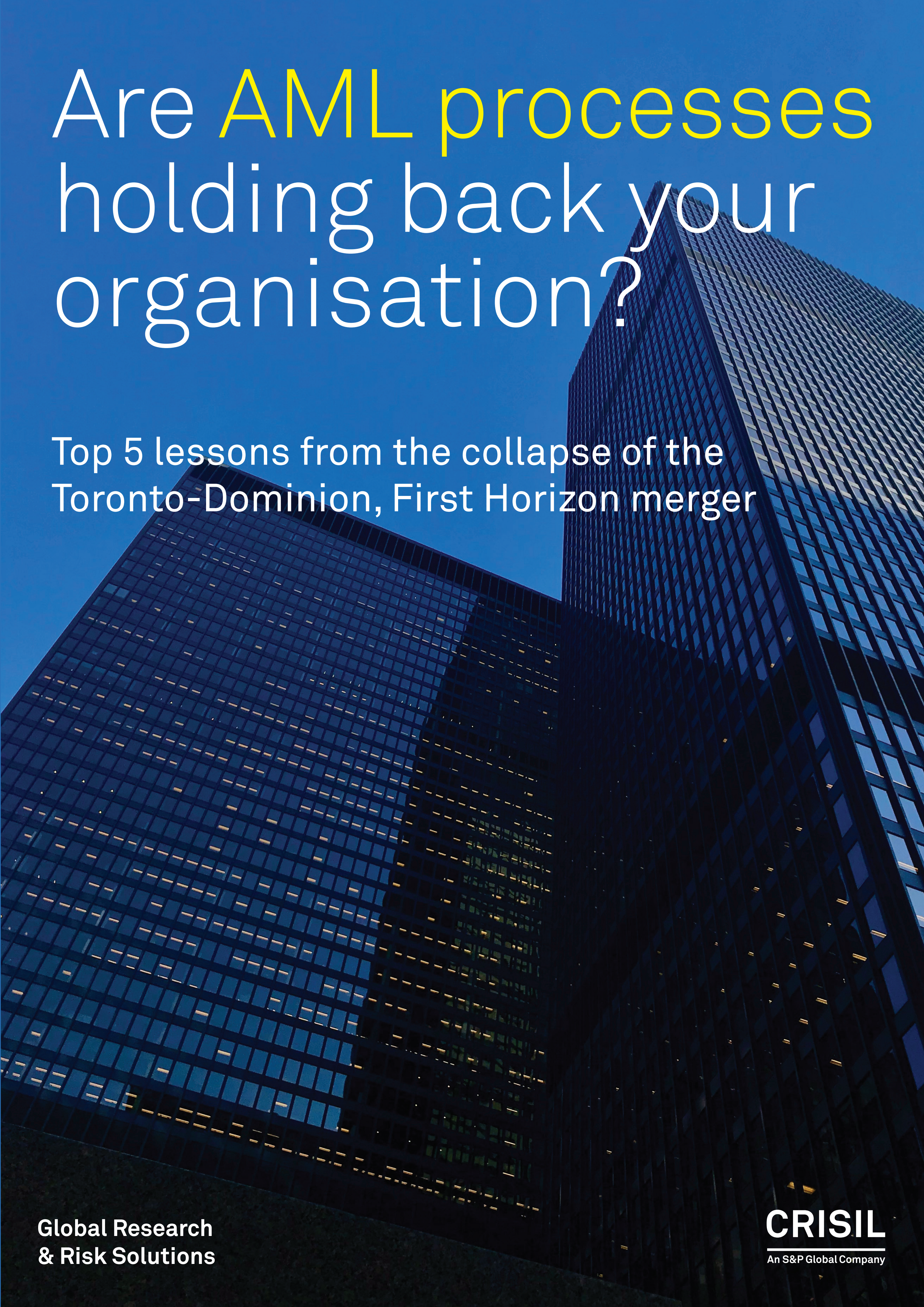


Are AML processes holding back your organisation?

Top 5 lessons from the collapse of the Toronto-Dominion, First Horizon merger

Global Research
& Risk Solutions

CRISIL
An S&P Global Company

The failed merger between Toronto-Dominion Bank (TD) and First Horizon took the banking world by surprise and led to yet another wave of volatility in the market for bank equities.

