



Auditing BSA/AML Incentive Structures

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I. Executive Summary

Post-mortem reviews of corporate scandals and enforcement actions indicate a clear linkage between incentive structures and compliance failures at financial institutions.

However, there is limited published guidance available to financial institution AML auditors to assist in:

1. Identifying both the monetary and non-monetary components of BSA/AML incentive structures
2. Performing a risk assessment of BSA/AML incentive structures covering the three lines of defense
3. Developing an audit approach for BSA/AML incentive structures

In this white paper, based on a survey of relevant corporate psychology literature, regulatory guidance, and a sample of public BSA/AML enforcement actions, I propose to provide a deeper understanding of and suggest best practices regarding the above three sensitive and challenging areas of interest for AML auditors.

I define incentive structure in its broadest sense to include any intentional decision or failure to act by a financial institution’s Senior Management which incentivizes a particular response or behavior, or creates a disincentive to unwanted behaviors by staff members with AML responsibilities in any of the three lines of defense. These incentives and disincentives can either strengthen or weaken a financial institution’s AML Compliance Program, depending on Senior Management’s risk appetite and prioritization of corporate profit vs. internal control / regulatory compliance goals (i.e. the tone from the top).

I exclude Board level incentive decisions relevant to Executive Management from the scope of this white paper, such as the granting and withholding of stock options, golden parachutes, and sign-on bonuses to top level executives. While these decisions will inform the tone from the top, I start my analysis at the point where the Board and Senior Management’s risk appetite is translated into staff level incentive structures with a direct impact on AML Compliance.

II. Two Relevant Psychological Frameworks

A. Maslow’s Hierarchy of Needs



Maslow’s hierarchy of needs theory is summarized below, and will be used as one framework to categorize sources of motivation by different actors within a financial institution’s three lines of defense in sections IV. and V. of this white paper. “Needs are psychological or physiological insufficiencies that provoke some type of behavioral response. The needs a person has can range from weak to strong and can vary based on

environmental factors, time and place. One of the most popular needs theories is Abraham Maslow’s hierarchy of needs theory. Maslow proposed that motivation is the result of a person’s attempt at fulfilling five basic needs: physiological, safety, social, esteem and self-actualization. According to Maslow, these needs can create internal pressures that can influence a person’s behavior. Physiological needs are those required for human survival such as air, food, water, shelter, clothing and sleep.

Safety needs include those needs that provide a person with a sense of security and well-being. Personal

security, financial security, good health and protection from accidents, harm and their adverse effects are all included in safety needs.

Social needs, also called love and belonging, refer to the needs to feel a sense of belonging and acceptance. Social needs are important to humans so they do not feel alone, isolated and depressed. Friendships, family and intimacy all work to fulfill social needs.

Esteem needs refer to the need for self-esteem and respect, with self-respect being slightly more important than gaining respect and admiration from others.

Self-actualization needs describe a person's need to reach his or her full potential. The need to become what one is capable of is something that is highly personal.

As the name of the theory indicates, Maslow believed that these needs exist in a hierarchical order. This progression principle suggests that lower-level needs must be met before higher-level needs. The deficit principle claims that once a need is satisfied, it is no longer a motivator because an individual will take action only to satisfy unmet needs."¹

B. The Fraud (or Intentional Non-Compliance) Triangle



The elements of the fraud triangle (perceived need/pressures, opportunity, rationalization) explained below will be used as a second frame of reference to analyze intentional departures from established AML controls in sections IV. and V. of this white paper. While intentional non-compliance with AML or sanctions regulations does not involve direct misappropriation of funds, financial advantage is often gained in the form of increased bonuses or commissions for either

onboarding or maintaining improper customer relationships, or for executing prohibited transactions. "The fraud triangle originated from Donald Cressey's hypothesis (Donald R. Cressey, *Other People's Money* (Montclair: Patterson Smith, 1973) p. 30): *Trusted persons become trust violators when they conceive of themselves as having a financial problem which is non-shareable, are aware this problem can be secretly resolved by violation of the position of financial trust, and are able to apply to their own conduct in that situation verbalizations which enable them to adjust their conceptions of themselves as trusted persons with their conceptions of themselves as users of the entrusted funds or property.*"²

"The three factors that make up the fraud triangle are:

1. Pressure. Most individuals require some form of pressure to commit a criminal act. This pressure does not need to necessarily make sense to outside observers, but it does need to be present.

¹ "The Needs Theory: Motivating Employees with Maslow's Theory of Needs", accessed November 18, 2017, <https://study.com/academy/lesson/the-needs-theory-motivating-employees-with-maslows-hierarchy-of-needs.html#/transcriptHeader>.

² "The Fraud Triangle", accessed November 18, 2017, <http://www.ace.com/fraud-triangle.aspx>

Pressures can include money problems, gambling debts, alcohol or drug addiction, overwhelming medical bills. Greed can also become a pressure, but usually needs to be associated with injustice. 'The company has not been paying me what I am really worth,' for instance.

2. Opportunity. An opportunity to commit the act must be present. In the case of fraud, usually a temporary situation arises where there is chance to commit the act without a high chance of being caught. Companies that are not actively working to prevent fraud can present repeated opportunities to individuals who meet all three criteria of the fraud triangle.
3. Rationalization. The mindset of a person about to commit an unethical act is one of rationalization. The individual manages to justify what he or she is about to do. Some may think they are just going to borrow the stolen goods, or they need the money more than the 'big' company they are stealing from."³

III. Regulatory Guidance with BSA/AML Incentive Structure Implications

Following are relevant excerpts from four key regulatory publications which include supervisory expectations regarding incentive structures at U.S. financial institutions. This guidance is used as the primary source for the AML incentive structure risk factor and expected control identification performed in sections V. and VI. of this white paper, respectively.

