automatically flagged by YellowHammer include transactions eclipsing $5,000 and any suspicious activity within a peer group. Other transactions are automatically flagged, such as charity and non-profit transactions, and cryptocurrency exchanges above $1,000. The team does not manually review any transactions that are under $5,000 or that have a YellowHammer risk score of less than 50%. However, transactions below the $5,000 threshold with a risk score greater than 50% are reviewed.

A team member who has been with F&M for three years has yet to see a noticeable change in the YellowHammer system. While there have been several minor updates to the software, the software seemed slow and outdated in observation. However, during our meeting with the BSA operations team, the team stated that they were satisfied with the software overall. Other banks agree that the software provides greater efficiency (Rodriguez). The main problems discussed were the speed of the software and the workload that comes with two people examining $800 million of assets.

The BSA compliance team at F&M believes that better software could help the team solve the common issues of kiting, cash structuring, and signature matching. Current software can assist in identifying these common issues, but this identification requires the BSA team to manually review transactions. As defined in Section 2.4, kiting occurs when a person has multiple checking accounts with different banks and takes advantage of unprocessed funds or “float” by moving it back and forth (Walsh). If the software could allow multiple financial institutions to share transactional information,
F&M Bank does not directly collaborate with any other banks or financial institutions on BSA reform.

kiting could be prevented. Cash structuring is the act of withdrawing cash on numerous occasions in a limited period to avoid the attention that withdrawing a larger sum of cash would garner. The use of better software could eliminate this issue by keeping a running total of withdrawals over a set period as opposed to tracking individual transactions. Signature matching is going through the digital copies of deposited checks to match the signature on those checks to the signature upon opening the account. The manual workload of F&M’s compliance team would be significantly smaller if F&M’s BSA compliance software could reduce some of the labor required to identify these common issues.

3.3 Collaboration

F&M Bank does not directly collaborate with any other banks or financial institutions on BSA reform. The primary source of collaboration with other community banks is roundtable meetings. As described in Section 2.5, these are informal meetings between banks, credit unions, and law enforcement held every two to three months where these groups can discuss current fraud trends, Suspicious Activity Reports (SAR), and changes to legislation and regulations.

3.4 BSA-Related Interactions

Our team interviewed a Capitol Hill staffer working on the Illicit Cash Act, a revision to the current Bank Secrecy Act. The Illicit Cash Act hopes to reduce the cost of BSA compliance by allowing for more innovative, cost-efficient processes for all financial institutions while improving the communication between the finance and law enforcement worlds. Much of our conversation with the Capitol Hill staff member revolved around the disconnect between banks, law enforcement, and federal agencies on the level of attention provided to suspicious activity reports (SARs). Through their background research for the Illicit Cash Act, Capitol Hill found that the individuals submitting SARs were often the individuals following up on these reports. This was believed to be the role of law enforcement, which was not responding in the timely manner the financial world had anticipated. Despite a poor response rate on SARs, law enforcement continues to reassure financial institutions that the more information they receive the better.

Another complaint of financial institutions is the concept of a “Defensive SAR.” A “Defensive SAR” is a report that may not have been warranted due to gray area content or a regulatory hot topic such as digital currency.
(Teng). Defensive SARs are common because defensive reports lessen the possibility of misreporting and being challenged by regulators (Teng). Regulators are continuously working to reduce the number of Defensive SARs, to ensure reports are purposeful. The Financial Conduct Authority, a major regulator in the United Kingdom, has already made changes to AML procedures to reduce SAR volume so banks can look at the “bigger picture” rather than the individual transactions which often flood the system (“Anti-Money Laundering”). Ultimately, the Illicit Cash Act streamlines communication between financial institutions and law enforcement and updates standards that have not changed since the 1970s such as the review threshold.

3.5 Change Through Innovative Technologies or Collaboration

One of the main challenges of the American financial system is identifying the purpose of large sums of foreign investment. While foreign investment can grow the economy, foreign investment in criminal activities needs to be prevented (Ariza). The Illicit Cash Act proposes that companies be required to list their owners at incorporation (United States). This would eliminate a loophole which criminals are taking advantage of for storing offshore funds.

Another issue that needs revision is the discrepancy between holding large financial institutions to the same standards as community banks. An effective BSA compliance framework should include scaling based on the capital levels of financial institutions. The current reporting threshold of $10,000 is exceeded frequently at F&M Bank which suggests the threshold is even more common at larger financial firms. An increase in the reporting threshold would reduce the strain placed on financial institutions regarding BSA compliance and transaction review.

3.6 Section Summary

After meeting with the BSA compliance team at F&M Bank, we found that the compliance team is satisfied with the current technology that they utilize for BSA compliance. However, the team at F&M feels as though the software could be improved to track common fraudulent activities such as kiting and cash structuring. F&M does not collaborate with other financial institutions in the Shenandoah Valley regarding BSA reform. However, they recognize the need for better communication between financial
institutions and law enforcement. With the introduction of the Illicit Cash Act, there is legislation on the table in D.C. to amend the BSA and work towards meaningful and consistent communication between banks, law enforcement, and government agencies. The community banking industry hopes that the passing of the Illicit Cash Act will alleviate some of the stress that is currently on their hand and modernize the BSA to prevent fraudulent bank activity in the technology age.