The revelation that the merger was called off due to regulatory concerns over TD's anti-money laundering (AML) practices was a further shock to the industry — one that underscored the fact that AML cannot be viewed merely as a compliance issue.

In the wake of the deal's collapse, it is increasingly apparent that any failure to maintain leading AML practices can lead to severe business consequences. In this note, CRISIL shares insights into how banks can better manage AML in their organisations.

What happened and when?

On May 4, 2023, the widely anticipated merger of TD and First Horizon was announced to be dead.

This announcement sent renewed shockwaves through the regional banking industry, with shares in Pacific Western Bank, Western Alliance Bank, and First Horizon itself being hit particularly hard.

On May 8, news outlets reported that the merger was called off after executives of the banks lost confidence they would obtain regulatory approval given concerns of the US regulators about TD's AML processes, specifically relating to suspicious activity reporting.

It appears the root cause of the deal's collapse was a deficient compliance framework at TD that lacked adequate supporting tools and processes needed to detect, assess and externally report suspicions to meet regulatory reporting obligations.

It is now up to TD to redress the issue, re-fresh their frameworks, educate their staff and improve their end-to-end suspicious activity report (SAR) process if they are to explore another merger in the future.

So, what does the law say?

Under the Bank Secrecy Act, financial institutions are required to file an SAR whenever there is a suspected case of money laundering "no later than 30 calendar days after the date of initial detection of facts...If no suspect was identified on the date of detection ...filing may [be] delay[ed] ... for an additional 30 calendar days to identify a suspect. In no case shall reporting be delayed more than 60 calendar days after the date of initial detection of a reportable transaction."

What does this mean for banks and financial services?

The TD/First Horizon event provides an opportunity for the industry to reflect and re-assess SAR regulatory reporting obligations and opine on whether wider AML and/or financial crime compliance (FCC) frameworks are fit to address regulatory needs.

In CRISIL's view, these topics are becoming increasingly significant as banks seek alternative routes to scale and grow their business through mergers. Regulators are getting stricter in holding banks to account and are not hesitating to block strategies or issue penalties if banks are found to be non-compliant.

What next?

We advise banks to ask themselves the following questions when assessing their AML arrangements:

- Is my compliance framework fit to drive or complement my business strategy and meet regulatory reporting obligations?
- What role should my compliance function play in managing AML risks and what should the operating structure look like?
- Do I have the right skills and experience in-house and authority to challenge the first line?
- Have I trained my staff to identify, detect and report risks/suspicions in a timely manner? Do I have the right risk culture to promote this on an ongoing basis?
- What measures have I built into my processes to safeguard staff who report suspicions?
- Does my business have sufficient ringfencing of the AML function from the credit and lending functions?
- What should my compliance, assurance and monitoring plans consider, and how do I report up the corporate governance chain?

Top 5 lessons to take away from the TD and First Horizon event

1. Compliance framework and strategy

Banks should ensure they have an approved AML/FCC framework with supporting policies and procedures articulating country-specific SAR requirements.

For local branches in a larger organizational structure, this framework should be integrated into group requirements with explicit reference to the applicable regulation.

Your AML framework should be top-down and linked to your overall strategy. This should be approved by the Board and/or designated executive, with risk appetite clearly defined to drive monitoring and reporting needs in order to assess performance and breaches when and where they occur.

At a minimum, your framework should articulate how suspicions are dealt with through the AML lifecycle, whether this be early in the client onboarding process, through payment screening and transaction monitoring, or through ongoing / enhanced due-diligence processes.

Specifically, the framework should identify:

- Staff responsible for managing compliance risks
- The process for identifying and evaluating suspicions/suspects
- Mechanisms to handle suspicions cautiously and confidentially so not to tip-off the suspects
- Formal internal reporting channels to report suspicions
- Measures to protect staff who report suspicions
- Access to alternative reporting channels (i.e., whistleblowing)
- Staff responsible for reporting suspicions externally to regulators
- The process for handling incoming requests from relevant regulators

- A process for reporting through wider risk governance channels/relevant committees (while acting in the spirit of the regulation so as to not breach confidentiality requirements)
- Tools to support the workflow process and store documentation

2. Compliance role and structure

Banks should think about how their compliance mandates deal with SARs and how the approach fits into the three lines of defence model to ensure effective governance.