A. FFIEC Bank Secrecy Act / Anti-Money Laundering Examination Manual 2014

"Management and Oversight of the BSA/AML Compliance Program
...The board should ensure that senior management is fully capable, qualified, and properly motivated to manage the BSA/AML compliance risks arising from the organization's business activities in a manner that is consistent with the board's expectations. The board should ensure that the BSA/AML compliance function has an appropriately prominent status within the organization. Senior management within the BSA/AML compliance function and senior compliance personnel within the individual business lines should have the appropriate authority, independence, and access to personnel and information within the organization and appropriate resources to conduct their activities effectively. The board should ensure that its views about the importance of BSA/AML compliance are understood and communicated across all levels of the banking organization. The board also should ensure that senior management has established appropriate incentives to integrate BSA/AML compliance objectives into management goals and compensation structure across the organization, and that corrective actions, including disciplinary measures, if appropriate, are taken when serious BSA/AML compliance failures are identified."⁴

"Private Banking – Overview – Board of Directors and Senior Management Oversight

...Employee compensation plans are often based on the number of new accounts established or on an increase in managed assets. Board and senior management should ensure that compensation plans do not create incentives for employees to ignore appropriate due diligence and account opening

³ "The Fraud Triangle Theory – Brumell Group", accessed November 18, 2017, <https://www.brumellgroup.com/news/the-fraud-triangle-theory/>

⁴ 2014 FFIEC Bank Secrecy Act/ Anti-Money Laundering Examination Manual, p. 158

procedures, or possible suspicious activity relating to the account.”⁵

B. OCC Interagency and NYDFS Guidance on Sound Incentive Compensation Policies

The key language from the 2010 OCC interagency guidance captured below was also mostly adopted unchanged in the 2016 NYDFS guidance:

“III. Final Guidance

...These principles are: (1) Incentive compensation arrangements at a banking organization should provide employees incentives that appropriately balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risk; (2) these arrangements should be compatible with effective controls and risk-management; and (3) these arrangements should be supported by strong corporate governance, including active and effective oversight by the organization’s board of directors...”^{6,7}

C. FinCEN Advisory to U.S. Financial Institutions on Promoting a Culture of Compliance

“A financial institution can strengthen its BSA/AML compliance culture by ensuring that (1) its leadership actively supports and understands compliance efforts; (2) efforts to manage and mitigate BSA/AML deficiencies and risks are not compromised by revenue interests; (3) relevant information from the various departments within the organization is shared with compliance staff to further BSA/AML efforts; (4) the institution devotes adequate resources to its compliance function; (5) the compliance program is effective by, among other things, ensuring that it is tested by an independent and competent party; and (6) its leadership and staff understand the purpose of its BSA/AML efforts and how its reporting is used.”⁸

D. NYDFS Part 504 – Banking Division Transaction Monitoring and Filtering Program Requirements and Certifications

“...the Department identified shortcomings in the transaction monitoring and filtering programs of these institutions attributable to a lack of robust governance, oversight, and accountability at senior levels.

§ 504.3 Transaction Monitoring and Filtering Program Requirements.

(c) Each Transaction Monitoring and Filtering Program shall require the following, to the extent

⁵ 2014 FFIEC Bank Secrecy Act/ Anti-Money Laundering Examination Manual, p. 277

⁶ Guidance on Incentive Compensation Arrangements, New York Department of Financial Services (October 11, 2016), p.2

⁷ Guidance on Sound Incentive Compensation Policies, Department of the Treasury, Office of the Comptroller of the Currency, Federal Register/Vol. 75, No. 122/Friday, June 25, 2010/Notices, pp. 36408-36410

⁸ FinCEN Advisory to U.S. Financial Institutions on Promoting a Culture of Compliance (FIN-2014-A007), pp. 1-2

applicable: ...6. funding to design, implement and maintain a Transaction Monitoring and Filtering Program that complies with the requirements of this part; 7. qualified personnel or outside consultant(s) responsible for the design, planning, implementation, operation, testing, validation, and on-going analysis of the Transaction Monitoring and Filtering Program...8. Periodic training of all stakeholders with respect to the Transaction Monitoring and Filtering Program.”⁹

⁹ NYDFS Part 504 – Banking Division Transaction Monitoring and Filtering Program Requirements and Certifications, pp. 1, 3-5

IV. The Empirical Evidence: Survey of a Sample of Enforcement Actions

The table below contains a post-mortem review of the role played by incentive structure issues in U.S. AML enforcement actions published between November 2016 and November 2017, in the context of the Maslow’s Hierarchy of Needs (MHN) themes and Fraud Triangle (FT) drivers defined in section II. above. The MHN themes and FT drivers highlighted below are used as a second source for the AML incentive structure risk factor identification performed in section V. below.

