FINANCIAL SERVICES BOARD INSIGHTS

AI Technologies and Risk Management Considerations

There are multiple reasons increasing numbers of financial institutions are jumping to adopt artificial intelligence (AI) and improve their systems' machine-learning capabilities: AI and machine learning can streamline workflows; manage operational, credit, capital, and liquidity activities; evolve customer experiences; improve fraud detection; and more.

Amid the rush to embrace the benefits, however, it's critical that financial institution leaders recognize the Catch 22 at play: AI and machine technologies are rapidly outpacing the governance and controls needed to guide their use.

Pros, Meet Cons

While AI can be a useful tool to enhance efficiencies, it also presents ethical, compliance, and data privacy concerns, including accountability of third-party vendors that provide AI-related services. That's because the more AI is deployed, the faster it develops, producing large amounts of data in short periods of time.

What is AI? AI is essentially the simulation of human intelligence—learning, inference, reasoning, etc.—by machines. It's different from Robotic Process Automation (RPA) because RPA doesn't change without human intervention; in contrast, AI evolves on its own. As such, it requires constant human monitoring, management, and control.

Compliance considerations in the use of AI vary significantly because state, federal and global regulatory requirements differ on a variety of factors, from how AI impacts customer, stakeholder, and organizational data privacy to the potential legal violations that could arise from the use of these loosely regulated tools. That's why, due to the potential risk of proprietary information being "leaked" when fed into public AI chatbots, some financial institutions have banned their use in the normal course of business, pending further evaluation.

That doesn't mean AI should be avoided. AI presents significant opportunities. It can be used to conduct research, differentiate between legitimate and fraudulent activities, create customized contracts and other documents, and even perform customer experiences, like onboarding or processing loan requests, more efficiently and potentially, with greater accuracy than its human counterparts.

Questions Every Bank Leader Should Ask

However, leadership, including board committees and legal and compliance officers, should thoroughly review any AI program or application prior to implementation to ensure it meets regulatory standards, especially for data privacy. With an eye on mitigating risk and maintaining compliance while leveraging AI's value in controlling expenses and gaining efficiencies, a recent NASDAQ article suggests asking these questions when evaluating what level and type of AI application might be right for your organization:

- What are the provider's AI data training practices?
- How is my financial institution's confidential data and IP information protected?
- What are the provider's security frameworks and practices?
- Is the provider using a customized, proprietary AI model—or one from another third-party?
- What are its policies for data retention, correction and removal?
- Will our financial institution's data be used to train the greater public AI model?

Next Steps

If you determine an AI application suits your organizations size, strategy, and operating model, consider its impact on existing operational frameworks and methodologies. Are you able to ensure unbiased data analysis through internal processes that use modeling to validate AI-produced outcomes?

Also consider AI's impact on employees. How will you train employees to appropriately use AI? What skills training and retraining will be required? How will you prepare employees for how AI will impact their roles and responsibilities? How will AI and other RPA technologies influence staffing requirements? After all, while automating workflows reduces manual tasks, it also creates voluminous amounts of data that require oversight, review, management, and internal controls.

Lean on an AI-in-Banking Expert

As AI use continues to proliferate, leaders of financial institutions must remain vigilant in protecting data privacy while supporting continuous operational improvement to remain competitive. To learn how your financial institutions can benefit from AI and similar technologies while managing and controlling risk, contact your Rehmann advisor or Jessica Dore at jessica.dore@rehmann.com or 989.797.8391.

Lessons Learned: Navigating CECL Implementation

For most nonpublic companies and federal credit unions, Jan. 1, 2023, marked the official adoption deadline for the new Current Expected Credit Losses (CECL) standard, designed to speed up recognition of credit losses on loans, investments in held to maturity debt securities, and certain other financial assets.