Your mandate should consider changes in the organisational structure and the nature of future changes (over a 3-5 year horizon where practicable) and be reviewed annually to ensure it is fit for purpose (with regulatory change factored in).

Compliance functions are expected to communicate the spirit as well as the letter of the law into practicable business processes.

They are also expected to monitor business adherence and periodically test whether processes, risks and controls are within appetite and operating effectively.

These responsibilities require compliance and the money laundering reporting officer (MLRO) to work with other areas of the bank (i.e., legal), and to have sufficient seniority, position and influence in the organisation to drive change proactively before risks crystalise into problems.

3. Staff, skills and expertise

Banks should adequately resource compliance activities with a blend of business, compliance, audit and consulting skills, and build relationships across the business. Establish first and second line of defence demarcations to manage risks effectively, while providing sound challenge to the business.

Banks should ensure staff training campaigns are in place for new joiners, check in on movers in the business, and refresh training to ensure continued compliance.

In some areas, compliance will need to consider tailored training, dependent on the product offering, roles and material risk takers in the business, as well as the areas where high-risk trends, or breaches, have occurred.

Make use of intranet sites, as well as standardised forms and templates with examples, to drive good practices and run workshops to help staff understand reporting obligations.

4. Compliance assurance and monitoring plans

Banks should conduct periodic (at least annual) risk assessments and leverage output to develop meaningful compliance plans to assess the risk and control environment, and test, track and monitor progress against such plans to drive improvements.

Regulators are demanding demonstratable challenge in the assurance process when it comes to suspicious activity. It is essential that banks know what risks are trending up (with actions plans to remediate gaps noted) and train staff to promote risk awareness and 'good conduct' culture. If systemic gaps are identified, banks can conduct root cause and periodic trend analysis to drive strategic and tactical fixes.

At a minimum, banks must strike a good balance between surveillance, testing and monitoring activities to direct resourcing needs. Rationalising resource plans, effectively executing assurance and monitoring activities, and challenging the first line will help banks manage risks better and prevent regulatory compliance issues from crystallising. Where material trends or systemic issues are identified, initiate 'change the bank' programmes.