Enforcement Action ¹⁰	MHN Themes	FT Drivers
Deutsche Bank AG; Deutsche Bank AG (New York Branch); DB USA Corporation; Deutsche Bank Trust Company Americas / 5/26/2017 / FRB / \$41,000,000 ¹¹	<u>Three Lines of Defense:</u> * Physiological (excessive workload / insufficient staffing, p.10); * Esteem (lack of active involvement in AML activities, p.5); * Self-Actualization (lack of training, p.10; lack of adequate resources, p.5)	<u>Business Line and Compliance Staff:</u> * Rationalization (lack of defined individual accountability for achieving compliance, p.6)
Banamex USA / 5/18/2017 / DOJ (Crim) / \$97,440,000 ¹²	<u>Compliance and Internal Audit Staff:</u> * Physiological (excessive workload / insufficient staffing, pp.1, 11); * Self-Actualization (lack of appropriate automated tools for effective transaction monitoring, p.17)	<u>Business Line Staff:</u> * Perceived Opportunity (lack of appropriate automated monitoring systems and insufficient staffing vs. transaction volume, p.17); * Rationalization (prioritization of revenue potential over compliance concerns; aggressive market share and revenue targets, pp. 14, 21)
UBS AG / 3/22/2017 / OCC / \$-0- ¹³	<u>Compliance Staff:</u> * Physiological (excessive workload / insufficient staffing of transaction monitoring)	<u>Business Line and Compliance Staff:</u> * Perceived Opportunity (Lack of Compliance challenge to account relationships and business)

¹⁰ Sullivan & Cromwell LLP “Banking Enforcement Action Tracker”, public version, accessed November 25, 2017, <https://www.sullcrom.com/beat>

¹¹ Deutsche Bank AG; Deutsche Bank AG (New York Branch); DB USA Corporation; Deutsche Bank Trust Company Americas, 5/26/2017 FRB Consent Order

¹² Banamex USA, 5/18/2017 DOJ Non-Prosecution Agreement

¹³ UBS AG, 3/22/2017 OCC Written Agreement

Enforcement Action ¹⁰	MHN Themes	FT Drivers
	and internal audit functions ,p.15);* Esteem (lack of authority regarding account relationships and business plans, p.4); * Self-Actualization (lack of training for transaction monitoring staff, p.15)	plans, p.4; excessive workload / insufficient staffing of transaction monitoring staff, p.15);* Rationalization (lack of defined individual accountability and roles & responsibilities for all three lines of defense,pp.4-5; lack of inclusion of compliance goals in business staff performance evaluations, pp. 4-5; lack of performance measurement benchmarks for Compliance staff, pp. 4-5)
Merchants Bank of California, N.A. / 2/16/2017 / FinCEN / \$7,000,000¹⁴	<u>Compliance Staff:</u> * Safety / Financial Security (threats of dismissal or retaliation by Bank insiders towards compliance staff, p.3); * Esteem (lack of authority by the BSA Officer, p.4); * Self-Actualization (lack of training, pp.4,10)	<u>Bank Insiders:</u> * Perceived opportunity (Use of Bank official position to facilitate transactions on behalf of self-owned MSBs, p.3); * Perceived opportunity (opportunity to override compliance controls and increase revenues through intimidation of compliance staff; insufficient internal audit coverage, not commensurate with Bank's complexity and risk profile, p.4); * Rationalization (prioritization of revenues over compliance concerns, pp.9, 15) <u>Three Lines of Defense:</u> * Rationalization (lack of defined individual accountability for all departments with Compliance responsibilities, p.9)

¹⁴ Merchants Bank of California, N.A., 2/16/2017 FinCEN Consent Order

Enforcement Action ¹⁰	MHN Themes	FT Drivers
Merchants Bank of California, N.A. / 2/14/2017 / OCC / \$1,000,000¹⁵	<u>Compliance Staff:</u> * Self-Actualization (lack of training, pp. 2-3)	<u>Bank Insiders:</u> * Perceived opportunity (BSA Officer and staff with insufficient technical expertise and experience, pp. 2-3)
Deutsche Bank AG; Deutsche Bank AG (New York Branch) / 1/30/2017 / NYDFS / \$425,000,000¹⁶	<u>Compliance Staff:</u> * Physiological (excessive workload / insufficient staffing, p.12); * Self-Actualization (lack of appropriate automated tools for effective transaction monitoring, p.15)	<u>Traders / Supervisor:</u> * Perceived opportunity (collusion with corrupt customers, p.3; exclusion of compliance staff from external Request for Assistance (RFA) responses, pp.11,15; active involvement by trader supervisor in approving onboarding and KYC documentation, p.14; lack of appropriate automated monitoring systems, p.15; and insufficient staffing, p.12); * Rationalization (prioritization of commission earnings over compliance concerns, p.7)
BB&T Corporation / 1/25/2017 / North Carolina Office of the Commissioner of Banks / \$-0-¹⁷ BB&T Corporation / 1/25/2017 / FRB / \$-0-¹⁷	<u>Compliance Staff:</u> * Physiological (excessive workload / insufficient staffing, pp.4-5)	<u>Business Line and Compliance Staff:</u> * Rationalization (lack of defined individual accountability, and roles & responsibilities for achieving compliance, p.5)
Western Union Financial Services, Inc. / 1/19/2017 / FinCEN / \$184,000,000¹⁸ Western Union Company /	<u>Compliance Staff:</u> * Esteem (lack of authority regarding agent relationships, FinCEN pp.3,4,8; DOJ pp.1,7)	<u>Sales Staff:</u> * Rationalization (prioritization of preserving agent relationships and revenue potential over