Your organization should have CECL data gathering, analysis, and modeling well underway to identify, evaluate, and mitigate risks, ensuring you avoid year-end 2023 audit issues, adjustments, and impact on earnings. Since board committees have oversight responsibility for the processes and reporting related to CECL, keeping your organization's directors up to date on CECL best practices is recommended to ensure stronger corporate governance.

Remember: CECL requires lifetime credit-loss estimates to be recognized immediately when an asset is originated or purchased (the recently released exposure draft will impact CECL's effect on purchased assets) by pooling the assets into groups with similar risk characteristics and calculating estimated credit losses.

Want to learn from those who went before you? Here, some useful highlights of lessons learned from early adopting banks:

- **Changes in reserves.** Institutions across the board, including community banks with a large portfolio concentration in commercial and CRE loans have experienced changes in reserves as a percentage of total loans. Banks with less than $5 billion in assets saw an average increase in their reserve of around 10%. Community Banks also saw increases, but they averaged 5%. While many institutions saw increases in their reserve, there were also many that saw a decrease in their reserve upon adoption. Recent financial results (Q2 of 2023) show that the reserve is continuing to fluctuate as assumptions are adjusted and credit conditions evolve. Additionally, CECL resulted in a more significant increase in reserves for unfunded commitments compared to the increase in reserves for funded loans. Worth noting: There is increased scrutiny on any unallocated reserve because models should have all reserves fully considered.
- **Models and methodology.** Community banks and banks with less than $5 billion in assets most often used the Probability of Default/Loss Given Default (PD/LGD) model, followed by Discounted Cash Flow and Loss Rate Models. Few reported using the Weighted-Average Remaining Maturity (WARM) model. Many community banks under $1 billion in assets used the SCALE model.
- **Forecast periods.** CECL requires a "reasonable and supportable economic forecast" to estimate potential losses, a subjective decision. The most common economic forecast timeframe used is one to two years.

Challenges

Early adopters reported other unexpected challenges related to CECL implementation—notably, the ability to retrieve complete, accurate, and auditable historical data for financial assets that fall under the CECL standard. Also troubling: Data issues can easily lead to inaccurate expected credit loss results, and the amount of historical data needed for accurate analysis might not be detailed or organized in a way that supports CECL analysis.

For example, it may be challenging to identify assets previously categorized in "other" catch-all balance sheet entries because they might have been one-time transactions or a combination of small transactions. While you can overcome this by incorporating external data into CECL modeling, be aware that examiners will require documentation for how external data was used and recognition of its limitations.

Insider Tips

Carving out and dedicating staff time to CECL is also key. Early adopters noted the most time-consuming activities involved obtaining, analyzing, and assessing data for various risk portfolios. A smooth process requires communicating the importance of CECL to support coordination with areas across the enterprise in diverse areas—think risk management, collections, portfolio managers and other non-accounting teams that will need to assist with ongoing data collection, integrity, and analysis. It's also appropriate to evaluate the benefits of automating workflows to support data accuracy and integrity.

Financial statement disclosures are another area requiring careful consideration and planning to ensure "day-one" entry is reported and disclosed appropriately. Since small changes in assumptions and modeling data points can have big impacts on results, it's important to determine the right level of detail to communicate to stakeholders.

Due to its nature, much of CECL is based on "best judgement" principles, so it can be challenging to determine the appropriate level of disclosure for transparency and clarity in your efforts to provide sufficient detail while avoiding confusion with the over-sharing of details.

