Understanding Anti Money Laundering

The U.S. Treasury Department has promulgated new regulations dealing with persons who make loans or sell manufactured homes, and who, even occasionally, accept or relay credit applications to lenders, including one's own seller finance operation. This clearly involves not only those engaged in lease option and purchase money financing, but also those who do nothing more than collect and transmit credit applications.

It is important to note that these regulations originate from the Treasury Department and are not part of, but in addition to, the Red Flags Rule, the Safe Guard Rule and the Disposal Act requirements enforced by the Federal Trade Commission and the SAFE Act which will be enforced by both state authorities and the CFPB.

Like all things that spring from the mind of regulators, this extension of the ruling made on February 29, 2012 is both confusing and laden with unspoken and unwritten consequences. Lenders that were not previously included in the compliance requirements for the Patriot Act and OFAC now are included. People that have never considered themselves "lenders" have been so recast for the purposes of Anti Money Laundering. The precedent being set by this rule extension may well set other regulators on a path to broaden the scope of their rules and laws to include this new definition of Residential Mortgage Loan Originator (RMLO) in the not too distant future.

The Treasury Department's new rules extended Anti-Money Laundering ("AML") and suspicious activity report ("SAR") requirements to non-depository residential mortgage lenders and originators. The regulations require non-depository primary residence lenders and originators to assist law enforcement agencies with fraud detection in a manner similar to the requirements that have existed for depository lenders for some time. It is worth noting that there is an eerie confluence with the statements coming out of the CFPB regulator's mouths, e.g. " non depository lenders will be regulated in the same way that depository lenders have been regulated for years". *Clearly, the trend is to recast both chattel lending and lending by non-depositories in the same light as depository lenders lending on real estate.*

As an industry, we need to start thinking about our lending and the rules and laws that govern that lending in the same manner those depository lenders have done over the years. We also need to be prepared for the continuing changes that banks and credit unions have had to face, and have a system in place to learn and adapt to new regulations and changes.

Where is All of This Coming From?

Since the War of 1812, the Federal Government has made attempts to control with whom business and commerce do business. During the Civil War, Lincoln, in one of his many power grabs, used his office to illegally suspend commerce and trade with a wide variety of businesses and people considered "Confederate sympathizers" complete with draconian rules and penalties for those who did not comply. In 1952, the federal government created the Office of Foreign Asset Control (OFAC) whose original authority covered only a very few and very large banks that did business with people and businesses outside of the United States. This agency then became in charge of preventing business and commerce from doing business with people the government didn't like by controlling the transactional means for moving payments in and out of the United States.

With 9/11, the government took advantage of the crisis and strong feelings to pass an additional piece of wide-sweeping regulatory legislation entitled the Patriot Act. Encapsulated within the Patriot Act was legislation that vastly expanded the power of OFAC and the Federal Bureau of Investigation while creating yet another entity – the Financial Crimes Enforcement Network (FinCEN) with the power to investigate and charge both businesses and individuals for violation of law and compliance issues,

Both the Patriot Act and the earlier legislation that created OFAC were extended to reach out to all depository institutions and even to those who were not depositories who made use of federally insured funds for lending. ***This is why much of this applied immediately to the outside lenders in our industry. It is also why, some of this did not apply to seller financiers until the SAFE Act changed the definitional nature of chattel lending, leaving a situation where it applied, but no one could figure out how to make it work without challenges.***

The Treasury Department, in their view, "closed a dangerous regulatory gap" with this rule extension. In doing so, seller financiers and RLOs became subject to compliance with the Patriot Act, OFAC, and the AML Rule. In creating that extension of regulatory authority and broadening the rule, they also ensnared community owners and retailers who sell homes but do not provide financing for those transactions – just on the basis of ever receiving, transmitting and/or conveying a credit application to a prospective lender or lenders.