¹⁵ Merchants Bank of California, N.A., 2/14/2017 OCC Consent Order

¹⁶ Deutsche Bank AG; Deutsche Bank AG (New York Branch), 1/30/2017 NYDFS Consent Order

¹⁷ BB&T Corporation, 1/25/2017, FRB Consent Order / BB&T Corporation, 1/25/2017, North Carolina Office of the Commissioner of Banks Consent Order

¹⁸ Western Union Financial Services, Inc., 1/19/2017 FinCEN Consent Order

Enforcement Action ¹⁰	MHN Themes	FT Drivers
1/19/2017 / DOJ (Crim) / \$586,000,000 ¹⁹		fraud & compliance concerns, FinCEN pp.3,4,8; DOJ pp.1,7)
Intesa Sanpaolo S.p.A.; Intesa Sanpaolo S.p.A. (New York Branch) / 12/15/2016 / NYDFS / \$235,000,000 ²⁰	<u>Compliance Staff:</u> * Physiological (excessive workload / insufficient staffing, p.23); * Esteem (lack of authority regarding BSA/AML compliance program, p.23); * Self-Actualization (lack of appropriate management information systems to achieve compliance, p.23; lack of training, p.23) <u>Internal Audit Staff:</u> * Esteem (lack of escalation and resolution of audit findings, p.26)	<u>Business Line, Compliance and Internal Audit Staff:</u> * Rationalization (lack of defined individual accountability, and roles & responsibilities for achieving compliance, pp.23,27); * Perceived opportunity (lack of escalation and resolution of audit findings, p.26)

¹⁹ Western Union Company, 1/19/2017 DOJ Deferred Prosecution Agreement

²⁰ Intesa Sanpaolo S.p.A.; Intesa Sanpaolo S.p.A. (New York Branch), 12/15/2016 NYDFS Consent Order

V. Risk Assessment Factors for BSA/AML Incentive Structures

Risk factors have been summarized in the three tables below on the basis of the regulatory guidance described in section III above, as well as the Maslow's Hierarchy of Needs (MHN) themes and Fraud Triangle (FT) drivers identified as part of the review of a sample of supervisory consent orders (COs) in section IV above. A set of inherent risk factors along with corresponding suggested risk factor weights has been defined for each of the three lines of defense (LoD) in the fourth column, labeled 'Risk Factor Identification', and fifth column of the following tables, respectively.

While this white paper will not focus on the detailed approach to performing a typical audit risk assessment process, the following steps are usually applied for a defined subject area:

1. Identify the relevant risk factors through interviews with management and the review of relevant internal documentation and external guidance
2. Assign a judgmental risk weight to each risk factor (adding up to 100% in the aggregate)
3. Assign a judgmental risk rating to each risk factor within a pre-defined scale (i.e. from 1 to 3 or from 1 to 5) based on the auditor's assessment of the likelihood of occurrence of the risks and potential impact on the institution's business objectives
4. Multiply the risk weight by the risk score to arrive at a weighted score for each risk factor (basis for the extent of audit testing procedures to be applied to each risk factor)
5. Add the individual risk factor weighted scores to arrive at an overall risk score for the subject area (basis for the portion of the overall audit budget / resources to be devoted to the subject area in question)

The three tables below provide suggestions regarding steps 1. (Risk Factor Identification) and 2. (Risk Factor Weights) of the process only, as steps 3-5 would be specific to each financial institution.

A. First Line of Defense Risk Assessment Factors

1 st LoD Regulatory Guidance	COs MHN Themes	COs FT Drivers	Risk Factor Identification	Risk Factor Weights
FFIEC Manual, p.277 ⁵	None	* Perceived opportunity (Use of Bank official position to facilitate transactions on behalf of self-owned MSBs)	1. High risk bank staff personal behaviour red flags	15%

1 st LoD Regulatory Guidance	COs MHN Themes	COs FT Drivers	Risk Factor Identification	Risk Factor Weights
		* Perceived opportunity (collusion with corrupt customers)		
FFIEC Manual, p.277 ⁵	None	* Rationalization (aggressive market share and revenue targets)	2. Achievability of financial targets	20%
FFIEC Manual, p.277 ⁵ OCC Interagency Guidance, p. 36398 ⁷	None	* Rationalization (prioritization of revenue potential / agent relationships / commission earnings over compliance concerns)	3. Balance between financial and compliance objectives	20%
FFIEC Manual, p.158 ⁴		* Rationalization (lack of defined individual accountability for achieving compliance); * Perceived opportunity (active involvement by trader supervisor in approving onboarding and KYC documentation); * Rationalization (prioritization of preserving agent relationships and revenue potential over fraud & compliance concerns)	4. Impact of Compliance Failures on Compensation and Job Security	10%

1 st LoD Regulatory Guidance	COs MHN Themes	COs FT Drivers	Risk Factor Identification	Risk Factor Weights
	None	* Rationalization (lack of inclusion of compliance goals in business staff performance evaluations)	5. Transparency and consistency of corporate performance appraisal policies	10%
FinCEN Advisory, p3 ⁸	None	* Perceived opportunity (opportunity to override compliance controls and increase revenues through intimidation of compliance staff); * Perceived opportunity (exclusion of compliance staff from external RFA responses)	6. Nature of interaction with the second line of defense	20%
FinCEN Advisory, pp.2,4-5 ²¹ NYDFS Part 504, p.5 ⁹	None	None	7. Appropriateness of AML compliance training	5%
TOTAL				100%