Make it Easier: Compile These Docs

Examiners are reviewing not just CECL levels; they are also focused on supporting documentation to validate reporting with clear explanations of the analysis and rationale to support decisions. Boards and leadership should act now to ensure a successful CECL regulatory exam or external audit. How? Compiling documentation, per guidance provided in the AICPA CECL Audit Practice Aid, such as:

- A narrative acknowledging management's responsibility for CECL implementation including board-approved policies and plans for internal controls, risk assessments, and monitoring activities
- Evaluations of the risk of material misstatement related to the estimate of credit losses when determining necessary audit procedures
- Portfolio/pool-segmentation risk characteristics
- Identification and management of risks related to estimations and uncertainty over the allowance and financial reporting process
- Third-party vendor and specialist management of the methods, inputs, models, and assumptions mirror management's other assumptions when designing and implementing controls
- Sufficiency of audit evidence for substantive and control procedures
- Considerations around any change in assumptions, or the lack thereof and the rationale for the conclusion. Any changes in assumptions should be reported to the audit committee and include the impact those changes had on the overall allowance for credit loss balance
- Post-implementation reviews and continued evaluations, which might require adjustments prior to year-end audits.

Audit Committees should additionally continue to challenge the reporting that is provided by the Board to ensure there is open and transparent communication related to CECL implementation and the ongoing monitoring.

Our expertise can guide you through the process to overcome CECL impacts on your financial asset portfolio and implement strong, reliable, compliant processes. Speak with you Rehmann advisor or contact Scott Gogolin at scott.gogolin@rehmann.com or 248.579.1200 or Kevin Frank at kevin.frank@rehmann.com or 989.797.8364 for a personal discussion about your unique needs and all the resources we have to assist you in your CECL journey.

Small Business Fair Lending: The Challenge Continues

The controversial Section 1071 rule continues to make news. Intended to enforce fair lending laws and identify opportunities for community development, the rule, part of the Dodd-Frank Act, has for more than a year faced legal challenges from financial institutions and elected officials. In January 2022, the American Bankers Association (ABA) and 51 state bankers' associations issued a joint comment letter to the Consumer Financial Protection Bureau (CFPB), noting that while their "members oppose discrimination in any form, and support enforcement of fair lending laws" they have raised concerns "to no avail" about overstatement of the rule's benefits to fair lending and the costs and burdens of implementation. Establishing a system for monitoring the level of reportable loans, collection of data required by the rule, validation of the data reported, and implementing the required reporting structure layer additional costs upon financial institutions. The burden of these requirements could negatively impact the availability of credit to small businesses.

In March 2023, ABA President and CEO Rob Nichols issued a further statement that the rule "will harm the relationship banking model [CFPB] Director [Rohit] Chopra often praises—the model that community banks have relied on to meet the unique needs of small businesses in their communities."

Nichols also expressed concern that the data collection presents privacy risks and "could provide an incomplete and potentially misleading picture of small business lending to underserved groups." Earlier this year, under the Congressional Review Act (CRA), Rep. Roger Williams (R-TX) introduced two joint resolutions to override CFPB's final section 1071: H.J. Res 50, introduced on April 3, is with the House Committee on Financial Services. H.J. Res 66, introduced May 31, was passed by the Committee in late July, a move hailed by ICBA President and CEO Rebecca Romero Rainey: "[The] intrusive and overly burdensome data collection and reporting requirements for small-business loans would ultimately harm the women- and minority-owned small businesses the rule is designed to help."

Sen. John Kennedy (R-LA), who sponsored a resolution of disapproval, received praise from the Credit Union National Association (CUNA) noting, "CUNA fully supports your efforts to rein in the CFPB and its imposition of this burdensome regulation on credit unions and other community financial institutions." Legal challenges working their way through the court system include a lawsuit filed in Texas federal court by the Texas Bankers Association, ABA, and Rio Bank in McAllen, Texas. The lawsuit relies on the finding that the CFPB's funding is unconstitutional (Community Financial Services Association of America Ltd. v. CFPB), and, therefore, this and other CFPB rules are invalid. The Texas court granted the injunction motion and stayed the compliance dates until the U.S. Supreme Court reviews the CFSA decision. The Supreme Court is scheduled to hear oral arguments in the CFSA case on October 3, 2023.