4. Policy Recommendation & The Future of BSA/AML Reform

4.1: Policy Recommendation

Based on our overall research, we recommend that policymakers implement the measures expressed in the Illicit Cash Act. We believe that it will solve many common issues with BSA compliance by adapting technologies to modernize provisions in the Bank Secrecy Act, enhancing communication between federal agencies and law enforcement, and amending FinCEN’s beneficial ownership policies.

The Illicit Cash Act addresses the shortcomings of many BSA provisions as modern technology has made 1970’s standards obsolete. It would create an Innovation Subcommittee within the U.S. Treasury Department to encourage and support technological innovation to fight money laundering (United States). The legislation accomplishes this by removing any existing obstacles that arise from current regulation, practices, and guidance related to the BSA.

The Illicit Cash Act proposes several changes regarding BSA reporting to create better communication chains. These changes will improve the quality of shared information. The first of these changes is the requirement of annual law enforcement reports for the Treasury Department. This will allow the Treasury Department to address frequently occurring issues.

A second major change that the Illicit Cash Act proposes is the review of the current CTR and SAR thresholds. A primary complaint F&M Bank cited in our discussion was the outdated $10,000 threshold for transaction reports (Hise). This threshold has not once been adjusted for inflation or other economic factors.

A third major proposal from the Illicit Cash Act modifies the requirements for beneficial ownership collections. This amendment would force shell companies to disclose beneficial ownership information to FinCEN at incorporation and within 90 days of any change in beneficial ownership. In addition, it would devise a study to determine whether the lack of beneficial ownership has stunted investigations into entities suspected of financial misconduct.

In summary, the passing of the Illicit Cash Act would reduce financial burdens of BSA compliance for community banks by updating BSA standards for modern technology, forming improved communication channels between financial institutions, law enforcement, and federal agencies, and implementing more structured policies related to beneficial ownership reporting.
4.2: Areas for Improvement

Another central objective of the *Illicit Cash Act* is to provide an incentive for large financial institutions to experiment with BSA compliance methods. The testing of BSA compliance methods by large banks could yield an approach that reduces BSA compliance costs for both large and small financial institutions. This bill aims to create a space for large institutions concerning software to monitor BSA compliance (Capitol Hill Staffer). This element of the legislation also anticipates firms will develop an efficient platform for SAR reporting and law enforcement monitoring. The politicians behind the Act believe allowing larger financial institutions to experiment with BSA compliance measures will not create additional expenses for large firms. Further, successful innovation from this measure could pass-down benefits to small financial institutions in the form of lower BSA compliance costs. This allowance would aid in F&M Bank’s desire to acquire new, affordable software to enhance its operational efficiency.

5. Conclusion

In this case study, we find that F&M Bank is making the most of its situation regarding Bank Secrecy Act compliance. F&M’s three-person compliance team has remained the same for several years now, and F&M has provided adequate capital and resources for the team to do its job successfully. Changes to the BSA framework could alleviate many regulatory obstacles created by the outdated nature of the Bank Secrecy Act.

In this case study, we find that F&M Bank is making the most of its situation regarding Bank Secrecy Act compliance.

Our case study identifies that the BSA needs reform. Two of our main recommendations are to transfer beneficial ownership liability back to the State Corporation Commission and to update the $10,000 reporting threshold. The newly proposed legislation, the *Illicit Cash Act*, proposes solutions to those main issues. The issues addressed by the proposed legislation are widespread, and the benefits of the legislation affect F&M, other community banks, as well as larger financial institutions. The primary goal of any community bank is to serve, invest in, and grow its community. Modernization of this regulation allows community banks to better utilize resources, therefore, spending less time on regulatory obstacles and ultimately more time working towards serving, investing, and growing the communities these banks serve.
Endnotes

1. De-risking is, “the practice of banks limiting certain services or ending their relationships with customers to, among other things, avoid perceived regulatory concerns about facilitating money laundering” (U.S. Government Accountability Office).

2. Namely, a system input error relating to the deferred cost amortization of indirect dealer loans.

3. Peer Group 5 is defined as an Insured Commercial Bank with average assets between $300 million and $1 billion.

4. Specifically, from revenue tied to VST Title, F&M Financial services, and F&M Mortgage, as well as service charges on deposit accounts (10-K).

5. F&M Bank has opened several branches over the last 5 years. 2015: Craigsville & Staunton; 2016: Grottoes; 2017: Myers Corner & Coffman’s Corner; 2018: Timberville; 2019: Stuarts Draft.

6. Organic loan growth is defined as internal growth in loan operations without acquisition or merger of loan portfolios.

7. Given the ambiguity surrounding the classification of loans, it is difficult to determine where each contract should be coded. As such, this category is likely larger than reported.

8. Since the launching of F&M Bank’s Dealer Finance Division in 2012, commercial loans have been its best performing sector, growing at an average YOY rate of 7.29% over the last five years. (10-K)

9. A write down is an accounting measure that reduces the value of an asset.

10. Community banks are subject to a standardized approach when calculating risk-weighted assets. For this method, assets are assigned to a risk category and weighted based on their credit risk and the amount of the asset on its balance sheet.

