Client Alert

May 2021

Significant Accounting Deficiencies

The challenges of addressing COVID-19, government closure orders, the Paycheck Protection Program, Main Street Lending Facilities and digital banking made this past audit season more challenging than most. Not surprisingly, it has given rise to quite a number of potential significant deficiencies.[1] Significant deficiencies that are not addressed will no doubt become "material weaknesses."[2] Obviously, the remediation required to address a material weakness is significantly higher and the ramifications regarding a bank's controls are (and potential disclosure) more acute if a material weakness is identified. Accordingly, set forth below are some of the significant deficiencies we observed in conjunction with the most recent audit season.

- Internal Controls. Some banks were not abiding by their controls around third party risks. For instance, in one situation, the bank's policies required annual due diligence of significant or critical vendors (a common control). Diligence may require obtaining a SOC 1 and 2. Absent doing so, the bank must review the vendor penetration testing and vulnerability assessments as part of its periodic vendor reviews. In short, the bank must confirm for itself that the critical vendor's control environment is acceptable. Other than by reviewing the SOC 2, the bank may not have the information or ability to do so.

- More Frequent Reviews. Depending on the nature of the activity, annual reviews are not sufficient. Higher risk activity may demand quarterly reviews. Banks that failed to do onsite reviews during COVID-19 were criticized for not doing them virtually. Such criticism included reviews of significant risk customers.

- Risk Assessments. Bank risk assessments are routinely showing levels of risk that are different from what the regulators think they ought to be. For instance, risk related to wires, BSA/AML/KYC should never be better than high and increasing before mitigation and never better than moderate and increasing after mitigation. Regulators view those matters especially for high-risk activity or geography banks (border banks, MRB, material online activities, etc.) as indicating whether the bank is realistic in its understanding of the risk environment.

- The following areas should almost uniformly be deemed to be high risk (pre-mitigation):

    - Wire transfers,
    - ACH/NACHA,
    - Consumer and corporate e-banking,
    - Remote deposit capture,
    - Correspondent banking,

[1] A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

[2] A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

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  - Trade finance,
  - Lending compliance,
  - Information technology,
  - Cybersecurity, and
  - BSA/AML/KYC.

In this year of COVID-19, we are also seeing banks designate asset/liability management, investments/BOLI, lending operations and credit administration, and methodology for the allowance for loan and lease losses (ALLL) as high-risk areas. Such risk-related issues then play into the significant deficiency designation.

- Policies. Banks are routinely not keeping up with steps that their policies require. Our experience is that banks have been lagging in the lower enforcement environment that is now about to sunset. To the extent a bank misses a material control action required by policy, a significant deficiency may result.

- Allowance. The ALLL has been an area of significant deficiency findings. These deficiencies have tended to relate to the methodology for the ALLL rather than the amount of the ALLL. Banks adopted COVID-19 "Q factors" and made other changes to justify higher reserves. These steps have been criticized as not having sufficient written support. Now that banks are seeking to lower provisions or even to take negative provisions to the ALLL, such methodology analysis is of particular importance.

- Fraud Risk. We are seeing many banks experience increasing fraud risk. Our experience is that bank Regulation E processes are not working consistent with the rules. Depending upon the level of operations, the failure with regard to Regulation E can be a significant deficiency.

- Remote Work. Due to COVID-19, banks implemented remote work environments. In a few cases, approval and dual control processes within departments were not appropriately changed to electronic formats.

- PPP. Banks did not put in place policy, risk appetites, risk assessments, procedures and support for the workflow of the PPP. In at least one instance, that resulted in a significant deficiency. In other instances, the lack of such documentation was criticized during examinations.

- ALCO. The ALM policy may need to be changed regarding the preparation, review and approval of assumptions, pricing for deposits and the review and revision of the ALM charter. Banks were not changing their IRR models to reflect the new environment. Such inaction could be a significant deficiency. Separately, examiners criticized the failure to reflect the non-reinvestment of PPP loans and the temporary nature of that lending program.

- Nontraditional Investments. Banks were criticized for not amending policy for investment activity changes. In addition, the documentation, underwriting and monitoring of such investments were also criticized. Banks were also criticized for their subordinated debt investments. In one case, we needed to show the OCC how the bank holding company that issued subordinated debt met the test for a "marketable security." The OCC also focused on bank post-purchase monitoring. A lack of such monitoring may also represent a significant deficiency.

- Wires. Banks were criticized for not training employees, including a detailed demonstration of the callback procedure, in order to adhere to the policies and

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procedures of the bank. Banks need to record callbacks in accordance with policies and procedures.

- ACH. Banks were not verifying information and limits in annual reviews corresponding to the information within the ACH system. Moreover, reviews were not in accordance with bank policy. The ACH originator logs were not up to date or promptly completed to include all customer information. Moreover, ACHs were being approved by individuals other than ACH originators.

- Dormant Accounts. Banks were not limiting access to dormant accounts. In light of the high risk of possible fraud and unauthorized use of funds associated with dormant accounts, such access should be restricted only to authorized personnel.

- Backup Withholding. Banks were not ensuring that expired W-8 forms were replaced with new forms or that the customer is subject to backup withholding in order to comply with FATCA requirements. Such a criticism did not seem like it should have risen to the level of a significant deficiency.

Contact

Peter G. Weinstock
pweinstock@HuntonAK.com

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