In early August, a separate motion and complaint the ICBA, the Independent Bankers Association of Texas (IBAT), and Texas First Bank filed with the U.S. District Court for the Southern District of Texas argued that the limited injunctive relief the CFPB requested and received should extend to all community banks and small business customers nationwide; not just the plaintiffs named in the earlier filing. ICBA President Rainey commented that the CFPB should do the right thing and stay its final rule while the Court reviews the complaint because the CFPB has "created an unlevel regulatory playing field that poses harm to community banks and small businesses across the country."

Leaders of financial institutions must continue to monitor the actions of the Supreme Court on this issue, as well as the level of covered loans originated, to ensure readiness to implement the Rule should the Court rule in the CFPB's favor.

To stay on top of the latest developments on Section 1071, contact your Rehmann advisor or Liz Ziesmer at liz.ziesmer@rehmann.com or 616.975.2855.

Beneficial Ownership Information (BOI) Reporting Requirements

In 2021, the Corporate Transparency Act (CTA) authorized the collection of Beneficial Owner Information (BOI) by financial institutions providing services to entities. The move, part of the Financial Crimes Enforcement Network's (FinCEN) BSA/AML efforts to protect the U.S. financial system from money laundering, terrorism financing, and other illicit activity, was followed in 2022 with FinCen's BOI reporting requirement—a means to increase transparency and identify and stop bad actors that use anonymous shell companies to hide their illegal transactions. In early 2023, the Federal Register published a notice with additional details about the BOI collection process. Here's what you need to know:

What is a Beneficial Owner

A beneficial owner is any individual who directly or indirectly exercises "substantial control" over the reporting company, or who directly or indirectly owns or controls 25 percent or more of the "ownership interests" of the reporting company. Senior officers have "substantial control," as do others who direct, determine, or have substantial influence over important entity decisions.

Who Must File a BOI Report

All domestic and foreign entities—including corporations, partnerships, and LLCs—that have filed formation or registration documents with a U.S. state or Native American tribe must file a BOI report unless they meet one of 23 exceptions, including:

Banks as defined in:

- Section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)
- Section 2(a) of the Investment Company Act of 1940 (15 U.S.C. 80a– 2(a))
- Section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80b– 2(a))
- Federal or state credit unions as defined in section 101 of the Federal Credit Union Act
- Bank holding companies as defined in section 2 of the Bank Holding Company Act of 1956
- Savings and loan holding companies as defined in section 10(a) of the Home Owners' Loan Act
- Large operating entities that employ more than 20 people in the U.S., had gross revenue or sales over $5 million on the prior year's tax return, and have a physical office in the U.S.
- Publicly traded companies that have registered under Section 102 of SOX.

When to File

FinCEN will begin accepting BOI reports on Jan. 1, 2024, based on these filing deadlines:

- New entities created or registered after Dec. 31, 2023: within 30 days of creation or registration
- Existing entities created or registered before Jan. 1, 2024: Jan. 1, 2025
- Reporting companies that have had changes to previously reported information or have discovered inaccuracies in previously filed reports: within 30 days of change or discovery of inaccuracy.

In Good Company

It's estimated that more than 32 million BOI reports will be filed with FinCEN in 2024, and up to 5 million filed each year thereafter. FinCEN estimates 59 percent of reporting companies will have one beneficial owner who is also the company applicant, 36.1 percent will have an intermediate structure, such as four beneficial owners and one company applicant, and 4.9 percent will have a complex structure, such as eight beneficial owners and two company applicants. The agency also estimates the average cost of filing an initial BOI report will range between $85.14 and $2,614.87 per entity, depending on its beneficial ownership structure.

The BOSS

FinCEN is in the process of creating the Business Ownership Secure System (BOSS), a web-based interface, to collect, store and retrieve BOI information. Entities will be expected to file BOI reports using this portal, although FinCEN is reviewing alternatives for the rare occasions entities are unable to file electronically. The process for financial institutions and other authorized requestors to access BOSS data is still to be determined.