11. A mortgage aggregator is a broker who buys mortgage loans from financial institutions, aggregates them into mortgage-backed securities, and sells them in the secondary market.

12. In 2019, F&M Bank’s Loans Held for Sale as a % of average assets totaled 8.19%. In contrast, Peer Group 5’s figure was only 0.13%.

13. Peer groups within YellowHammer are defined as accounts used for personal or business purposes.
Works Cited


Ariza, Juan Carlos. Challenges of Finding the Ultimate Beneficial Owners in AML and ATF. ACAMS, 2014, Challenges of Finding the Ultimate Beneficial Owners in AML and ATF.


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We appreciate the encouragement and insight all of those listed have offered. We simply could not have completed this case study without them.

*The authors alone are responsible for any errors and for the views expressed in this paper.
Introduction

C&N has proudly served its community since its founding in 1864 (originally named the First National Bank of Wellsborough). During its history, the bank has withstood many wars, recessions, and periods of intense and rapid change. After the Great Recession in 2008, community banks struggled to recover, and many experienced extreme fallouts resulting from the mortgage crisis and other complications; however, C&N made a timely recovery and reported the highest net income in its history at the end of 2010. Currently, Citizens & Northern Corporation, as a bank holding company, possesses assets exceeding $1.2 billion and is publicly traded on the NASDAQ Capital Market Index (“C&N Profile”). Part I will provide an in-depth financial analysis of C&N covering the last five years.
Throughout C&N’s lifetime, it has successfully extended its operations, currently operating twenty-seven branch locations and three limited purpose offices in eleven counties, spanning from Steuben and Chemung counties, New York, to Philadelphia and York County, Pennsylvania. In April 2019, C&N finalized an acquisition of Monument Bank headquartered in Bucks County, Pennsylvania, adding two full-service branches and a loan production office. Citizens & Northern Corporation has approximately 330 employees who all work toward C&N’s mission to “create value through lifelong relationships” with its neighbors in Pennsylvania and New York (“C&N Corporate Profile”). Driven by valued relationships with its customers, C&N provides various conveniences to serve the surrounding community better.

In 2019, C&N made more than $78,000 in monetary donations and its employees devoted 345 volunteer hours to local organizations through its Giving Back Giving Together program (“BanCNewsletter”). These donations have helped to support local services such as the fire department, food pantry, and public library. In a highly competitive market, C&N continues to strengthen its rapport with its customers.

**Part I: Financial Analysis**

**Earnings Performance**

As a community bank serving a rural area, C&N is not guaranteed growth in its net income. According to the bank’s 10-K document, it gradually decreased from 2015 through 2017. However, the net income drastically increased in 2018 as a reflection of the Tax Cuts and Jobs Act of 2017, signed into law by the Trump Administration. The change in accounting and tax law substantially benefited the bank. The slight decrease in the net income shown in 2019 is likely due to a temporary decline as a result of one-time expenses from the acquisition of Monument Bank. Going forward, the bank believes the net income will rise again in the next year since, it has paid the one-time fee and the acquired bank will provide an additional source of revenue. Figure 1 visually displays the changes in net income during the past five years.

COVID-19 will undoubtedly play a significant role in determining the performance of the bank in 2020. The impact of the pandemic and quarantine is not entirely clear, but the stimulus packages and the enlarged role of the bank that serves various small businesses may benefit the bank’s future revenue. The talks of further stimulus packages give the bank a good reason to remain optimistic about the future. As discussed in the

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**Figure 1: Net Income (in thousands)**

![Net Income Chart](image-url)
later parts of the case study, the current volatile environment will award the fiscally conservative institutions. This financial analysis demonstrates that C&N cautiously remains conservative, which will grant it a strategic advantage to expand and grow its balance sheet.

Year-over-year earning assets shed an interesting light when analyzing the bank’s performance. As shown, the earning assets provide a steady income, increasing by over 500% between 2018 and 2019. Managing the earning assets allow the bank to ensure the cash flow that the institution needs. Unlike net income, earning assets have increased for the past few years. The sudden growth in 2019 is likely a result of the acquisition of Monument Bank. Table 1 shows the growth the bank could accomplish quite vividly. As stated previously, the bank’s performance for the next fiscal year will depend on the impact of COVID-19.

**Loan Portfolio Composition**

Over the past five years, C&N has continually kept an impressive loan portfolio. Overall, the percentage of consumer loans makes up a very small percentage of its portfolio because the bank focuses mostly on residential and commercial loans. It is important to note that the proportion of commercial loans increased by about 5% from 2015 to 2020. Most of the bank’s loans are taken by local businesses. As the economy began to steadily grow in 2018, businesses decided to take out more loans. However, Figure 2 does not present the complete picture of the nature of C&N’s

<table>
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<th>Table 1: C&amp;N’s YOY</th>
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<tr>
<td><strong>Earning Assets</strong></td>
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<tr>
<td><strong>Increase/Decrease</strong></td>
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![](image1.png)

![](image2.png)

![](image3.png)
portfolio. It shows the shift of the emphasis, but it does not show how the focus has shifted or whether the change is in tune with the bank’s strategic plan, which is to grow commercial loans and sell more of the mortgages to the secondary market.