²¹ FinCEN Advisory to U.S. Financial Institutions on Promoting a Culture of Compliance (FIN-2014-A007), p.4

B. Second Line of Defense Risk Assessment Factors

2 nd LoD Regulatory Guidance	COs MHN Themes	COs FT Drivers	Risk Factor Identification	Risk Factor Weights
FinCEN Advisory, pp.3-4 ^{22,21} NYDFS Part 504, p4 ⁹	* Physiological (excessive workload / insufficient staffing); * Self-Actualization (lack of appropriate automated tools for effective transaction monitoring);* Self-Actualization (lack of appropriate management information systems to achieve compliance)	* Perceived Opportunity (lack of appropriate automated monitoring systems and insufficient staffing vs. transaction volume in the second line of defense)	1. Adequacy of staffing level and technology resources	25%
FFIEC Manual, p.158 ⁴	None	* Rationalization (lack of defined individual accountability for achieving compliance)	2. Impact of compliance failures on compensation and job security	10%
FinCEN Advisory, pp.2-3 ^{8,22} FFIEC Manual, p.158 ⁴	* Financial Safety (threats of dismissal or retaliation by Bank insiders towards compliance staff)	* Rationalization (lack of defined individual accountability for achieving compliance); * Rationalization (lack of performance measurement	3. Transparency and consistency of corporate performance appraisal policies	10%

²² FinCEN Advisory to U.S. Financial Institutions on Promoting a Culture of Compliance (FIN-2014-A007), p.3

2 nd LoD Regulatory Guidance	COs MHN Themes	COs FT Drivers	Risk Factor Identification	Risk Factor Weights
		benchmarks for Compliance staff)		
FinCEN Advisory, pp.2-3 ^{8,22} FFIEC Manual, p.15 ⁸	* Esteem (lack of active involvement in AML activities); * Esteem (lack of authority regarding account / agent relationships and business plans)	* Perceived Opportunity (Lack of Compliance challenge to account relationships and business plans)	4. Organizational status	25%
FinCEN Advisory, p.3 ²² NYDFS Part 504, p4 ⁹	None	* Perceived opportunity (BSA Officer and staff with insufficient technical expertise and experience)	5. Compliance/AML team competence and experience	20%
FinCEN Advisory, p.4 ²¹ NYDFS Part 504, p5 ⁹	* Self-Actualization (lack of training)		6. Appropriateness of AML compliance training	10%
TOTAL				100%

C. Third Line of Defense Risk Assessment Factors

3 rd LoD Regulatory Guidance	COs MHN Themes	COs FT Drivers	Risk Factor Identification	Risk Factor Weights
FinCEN Advisory, p.4 ²¹	None	None	1. Degree of independence and objectivity	20%
None	* Esteem (lack of escalation and resolution of audit findings)	* Perceived opportunity (lack of escalation and resolution of audit findings)	2. Organizational status	15%

3rd LoD Regulatory Guidance	COs MHN Themes	COs FT Drivers	Risk Factor Identification	Risk Factor Weights
None	* Physiological (excessive workload / insufficient staffing of transaction monitoring staff and internal audit)	* Perceived opportunity (excessive workload / insufficient staffing of transaction monitoring and internal audit functions)	3. Adequacy of staffing level	15%
FFIEC Manual, p.158 ⁴	None	* Perceived opportunity (insufficient internal audit not commensurate with Bank's complexity and risk profile)	4. Impact of audit quality issues on compensation and job security	10%
	None	* Rationalization (lack of defined individual accountability and roles & responsibilities for all three lines of defense)	5. Transparency and consistency of audit department performance appraisal policies	10%
FinCEN Advisory, p.4 ²¹	None	* Perceived opportunity (insufficient internal audit coverage, not commensurate with Bank's complexity and risk profile)	6. Audit team AML competence and experience level	20%
FinCEN Advisory, pp.2,4 ²¹	* Self-Actualization (lack of training)		7. Appropriateness of AML Compliance Training	10%
TOTAL				100%

VI. Proposed Audit Objectives for BSA/AML Incentive Structures

A. Risk Based Selection and Approach

For each inherent risk factor identified in section V. above, relevant expected controls and proposed audit objectives are identified in the three tables below, by line of defense (LoD). The proposed audit objectives include both a design effectiveness assessment (DEA) and operating effectiveness testing (OET) component, as applicable. These are either sourced from the regulatory guidance reviewed earlier when available, or based on personal auditor experience.

B. Timing

The timing of coverage of the audit objectives may vary, depending on the financial entity's audit plan cycle. For example, certain objectives may have been addressed during recent human resources, governance, or compensation structure audits. In those instances, duplication of effort would not be required during the BSA/AML audit. Instead, the adequacy and completeness of the audit work previously performed should be evaluated for reliance during the BSA/AML audit, and the previous conclusions leveraged to reach an overall audit assessment of the BSA/AML program. Any remediating action taken by management in the interim might also require audit validation to reflect the current state of internal controls in the BSA/AML audit report.