Impact for financial institutions

Financial institutions should develop a process for accessing information from FinCEN's BOSS system, documenting the data obtained, and ensure training is provided to appropriate personnel on these reporting requirements for entities.

For updates on the status of FinCEN's BOSS system and how it can assist in BSA/AML compliance, reach out to Beth Behrend at beth.behrend@rehmann.com or 616.975.4100. For any questions or updates on BOI reporting oversight and compliance, call your Rehmann advisor.

Evolving Regulatory Landscape: Compliance Challenges and Best Practices for Bank Directors

The FDIC issued its latest Consumer Compliance Supervisory Highlights this past April, summarizing high-risk issues compliance officers and bank executives should focus on when reviewing and updating operational policies and procedures.

Below are common pitfalls uncovered during recent examinations and—more importantly—helpful tips to avoid them:

TRID reporting accuracy continues to be a problem for financial institutions that are not correctly completing the disclosure as required by TILA/Reg Z. You can ensure compliant reporting by validating that loan origination systems and software capture required fees and information, whether through automated or manual workflows. Establishing a secondary review and quality control (QC) process before providing the disclosure to consumers can identify one-time issues versus systemic errors.

UDAAP and Representment Fees, such as non-sufficient funds (NSF) fees, are being charged multiple times for the representment of the same unpaid transaction without bank disclosures clearly explaining the policy. Review current fee schedules and disclosures to ensure your system is charging fees as disclosed and train staff to clearly communicate fees to impacted customers.

Flood Insurance is required to be in place at the time a covered loan is made, increased, extended, or renewed, and it must remain in place throughout the life of the loan. Review policies and procedures to ensure they specify the flood coverage requirements for all types of real estate secured loans.

Regulation E Error Resolution (related to EFTA/Reg E requirements) to investigate allegations of EFT errors and report and correct errors within a specified timeframe. Compliance missteps in this area can be avoided with robust procedures focused on timeline requirements, as well as thorough documentation of investigations, corrective actions, and customer communication.

Deposit Account Disclosures in TISA/Regulation DD establish timing and content requirements for deposit account disclosures that must be provided when an account is opened. The disclosures must include balance requirements, explain how the APY is calculated, and detail interest rates, fees, limitations, terms, and other applicable restrictions. Ensure compliance by reviewing disclosures and fee schedules for accuracy, validating set-up in the core and testing how they are provided to the customer when an account is opened in person or online, the latter of which requires eSign consent. Remember, accountholders must be notified in advance of a product change that will negatively impact them. Also, conduct a thorough compliance review of all advertisements, social media posts, and website content to ensure all contain accurate disclosures.

Overdraft Protection concerns were addressed in an April OCC bulletin urging best practices to mitigate risks associated with overdraft protection programs—specifically, prohibitions against unfair or deceptive practices. With a focus on ensuring banks operate in a safe and sound manner (and acknowledging that overdraft protection programs can help consumers meet short-term liquidity needs), the OCC also recognized that banks have a responsibility to institute appropriate risk management practices.

Keeping up with Regulatory Changes

The continuing challenge for leaders of financial institutions is the ability to keep up with the constant changes and updates to regulatory requirements, ensuring effective implementation, while continuing to effectively and efficiently deliver products and services to clients.

Rehmann advisors routinely monitor regulatory and compliance trends and are uniquely qualified to help your leadership deftly navigate the rapidly changing landscape. For more information, contact Beth Behrend at beth.behrend@rehmann.com or 616.975.4100.

Rehmann is a financial services and business advisory firm. We excel at helping clients because we take a collaborative, personalized approach and build a customized team of specialists to help them achieve their objectives. We focus on the business of business — allowing people to focus on what makes them extraordinary. The firm started as a CPA firm more than 75 years ago. Now, we are a multifaceted advisory firm that helps businesses and high-net-worth families maximize potential. Clients who work with us want us to be more than a vendor. They want collaboration, innovation, and continuous improvement.

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