Figure 3 displays the dollar value of loans in each category, which provides a better look into the portfolio. The dollar amount of residential mortgage increase had a significant bump in 2019; commercial loans experienced a similar event. This displays that the bank has grown its commercial loan organically. Also, the recent acquisition explains the sudden increase in both residential mortgage and commercial loans. While the bank’s desire for the growing commercial loan in the organic approach is vividly displayed in Figure 4, the composition of the bank played a dominant role in the change in the loan portfolio.

This change in the portfolio will likely result in improved performance of the bank, considering that the yield on commercial loans is typically higher than the residential mortgages. Additionally, this shift reduces the interest rate risk. The reduction of such risk is particularly crucial in the time of economic contraction induced by the COVID-19 pandemic. The US Federal Reserve greatly reduced its interest rates in March 2020, and many customers began to refinance their homes. The shift to a greater percentage of commercial lending will provide the bank stability in the future.

As shown to the Figures 4 and 5, Tier 1 capital to risk-weighted assets and total capital to risk-weighted assets remain stable and well above the well-capitalized level. This reflects the bank’s policy to keep the capital level high so the bank can absorb losses. It also allows the bank to acquire other banks when the...
asset prices are discounted. Although the bank has been profitable in recent years, its approach remains conservative to ensure it can properly serve its constituents without placing them in jeopardy.

**Liquidity**

At C&N, both net loans and deposits have increased in the last five years. The sudden increase in loans in 2019 is the result of the acquisition, as the acquired bank had more loans than deposits. As shown in Figure 6, liquidity risk rose, but it is still at a comfortable level for the bank. As opportunities for new acquisitions arise in the future, the bank can take advantage of such opportunities. Naturally, deposit growth is the primary strategy in 2020.

Total Equity/Total Asset ratio decreased until 2017, then suddenly increased in 2018, and finally decreased again in 2019. The behavior is similar to net income. The change in 2017 and the tax act can explain the change in 2018, and how the acquisition impacted 2019. The higher level of debt is certainly concerning in a time of economic contraction. However, it is crucial to note the bank has a sufficiently high level of liquidity and outstanding capital to the risk-weighted assets ratio, shown in Figure 7. Such a conservative level will allow the bank to endure the time of turmoil and seek opportunities that arise when the market feels squeezed and must be more efficient.

**Part II: Bank Secrecy Act and Anti-Money Laundering Act Compliance Assessment**

**Process, Methods, and Structure**

The Bank Secrecy Act and anti-money laundering regulations pose the same basic rules and regulations for all banks in the United States. However, larger banks may be exposed to a higher risk of financial crimes because they
**C&N offers a variety of different options for their customers, which, in turn, creates more risk.**

possess more assets. C&N is a lower risk due to the geography it operates in and the nature of its customers but still conducts correct procedures to make sure it is compliant with BSA/AML regulations. Like most banks, C&N uses standardized risk assessment tools to develop a comprehensive BSA/AML compliance program tailored to the bank’s risk profile. Besides this process, C&N also gathers information about clients when opening an account to develop a customer risk profile. And because of the fifth pillar added to the BSA requirements, C&N must gather information on all persons in the company who own 25% or more of all legal entities that opened accounts after May 11, 2018.

C&N offers a variety of different options for their customers, which, in turn, creates more risk. They offer amenities such as international/national wire transfers, telephone transfers, and online banking. Risk can be identified in many ways, but in summary, it encompasses all of the (1) products and services, (2) customers and entities, and (3) geographic location in relation to the bank (Marco). C&N has a low risk in the second and third categories, but does provide many options as its products and services. Consequently, C&N can be identified as a “moderate risk” bank.

There are three lines of defense that C&N uses in its BSA compliance program. The first line of defense is identifying risks through its software tools. They process alerts through C&N’s system, which brings up red flags. These alerts give banks like C&N insight to see whether officers may need to look into transactions further. With these assessment tools, C&N can also monitor wire transfers, automated clearing house payments, and other specific electronic bank processes. According to Bloomberg, "criminals who are engaging in money laundering most likely have several accounts with different banks" (Weber). If someone raises suspicion, C&N can look into the situation using the 314(b) system. This system is voluntary for banks, but allows them to share information with any other bank that is also a registrant of 314(b). Collaborating with other banks is especially useful for fraud cases and allows institutions to track users to different transactions.

The second line of defense is the use of BSA/AML officers to oversee the alerts that come through the system. Most alerts that come through the system do not lead to suspicious activity, so it is up to the risk management personnel to filter through to see which transactions may need further investigation.
As regulations continue to develop and become more complicated, banks find they are dedicating more hours to screening, which adds to overall labor costs. A 2019 study of Canadian and American financial firms revealed that firms with less than $10 billion in assets screened an average of 255 names per day (“LexisNexis”). Even though more banks are moving toward incorporating machine learning into their software, having officers go in manually will always be crucial to the process.