C. First Line of Defense Audit Objectives

1 st LoD Risk Factors	Expected Controls	Proposed Audit Objectives
1. High risk bank staff personal behaviour red flags	1.1. Thorough background investigations of newly hired high risk employees in the first line of defense (e.g. private banking relationship managers) ⁵	1.1.1. Assessment of the adequacy of initial background check policies and procedures for high risk employees in the first line of defense (DEA) ²³ 1.1.2. Testing of the performance of background checks for a sample of newly hired high risk first line employees during the audit period (OET)
	1.2. Monitoring program to oversee relationship managers' activities and to detect any evidence of inappropriateness ⁵	1.2.1. Assessment of the adequacy of policies and procedures regarding the monitoring and dispositioning of negative news on high risk first line employees (DEA) ²³

²³ 2014 FFIEC Bank Secrecy Act/ Anti-Money Laundering Examination Manual, p. 278

1 st LoD Risk Factors	Expected Controls	Proposed Audit Objectives
		1.2.2. Testing of the inclusion of high risk first line employees in the negative news ongoing monitoring program during the audit period (OET)
2. Achievability of financial targets	2.1. Setting of well-developed goals and objectives which describe the target client base’s characteristics; types of clients accepted or prohibited; and new client acceptance authorization levels ⁵	2.1.1. Evaluation of the comprehensiveness of the business goals and objectives setting process, including target clientele, and client acceptance authorization levels (DEA/OET) ²³ 2.1.2. Testing of adherence to authorization levels for a sample of new high risk clients on-boarded during the audit period (OET)
	2.2. Periodic review by the Board and senior management of relationship manager compensation reports, budget or target comparison reports, and applicable risk management reports ⁵	2.2.1. Evaluation of the comprehensiveness of the periodic reviews of relationship manager budget vs actual and risk management reports performed by the Board and senior management (DEA/OET) ²³ 2.2.2. Testing of the accuracy of a sample of budget vs actual and risk management reports submitted to the Board and Senior Management for review during the audit period (OET) ²⁴
3. Balance between financial and compliance objectives	3.1. Establishment by Senior Management of appropriate incentives to integrate BSA/AML compliance objectives (including appropriate due diligence and account opening procedures, and flagging of suspicious activity) into	3.1.1. Assessment of first line of defense standard employment agreements / contracts for inclusion of BSA/AML compliance objectives into the compensation structure (DEA) ²³ 3.1.2. Review of a sample of new employment agreements / contracts entered into during the audit period for

²⁴ 2014 FFIEC Bank Secrecy Act/ Anti-Money Laundering Examination Manual, pp. 161-163

1 st LoD Risk Factors	Expected Controls	Proposed Audit Objectives
	<p>management goals and compensation structure across the organization^{4,5}</p> <p>3.2. Use of appropriate methods to make compensation more sensitive to risk, such as risk adjustment of awards; deferral of payment; longer performance periods; or reduced sensitivity to short-term performance⁷</p>	<p>adherence to the standard approved language regarding BSA/AML compliance objectives (OET)</p> <p>3.2.1. Refer to Audit Objective 3.1.1 above (DEA)</p> <p>3.2.2. Refer to Audit Objective 3.1.2 above (OET)</p>
<p>4. Impact of Compliance Failures on Compensation and Job Security</p>	<p>4.1. Imposition of corrective actions, including disciplinary measures, if appropriate, when serious BSA/AML compliance failures are identified⁴</p>	<p>4.1.1. Assessment of the existence of a process and forum to perform a full root cause analysis of each serious AML compliance failure (DEA)</p> <p>4.1.2. For any serious BSA/AML compliance failures experienced during the audit period, evaluation of the comprehensiveness of post-mortem reviews performed, including root cause analysis (DEA/OET)</p> <p>4.1.3. For any serious BSA/AML compliance failures experienced and which involved first line of defense responsibility, assessment of appropriateness of corrective actions and impact on employees' level of compensation, responsibilities, or employment (OET)</p>
<p>5. Transparency and consistency of corporate performance appraisal policies</p>	<p>5.1. Inclusion of qualitative measures in compensation program provided to employees to comply with account opening and suspicious activity monitoring and reporting requirements⁵</p>	<p>5.1.1. Assessment of the inclusion of AML compliance objectives in formal performance appraisal factors (DEA)²³</p> <p>5.1.2. Evaluation of actual performance appraisals for first line of defense staff with compliance issues or complaints during the audit period (lapses in collection of KYC information; failure to complete AML training on a timely</p>

1st LoD Risk Factors	Expected Controls	Proposed Audit Objectives
		basis; etc.) for reflection of such issues in appraisal results (OET)
6. Nature of interaction with the second line of defense	6.1. Requirement for relevant information to be shared with compliance staff to further BSA/AML efforts ⁸	6.1.1. Independent evaluation of timeliness of responses by first line of defense staff to Compliance investigations (as part of suspicious activity investigations; customer on-boarding and periodic reviews; etc.) (OET)
7. Appropriateness of AML compliance training	7.1. Training to ensure leadership and staff understand the purpose of BSA/AML efforts and how financial institution reporting is used ⁸	7.1.1. Assessment of the adequacy of AML training coverage, taking into account the financial institution's size, products, and services, and the first line of defense AML compliance responsibilities (DEA) 7.1.2. Testing of successful completion of AML training by first line of defense staff (OET)
	7.2. Inclusion of periodic training with respect to the Transaction Monitoring and Filtering Program ⁹	7.2.1. Assessment of inclusion of key transaction monitoring and filtering program topics in AML training provided to first line of defense staff (DEA)