5. Technology

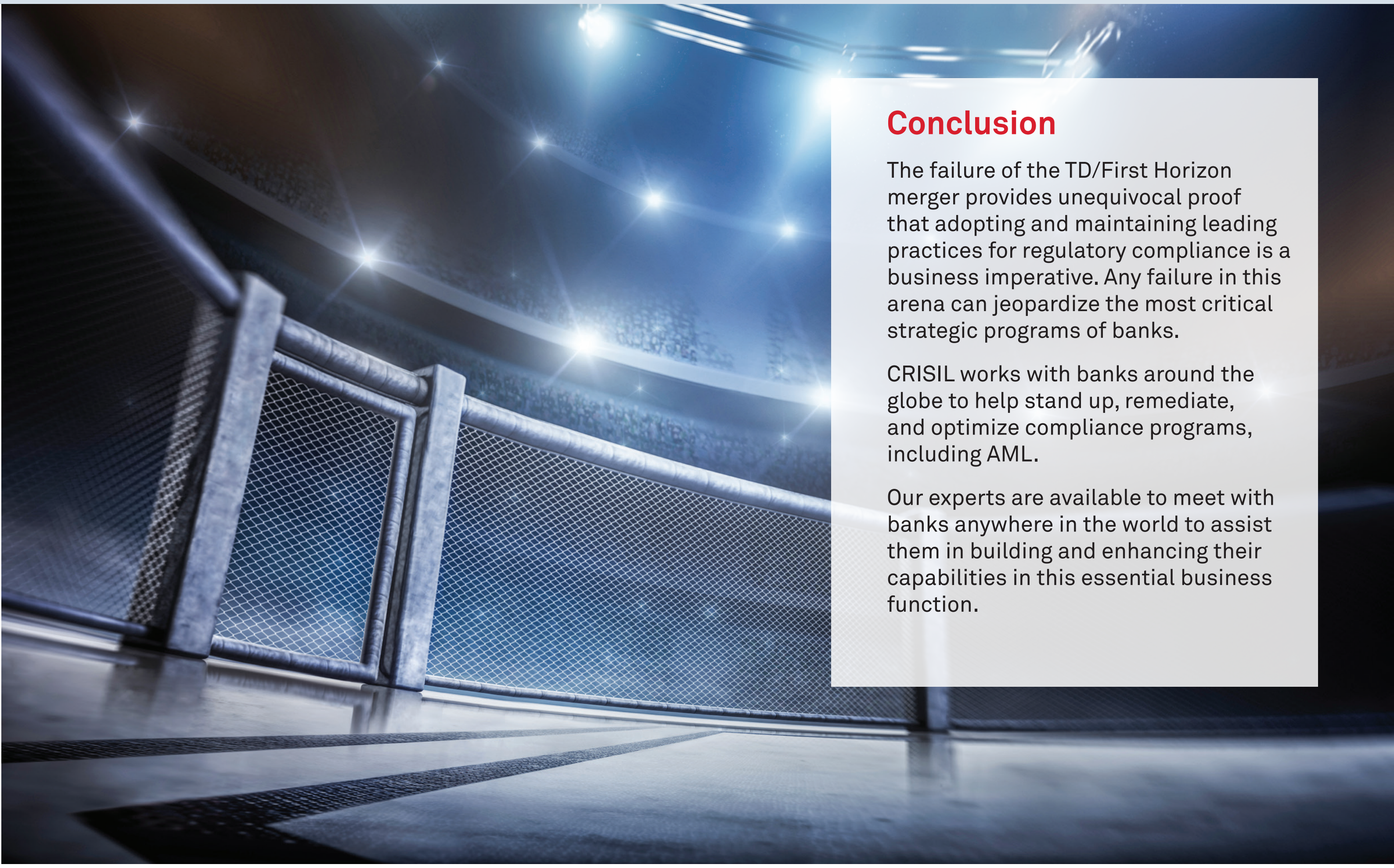
Banks should be working to digitalise and automate AML processes to improve accuracy, timeliness, and completeness of reporting.

When considering IT solutions, compliance should engage in the systems development phase to identify business and functional requirements and drive optimal solutions.

Managing, recording and monitoring SARs (internal/external) and producing management information through automated workflow platforms can improve efficiency and provide enhanced view of open risks/suspicions.

Specifically, banks should consider documenting their SAR typologies based on business activity, and migrate this framework to a systems' solution to fully embed the typology into their suspicious activity/transaction monitoring systems that will raise alerts for manual monitoring/intervention.

Furthermore, banks should understand and consider the preference of their regulators for reporting suspicions. Some regulators have automated forms for submission, while others rely on manual reporting mechanisms. Best to check with the local regulator for further information.



Conclusion

The failure of the TD/First Horizon merger provides unequivocal proof that adopting and maintaining leading practices for regulatory compliance is a business imperative. Any failure in this arena can jeopardize the most critical strategic programs of banks.

CRISIL works with banks around the globe to help stand up, remediate, and optimize compliance programs, including AML.

Our experts are available to meet with banks anywhere in the world to assist them in building and enhancing their capabilities in this essential business function.

Enquiries

US

Alex Paladino
Head of Business Development, Americas
CRISIL Global Research & Risk Solutions
alexandra.paladino@crisil.com

UK/Europe

Maninder Singh
Head of Business Development, Europe
CRISIL Global Research & Risk Solutions
maninder.singh@crisil.com

Asia-Pacific

Jose Ordonez
Head of Business Development, Asia Pacific
CRISIL Global Research & Risk Solutions
jose.ordonez@crisil.com

Analytical contacts

Rakesh Gajjar
Global head, Credit and Lending Solutions
CRISIL Global Research & Risk Solutions

Farhana Majid
Associate Director, Non-Financial Risk Services
CRISIL Global Research & Risk Solutions

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CRISIL Limited: CRISIL House, Central Avenue, Hiranandani Business Park, Powai, Mumbai – 400076. India
Phone: + 91 22 3342 3000 | Fax: + 91 22 3342 3001 | www.crisil.com
/company/crisil-global-research-&-analytics @CRISILGRA @CRISILLimited /user/CRISILLimited /lifeatcrisil

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