The final line of defense that C&N uses is internal auditing, which conducts independent evaluations of the risk management program. This includes reviewing the policies, activities, internal controls, and organizational structure relating to BSA compliance. The Federal Financial Institutions Examination Council (FFIEC) states, “The audit should be risk-based and evaluate the quality of risk management for all banking operations, departments, and subsidiaries” (Cannon). However, there is no standard auditing procedure; each tailors its procedures to fit the institution’s needs. Factors that are considered when evaluating the quality of risk management are geographic location, transactions, customers, services, and products.

**Dedicated Employees**

C&N trains all its employees in risk assessment and BSA/AML compliance. However, there are two employees who are specifically responsible for maintaining the BSA department, along with the executive who serves as the BSA officer. This is lower than the average of banks that possess $1 billion to $9 billion in assets, which is four full-time employees (Alter). However, since C&N lies at $1.2 billion in assets, it aligns with the statistic.

These two full-time BSA employees at C&N work through the software alerts, which can range from 500 to 600 alerts per month, and also monitor accounts for unexpected behavior. They assess if the alerts are potentially suspicious or unexpected for the type of account and customer. If the BSA staff believes something is suspicious, they will do further research and move it to a separate case that will be researched with more detail. They analyze and research these cases more thoroughly, which takes much more time and resources. Officers may have to file a Suspicious Activity Report (SAR), when necessary.

SARs are extremely important; the officers regularly use them when law enforcement goes to initiate financial investigations and other criminal cases. Transactions of $5,000 or
more are enough to file a SAR if the institution has reason to suspect someone is using funds illegally, and transactions of $25,000 or more constitute enough to file even if a potential suspect cannot be identified (“1st Review”).

BSA staff must file SARs to FinCEN no more than 30 days after the initial detection of facts that create a basis for filing the report. Examples of suspicious activity that would incite a financial institution to file a SAR include seeing a large volume of wire transfers, suspected shell entities, and unusual transactions occurring between different business types.

After deciding to file a report, BSA employees must address who is conducting the activity, what instruments they are using to do so, when the transaction(s) took place, and why the institution believes it is suspicious. All this information is then compiled into a SAR narrative that provides a detailed, yet concise account of suspicious activity in question.

### Compliance Costs

All banks must pay a certain amount of compliance costs each year, and C&N is no exception. Many things are included in these compliance costs, which are both direct and indirect costs. Examples of direct costs include salaries, training for employees, software costs, etc. Examples of indirect costs include loan processing and issuing mortgages. These costs are harder to put a dollar amount on but still act as an expense for C&N. There are many costs and fees that go into issuing a mortgage, and some would be considered compliance costs.

Overall, personnel expenses account for the largest percentage of community bank costs of about 60% (“LexisNexis”). This far exceeds the cost of software and other expenses. Perhaps this is the case because there is currently a shortage of qualified personnel who have the ability to satisfy the ever-expanding BSA/AML regulations (Alter). So, smaller institutions may have trouble finding personnel that can properly develop a bank’s compliance program when many of the top professionals in the field find themselves at larger institutions.

C&N focuses on efficiency and trying to automate and reduce costs, when appropriate. In 2015, it switched from performing manual reporting to using software to monitor transactions and automate the filing of SARs and CTRs. By cutting down on physical labor, the bank became more effective in monitoring for suspicious activity. According to its financials, C&N spends approximately $250,000 a year on BSA/AML compliance, which makes up the majority of its compliance spending in...
total. Considering all of C&N’s other expenses, this constitutes a significant percentage the bank must account for every year.

A 2019 study of 143 participating financial institutions revealed that the cost of AML compliance as a percentage of total assets was up to 0.08% for firms with more than $10 billion in assets and up to 0.85% for firms with less than $10 billion in assets (“LexisNexis”). Even though large banks have larger compliance expenditures, the costs affect smaller banks more extremely when compared to the bottom line.

**Changes and Challenges**

Due to advancements in technology, mobile threats are becoming more of a threat. Fraudsters may take advantage of amenities such as online check deposits, and C&N must handle all fraudulent cases that may occur as a result. Since it is a smaller bank, these fraud cases fall under its BSA department for further investigation. It is critical that C&N adapts to these new changes with the services it offers.

As mentioned in the executive summary, the Patriot Act was the biggest change in BSA regulations and affected many of C&N’s previous compliance processes. This bill introduced a plethora of new regulations, including the Customer Identification Program (CIP), which prescribes “the minimum standards for financial institutions and their customers regarding the identity of the customer that shall apply in connection with the opening of an account at a financial institution” (“Five Things”).

For individual accounts, the customer must provide name, date of birth, address, and some form of identification. C&N must also calculate the risk of a customer and assign a risk rating. Each bank has a different process when calculating this risk; it depends on many factors, including the geographic location of the bank, its customer base, what kinds of accounts it offers, and the methods of opening the accounts. The CIP is part of the Know Your Customer (KYC) process, which all banks undergo to ensure safety and defend against financial crimes.

In addition to the regulations from the Patriot Act, C&N must also follow the rules of the 2018 customer due diligence rule, another component of the KYC regulations. This rule has many of the same components required for the CIP, but with additional requirements. To comply with CDD, C&N monitors customer accounts and reports suspicious transactions to detect anomalous behavior. Banks may ask to verify information by asking customers to
The consensus in the banking industry is that these regulations put a strain on regular business operations.