D. Second Line of Defense Audit Objectives

2nd LoD Risk Factors	Expected Controls	Proposed Audit Objectives
1. Adequacy of staffing level and technology resources	1.1. Allocation of appropriate support staff to BSA/AML compliance function and compliance areas within the business lines to conduct their activities effectively ^{4,8}	1.1.1. Evaluation of the comprehensiveness of BSA/AML compliance staffing level assessments performed by Management during the audit period (DEA) 1.1.2. Evaluation of the level of operational backlogs experienced during the audit period (new accounts; periodic reviews; transaction monitoring alerts; SAR filings; other recurring tasks) (OET)

2 nd LoD Risk Factors	Expected Controls	Proposed Audit Objectives
	1.2. Allocation of appropriate technological resources to BSA/AML compliance; and allocation of sufficient funding to design, implement and maintain a compliant Transaction Monitoring and Filtering Program, based on the Risk Assessment of the institution ^{4,9}	1.2.1. Evaluation of the comprehensiveness of BSA/AML technology tool adequacy reviews performed by management or external consultants during the audit period, with a focus on transaction monitoring, sanctions screening, and KYC / Client on-boarding systems (DEA/OET)
2. Impact of compliance failures on compensation and job security	2.1. Imposition of corrective actions, including disciplinary measures, if appropriate, when serious BSA/AML compliance failures are identified ⁴	2.1.1. Refer to First Line of Defense Audit Objective 4.1.1 (DEA) 2.1.2. Refer to First Line of Defense Audit Objective 4.1.2 (DEA/OET) 2.1.3. For any serious BSA/AML compliance failures experienced and which involved second line of defense responsibility, assessment of appropriateness of corrective actions and impact on employees' level of compensation, responsibilities, or employment (OET)
3. Transparency and consistency of corporate performance appraisal policies	3.1. Inclusion of qualitative measures in compensation program provided to employees to comply with account opening and suspicious activity monitoring and reporting requirements ⁵	3.1.1. Assessment of the relevance and appropriateness of performance appraisal qualitative factors for the various AML related roles within the second line of defense (DEA) 3.1.2. Review of actual performance appraisals for second line of defense staff with AML issues or previous audit or regulatory findings during the audit period (transaction monitoring delayed SAR filings; new accounts or periodic review backlogs; failure to complete AML training on a timely basis; etc.) (OET)
4. Organizational status	4.1. Board measures to ensure the BSA/AML compliance function has an	4.1.1. Evaluation of second line of defense formal organizational status measures (independence of

2 nd LoD Risk Factors	Expected Controls	Proposed Audit Objectives
	appropriately prominent status within the organization ^{4,8}	reporting line; voting membership in relevant committees such as new product approval and reputational risk committees; decision making authority for approval of high risk accounts; etc.) (DEA) ²⁴
	4.2. Appropriate authority, independence, and access to personnel and information by BSA/AML compliance function and compliance personnel within the business lines ^{4,8}	4.2.1. Refer to First Line of Defense Audit Objective 6.1.1 (OET)
5. Compliance/AML team competence and experience level	5.1. Recruitment of senior management that is fully capable, qualified, and properly motivated to manage the BSA/AML compliance risks arising from the organization's business activities in a manner that is consistent with the board's expectations ⁴	5.1.1. Evaluation of extent and relevance of prior AML experience of second line of defense leadership team members, in light of the financial institution's size, products, and services (DEA/OET) 5.1.2. Review of prior regulatory examination and audit results for any comments which may have raised doubts regarding the Compliance/AML team's competence and experience level (OET)
	5.2. Use of qualified personnel or outside consultant(s) responsible for the design, planning, implementation, operation, testing, validation, and on-going analysis of the Transaction Monitoring and Filtering Program ⁹	5.2.1. Evaluation of extent and relevance of prior Transaction Monitoring and Filtering Program experience of second line of defense leadership team members and any outside consultants, in light of the financial institution's size, products, and services (DEA/OET) 5.2.2. Review of prior regulatory examination and audit results for any comments which may have raised doubts regarding the Compliance/AML team's competence and experience level regarding Transaction Monitoring and Filtering Programs (OET)

2nd LoD Risk Factors	Expected Controls	Proposed Audit Objectives
6. Appropriateness of AML compliance training	6.1. Training to ensure leadership and staff understand the purpose of BSA/AML efforts and how financial institution reporting is used ⁸	6.1.1. Assessment of the adequacy of AML training coverage, taking into account the financial institution's size, products and services, and the second line of defence AML compliance responsibilities (DEA) 6.1.2. Testing of successful completion of AML training by second line of defence staff (OET)
	6.2. Inclusion of periodic training with respect to the Transaction Monitoring and Filtering Program ⁹	6.2.1. Assessment of inclusion of key transaction monitoring and filtering program topics in AML training provided to second line of defence staff (DEA)

E. Third Line of Defense Audit Objectives

This review should be performed by the Internal Audit Quality Assurance function and/or an external peer reviewer:

3rd LoD Risk Factors	Expected Controls	Proposed Audit Objectives
1. Degree of independence and objectivity	1.1. Appointment of an independent party for testing of the compliance program ⁸	1.1.1. Review of any potential conflicts of interest for audit team members based on responsibilities, affiliations or prior assignments (DEA) 1.1.2. Testing of a sample of BSA/AML audit work papers and reports to evaluate the audit team's independence and objectivity in setting the audit budget, program, and approach; and in dispositioning potential audit issues (OET)
2. Organizational status	2.1. Timely escalation and resolution of audit findings and follow-up reviews to ensure completion of corrective measures ²⁰	2.1.1. Review of the adequacy of audit issue follow-up procedures and process (DEA) ²⁴ 2.1.2. Evaluation of the timeliness and quality of the tracking, remediation, and validation of the correction of BSA/AML audit issues (OET)