Provide financial statements, sources of funds, and a description of business operations.

Due to the added regulations with CDD, C&N must devote more time to BSA/AML compliance than it did before the regulation enactment. Gathering information to comply with CDD (including seeking out primary business owners and their ownership percentages) is a very time consuming and resource-heavy process that often takes away from other important duties.

Another issue that community banks face is the fact that the dollar amount thresholds have not changed since the original passage of the Bank Safety Act. For example, the requirement to submit a CTR if someone deposits more than $10,000 passed in 1970. These numbers do not count for inflation since $10,000 in 1970 is now around $65,000 in 2020 ("CPI Calculator"). C&N files anywhere between 1000 to 1200 of these reports yearly and could save on these expenses if the threshold were to increase. Filling out reports is extremely time-consuming, and many of the reports filed do not result in any law enforcement action.

The threshold for filing suspicious activity reports is also outdated. In 1992, Congress passed the Annunzio-Wylie Anti-Money Laundering Act, which required all institutions to fill out SARs. After adjusting for inflation, $5,000 then would be closer to $10,000 ("CPI Calculator").

The consensus in the banking industry is that these regulations put a strain on regular business operations. However, it is necessary to abide by the policies, and C&N acts in accordance with the rules and meets every compliance regulation to ensure customer safety. John Reber, EVP and Director of Risk Management at C&N, states that “Part of the [goal of] modernization is bumping the threshold $5,000 to $10,000.” In this sense, any progress that can be made toward updating and streamlining the BSA/AML compliance process is significant.

Banks also face costly repercussions if they violate BSA regulations. Former U.S. Deputy Attorney General Paul McNulty once said, “If you think compliance is expensive, try non-compliance” (Orunkhanov). FinCEN may administer multimillion-dollar penalties if institutions fail to comply to regulations. According to Deloitte, AML and sanctions-related regulatory actions in 2014 issued $2.35
billion in fines ("Meeting New"). For example, the First National Community Bank of Dunmore, Pennsylvania, was cited $1.5 million in 2015 for failing to file suspicious activity reports that involved illegal funds that were part of a judicial corruption scheme (Hudak). In this situation, the bank was aware of the red flags but purposely did not file reports.

FinCEN issued an even larger penalty of $15 million to the First Bank of Delaware in 2012. This bank allegedly conducted inadequate AML measures and aided fraudulent transactions. Even though the bank closed, due to other regulatory problems, before being cited, it was still liable for the penalty.

These two examples demonstrate the heavy fines banks may be subject to if found with insufficient policies. Although banks acknowledge that compliance costs are rising, they are fully aware it would be more expensive to risk a heavy fine for not following the regulations.

**Part III: Technology, Innovation, and Collaboration**

**BSA Software**

During these times when technology is evolving so rapidly, it is imperative banks use the most up-to-date technology for their BSA/AML compliance efforts. C&N currently uses BAM+ by Abrigo, a software that prides itself on detecting suspicious activity and giving its customers the best chance of detecting financial crimes.

BAM+ is vital to C&N for a variety of reasons, including its many features that help to automate the BSA compliance process. The software helps to streamline the process of filing CTRs by auto-populating beneficiary and conductor information from previous reports and including an automated risk rating based on C&N’s individual risk tolerances ("Anti-Money Laundering"). BAM+ provides a uniquely tailored software to fit C&N’s individual needs. However, C&N feels that as a whole, all systems could begin to introduce more Artificial Intelligence (AI) into its software. Much of the work being done is still manual, which exhausts the banks’ resources, specifically employees’ time and energy.

John Reber reports that employees do 95% of BSA-related work in the back office, while the rest is in the front office. Alerts from the system come out on a set schedule, amounting to
With other banks every two to three times a month. SARs filed by one institution can be linked to SARs filed at other institutions, which facilitates this process. Financial crimes can often span the country and involve many banks. This collaboration is crucial because it provides key information to law enforcement that helps identify links to illicit activity.

Section 314(b) of the Patriot Act also helps to encourage collaboration among financial institutions. There is a process, however, that must be followed before sharing information. First, the institutions must submit a notice to FinCEN that states their intention to voluntarily share information; this is effective for one year (“31 CFR”). They must also confirm the other institution has also submitted this notice, and it is up-to-date. The final requirement limits the kind of information the banks can share. Information can only be shared to identify and report on money laundering/terrorist activities, determine whether to establish or maintain an account, or to assist the financial institution in complying with any of the information-sharing requirements (“31 CFR”). Overall, this section of the Patriot Act is effective when helping to assist banks collaborate with each other. C&N is a 314(b) registrant and has used the Patriot Act as needed. On a larger scale, C&N also has direct interactions with FinCEN and state/federal examiners when it feels the need to seek additional guidance on BSA matters.

BSA-Related Actions with Law Enforcement

C&N hopes that there will be more legislation to directly address the relationship between
The relationship between financial institutions and law enforcement is extremely important.

C&N also expressed concern regarding cryptocurrency and how the development of the digital currency will affect the relationship that law enforcement has with banking in the future. In May 2019, FinCEN issued a guidance document that addressed how convertible virtual currencies (CVCs) apply to BSA/AML compliances and how to effectively identify criminal activity with the unconventional medium of exchange. Although the document did not establish any new regulations, “it consolidates current FinCEN regulations, and related administrative rulings and guidance issued since 2011” (“Application”). There is still a gray area when it comes to CVCs, but FinCEN is working to provide solutions about how to adapt to the changing currency, and banks are learning to respond.

Future of BSA Compliance Methods

C&N is always looking for new and innovative ways to improve its BSA compliance methods since there is no such thing as too much security. Recently, the bank has also been looking into new software to invest in law enforcement and financial institutions. In addition, C&N also wishes that it received more comprehensive feedback about the findings of criminal investigations that relate to banks. The relationship between financial institutions and law enforcement is extremely important. In the last five years, the Internal Revenue Service Criminal Investigation force used the BSA database 126,000 times, which helped to launch 25% of its investigations (“Promoting Corporate”). When banks know important information about a specific case, they will relay it all to law enforcement. However, the banks are rarely provided updates after the fact, despite volunteering key information.

Another bill that would work to modernize the BSA is the Corporate Transparency Act. The U.S. House of Representatives passed the bill in October 2019, but it has yet to move to the Senate. One obstacle when attempting to deter financial crimes is that states do not require companies to disclose their beneficial owners (“Promoting Corporate”). This allows for various criminals to hide behind their companies and avoid proper punishment. This act would regulate anonymous shell companies by defining a “beneficial owner” as the person or persons who possess most of the company’s control or receive the most monetary benefits. From this information, the involved parties could create a database, which law enforcement could access when necessary (“Promoting Corporate”). This bill would improve the relationship between law enforcement and financial institutions, as well as create a better path to detecting financial crime.
Over the next few years, it can be expected that more firms will start to branch out and use machine learning and AI.

After its contract with Abrigo expires. The biggest innovation that would benefit C&N is a larger Artificial Intelligence/machine learning presence to address more alerts in a shorter amount of time. A study conducted by LexisNexis reports that only 25% of financial institutions have incorporated AI/machine learning into their normal compliance processes (Orunkhanov). This number is relatively small when considering how many FinCEN reports are filed per year. In 2016, banks (not including financial institutions) filed more than 700,000 money-laundering reports, up from less than 100,000 in 2012 (“SAR Stats”). It’s clear that even though the amount of reports being filed per year is increasing, the corresponding technology is growing at a slower rate. In a conference in 2018, American economist Dr. Lael Brainard stated, “AI approaches are better than conventional approaches at accommodating very large and less-structured data sets and processing those data more efficiently and effectively” (Gibson). The benefits of AI in BSA/AML compliance methods are limitless.

C&N also hopes to see software that would produce the least number of false-positive alerts possible and accurately assign customer risk. On average, false-positive alerts constitute up to 90% of the total alerts that BSA officers must wade through to find the transactions that lead to any suspicious behavior (Gibson). Thus, machine learning is becoming more necessary as regulations become more extensive. Findings show that institutions that effectively use compliance technology spend a lower percentage on labor costs because they are dedicating less time to manually screening activity (“LexisNexis”). Although it is a pricey investment, many firms feel it is necessary to keep up with the evolving technology. Over the next few years, it can be expected that more firms will start to branch out and use machine learning and AI. Many already see it as the future and hope that it will help to save resources in the long run.

Part IV: Policy Recommendations and the Future Of BSA/AML Reform

Clarifying Components

FinCEN and other regulators help to clarify key components of the BSA and compliance expectations by understanding the unnecessary burden the regulations put on community banks. By listening to the collective opinion of the banks, the regulators can offer their
best advice and guidance on how to make the process as efficient as possible. Communication with individual banks is important since each is unique and has its own specific situations. FinCEN and other regulators should try to be understanding when institutions have questions regarding policies and compliance expectations.

Many banks believe the customer due diligence rule in 2018 was too ambiguous and left too many questions unanswered (Leutkeyemer and Pearce). Because this was a new rule, many banks, including C&N, found this process to be an enormous burden. It can take hours for a bank to complete customer due diligence, especially when dealing with wealth management. FinCEN should be as thorough as possible and address as many questions as it can when announcing any new additions to policy, predicting what banks will ask in response and being ready to answer frequently asked questions.

There are always unique situations that may need more of an explanation. For example, many institutions offer non-traditional banking services that will not fall under a regular account. It is in FinCEN’s best interest to always be as thorough as possible when laying out new policies and future plans that will affect the country’s banks.

Policy Measures

There have been different measures enacted to modernize BSA provisions, but there are also many pieces of legislation that community banks would like to see passed to progress even more. One solution is FinCEN’s Bank Secrecy Act Information Technology (IT) Modernization Program. It added this program to help modernize the way information is collected, stored, shared, and analyzed. The regulations must be modernized because they will help the government detect crime, strengthen security, and improve data quality (“FinCEN’s IT”). The program also mandated the electronic filing of FinCEN reports, rather than using paper reports.