3 rd LoD Risk Factors	Expected Controls	Proposed Audit Objectives
	2.2. Clearly defined roles, responsibilities, and accountability regarding compliance with BSA/AML requirements ²⁰	2.2.1. Evaluation of third line of defense formal organizational status (independence of reporting line; non-voting membership in relevant committees such as new product approval, reputational risk, etc.; adequacy of systems and automated audit tools and AML resources) (DEA)
3. Adequacy of staffing level	3.1. Allocation of adequate staffing levels and resources to ensure compliance with the applicable BSA/AML requirements ¹¹	3.1.1. Assessment of the comprehensiveness of BSA/AML audit budget and staffing level assessments performed by Management during the audit period (DEA) 3.1.2. Evaluation of audit department ability to complete the annual BSA/AML audit plan in a timely and comprehensive manner (OET)
4. Impact of audit quality issues on compensation and job security	4.1. Imposition of corrective actions, including disciplinary measures, if appropriate, when serious BSA/AML compliance failures are identified ⁴	4.1.1. Refer to First Line of Defense Audit Objective 4.1.1 (DEA) 4.1.2. Refer to First Line of Defense Audit Objective 4.1.2 (DEA/OET) 4.1.3. For any serious BSA/AML compliance failures experienced and which involved third line of defense responsibility, assessment of appropriateness of corrective actions and impact on employees' level of compensation, responsibilities, or employment (OET)
5. Transparency and consistency of audit department performance appraisal policies	5.1. Establishment of appropriate incentives to integrate BSA/AML compliance objectives into management goals and compensation structure across the organization ⁴	5.1.1. Evaluation of auditor performance appraisals factors and level of priority given to AML audit quality (DEA) 5.1.2. Evaluation of actual performance appraisals for third line of defense staff with AML audit quality issues or previous regulatory findings (OET)
	6.1. Appointment of a competent party for testing of the compliance program ⁸	6.1.1. Evaluation of extent and relevance of prior AML experience of third line of defense team members as a

3 rd LoD Risk Factors	Expected Controls	Proposed Audit Objectives
6. Audit team AML competence and experience level		whole, in light of the financial institution's size, products, and services (DEA/OET)
	6.2. Use of qualified personnel or outside consultant(s) responsible for the testing, validation, and on-going analysis of the Transaction Monitoring and Filtering Program ⁹	6.2.1. Review of prior regulatory examination and audit quality assessment results for any comments which may have raised doubts regarding the audit team's BSA/AML competence and experience level (OET)
7. Appropriateness of AML Compliance Training	7.1. Training to ensure leadership and staff understand the purpose of BSA/AML efforts and how financial institution reporting is used ⁸	7.1.1. Assessment of the adequacy of AML training coverage, taking into account the financial institution's size, products and services, and the third line of defence AML compliance responsibilities (DEA) 7.1.2. Testing of successful completion of AML training by third line of defence staff (OET)
	7.2. Inclusion of periodic training with respect to the Transaction Monitoring and Filtering Program ⁹	7.2.1. Assessment of inclusion of key transaction monitoring and filtering program topics in AML training provided to third line of defence staff (DEA)

VII. Conclusion

This white paper aimed to document a review of relevant management psychological frameworks, regulatory guidance, and a sample of public BSA/AML enforcement actions for the purpose of:

1. Identifying both the monetary and non-monetary components of BSA/AML incentive structures
2. Performing a risk assessment of BSA/AML incentive structures covering the three lines of defense
3. Developing audit objectives for BSA/AML incentive structures

The Maslow's Hierarchy of Needs (MHN) and Fraud (or Intentional Non-Compliance) Triangle (FT) theories were used as two frameworks to identify positive and negative drivers of employee motivation, respectively. As a next step, relevant sections of guidance issued by the FFIEC, OCC, FinCEN, and the NYDFS were identified as pertaining to BSA/AML incentive structures.

Empirical evidence in the form of BSA/AML enforcement action letters issued from November 2016 to November 2017 was then reviewed to identify comments regarding incentive structure weaknesses flagged by the Regulators at the respective supervised financial institutions during this period. These regulatory comments were also categorized against the MHN and FT framework components.

Proposed BSA/AML incentive structure inherent risk factors were then summarized for each of the three lines of defense (LoD), based on the regulatory guidance and regulatory enforcement actions. Weights were subjectively assigned to each risk factor component based on the perceived strength and frequency of the regulatory guidance issued and criticism raised in the enforcement action letters.

The top three incentive structure risk factors identified for each line of defense are summarized in the table below:

Line of Defense	Risk Factor	Risk Factor Weight
1st LoD	Achievability of financial targets	20%
	Balance between financial and compliance objectives	20%
	Nature of interaction with the second line of defense	20%
2nd LoD	Adequacy of staffing level and technology resources	25%
	Organizational status	25%
	Compliance/AML team competence and experience	20%

Line of Defense	Risk Factor	Risk Factor Weight
3 rd LoD	Degree of independence and objectivity of the audit team	20%
	Audit team AML competence and experience level	20%
	Adequacy of staffing level	15%

Finally, for each incentive structure inherent risk factor, expected controls as well as proposed audit objectives were identified. The audit objectives were classified as addressing either control design effectiveness assessment (DEA) or operating effectiveness testing (OET).

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