The fundamental problem that banks see with BSA/AML regulations is that they are simply outdated. Jim Reuter, CEO of FirstBank Holding Co. in Colorado, states, “The problem is that we are still operating as if it was 25 to 30 years ago” (Finkle). One new bill introduced to modernize the system is the Counter-Terrorism and Illicit Finance Act, introduced in June 2018, which would increase the CTR threshold from $10,000 to $30,000. It would also provide more detailed feedback to banks (regarding their reports) and modernize the AML system. The $30,000 figure still does not come close to the correct amount adjusted for inflation, but the House of Representatives tabled the bill, and it has yet to be voted on.

In 2017, financial institutions filed 1.5 million SARs and 15.8 million CTRs (Leutkeyemer and Pearce). As mentioned previously, C&N files anywhere from 1,000 to 1,200 CTRs per year. If the threshold were to increase to $30,000, C&N predicted it would file closer to 100 to 200 per year, as many of the CTRs filed relate to ordinary business transactions. On a national scale, many filed reports go unseen, and only a small percentage result in criminal charges. An
overwhelming amount of reports in the system make it even more difficult to filter through and find those that will lead to criminal activities.

Another piece of BSA legislation is the Illicit Cash (Improving Laundering Laws and Increasing Comprehensive Information Tracking of Criminal Activity in Shell Holdings) Act. Introduced in September 2019, it is still under consideration by the Senate Committee on Banking, Housing, and Urban Affairs. Like the Counter-Terrorism and Illicit Finance Act, it hopes to modernize both BSA and AML requirements by establishing federal beneficial ownership requirements. It also hopes to improve the coordination between supervisors, intelligence agencies, and law enforcement.

Effectiveness
Key factors in reducing the burden of BSA/AML include efficiency and automatization. To do this all, the manual effort on behalf of the banks has to decrease. Therefore, the resources saved by not manually filling out the reports can be spent in other important functions. Artificial Intelligence can help with monitoring transactions for suspicious activities that occur. Even with a software program, the research and analysis of the transactions require a large amount of manual effort and time. For this process to improve, a software program is necessary to produce fewer false positive alerts for suspicious activity. Generally, community banks spend a greater percentage on BSA compliance costs because they do not have the capital to invest in expensive software that uses more Artificial Intelligence. A survey of more than 1,000 different community banks showed that those with less than $100 million in assets spent 9.8% of their noninterest expenses on BSA/AML compliance costs, while those with at least $1 billion in assets spent 5.3% (Dahl et al.). This shows how significant the compliance costs are, especially to the smallest banks in the country.

To be more effective, FinCEN should consider reforming the process of how banks file SARs. Institutions must go through the same process when filing SARs, no matter the level of potential risk. To save more time, it would be more efficient to offer different filing options when reporting SARs, depending on how major or minor the potential risk may be. This would also improve the quality of information reported because law enforcement could quickly identify the reports that banks believed to be at a significant likelihood of a potential crime. When the system becomes too overcrowded with too much information, it is harder to find what is most important. Banks should be recognized more for their actions that lead to the right outcomes, rather than how well they fill out reports that often do not lead to further developments.

FinCEN and law enforcement can better inform the bank on the effectiveness of SAR and CTR submissions by keeping the bank up-to-date once it hands over a case to be used in an investigation. For example, after C&N provides law enforcement with a suspicious activity report, it usually does not receive feedback after submitting the case. To improve this, law enforcement should give the financial
institutions scheduled updates regarding the state of the investigation so that banks are more informed. Communication is the most important factor in this situation, because it is sometimes unclear what exactly happens as a result of the reports. More communication between the two would be more beneficial for both parties.

**Conclusion**

In this case study, we examined the impact of BSA/AML regulations on C&N and how legislative reform can improve the compliance measures on community banks. We found that C&N has a moderate risk-level due to its risk profile, but still spends a significant amount on compliance costs every year. Having to spend substantial resources on compliance and customer due diligence can greatly reduce the bank’s ability to spend vital resources on other departments that more directly benefit customers, as well as donations to the local community. In this study, we have identified various pieces of legislation that would help to modernize BSA/AML regulations to ease the stress of community banks.

Earlier, we noted that community banks are often defined by the value of assets they possess. However, there is much more that contributes to the term than its asset size. C&N is the perfect example of a community bank because it is locally owned and operated, and many people in the area utilize the bank in their everyday lives. By coming up with tailored solutions, the bank focuses on the needs of the local businesses and families. Each of the bank’s branches is distinct and serves entirely different customers and legal entities; C&N acknowledges this and develops its products and services to see every customer as an individual. All employees, whether a manager, teller, loan officer, or support personnel, work toward C&N’s greater vision that one person alone cannot achieve. This vision works toward the hope that every customer believes “C&N is the ONLY bank I need” (“2018 Highlights”).

Between the bank’s core values and growth over the past few years, the future for C&N is positive. The bank’s conservative fiscal strategy will continue to show its benefits in the future, and the new acquisition of Monument Bank will bring in another source of revenue, as well as new customers. Hopefully, in the future, BSA regulations will be modernized to relieve community banks of certain pressures. But no matter what, C&N will continue to prosper and serve its customers with the utmost support for many years to come.
Works Cited


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