Unlike the rules created by the SAFE Act, the Treasury Department quite deliberately chose to avoid the safe passages created by the Final Rule of the SAFE Act by HUD. For all practical purposes, if a retailer or community owner sells homes, they are going to need to comply with Red Flag, Safe Guard, the Disposal Act, the Patriot Act, OFAC, and AML.

For those in the manufactured housing industry who are selling or financing homes that are not their personal property (meaning the individual actually resided in them before selling) there really aren't any exemptions that matter. Pursuing a strategy of evading the compliance responsibility is fraught with danger and could imperil long-held assets.

The best advice we can offer is to stop trying to evade compliance responsibility. The time, effort and money used on such efforts far exceeds the cost of compliance with these issues.

It is also important to understand that this inclusion is only the first step by the Treasury Department to include others in this responsibility. Any gray areas or narrow gaps that might exist today, they intend to close.

SAFE Act versus AML

The HUD Final Rule on the SAFE Act allows opportunity for sales personnel to sell using credit if it is done along a very narrow path. The AML Rule Extension, while not addressing individuals but rather the entities they work for, closes those very same routes of escape for AML responsibility.

The definition of a loan or a finance company by the Treasury Department is different than what most people would believe defines a loan or finance company. Their definition says: a loan or finance company is limited to RMLOs. The Final Rule is intended to be "broad in scope" and cover "most non-bank residential mortgage originators," including:

- Any business that, on behalf of one or more lenders, accepts a completed mortgage loan application, even if the business does not in any manner engage in negotiating the terms of a loan.

- Any business that "offers" or "negotiates" specific loan terms on behalf of either a lender or borrower, regardless of whether they also accept a mortgage loan application.

The Final Rule modifies the definition of "residential mortgage loan originator" to include "persons" who "accept a residential mortgage loan application or that offer or negotiate terms of a residential mortgage loan." The change made from the NPRM of replacing the term "take" with "accept" is intended to differentiate the Final Rule from the SAFE Act.

The change from "and" to "or" is intended to ensure that businesses who either accept an application for relay to a lender or offer or negotiate the terms of a loan are both responsible for compliance.

The Final Rule applies to residential mortgage loan originators, irrespective of whether they receive compensation or gain for acting in that capacity. Accordingly, the phrase "for compensation or gain" in the proposed definition is removed from the definition in the Treasury Final Rule on AML.

These changes create significant differences between the definitions in Treasury's Final Rule and those used in the SAFE Act by HUD and other federal mortgage-related statutes. This was done intentionally to differentiate this Final Rule from those statutes so that the interpretation of this Final Rule is not based on the interpretation of those statutes. The Final Rule is to be consistent with the SAFE Act only to the extent deemed appropriate by the Treasury Department.

The AML Final Rule does not discriminate between for-profit and not-for profit enterprises, so this rule also applies to resident owned community organizations.

Compliance with any rule such as AML requires the entity to do three things:

1. Create a written Policy and Procedure Manual for each area of compliance that is reviewed and approved by the highest authority of the entity.

2. Create and implement a formal employee-training program that is effective in instructing employees in their responsibilities. This program should be varied with the levels of responsibility and should also include the highest level of authority in the organization.

3. Either contract with a qualified third party, or create an internal audit team that is independent of the Compliance Officer and staff to audit the policies and the procedures for success or failures and directing the implementation of corrective action by the Compliance Officer and their staff.

There are only three steps involved, and, with qualified outside help, can be relatively easy and inexpensive to achieve. However, like anything, there are small and large details that must be paid attention to, if the Compliance Management System is to pass muster.

Risk Assessments

Prior to starting on the requisite policy and procedure manuals a Risk Assessment should be conducted to determine both the "Level of Risk" and what policies and procedures are relevant and germane to the operation itself. For operators with multiple locations, it may be necessary to conduct Risk Assessments on each phase of the business and on each location. ***Risk Assessments for Red Flag may well be different from Risk Assessments for Safe Guard and both may be different from the Risk Assessment for AML.*** The Risk Assessment for a seller finance operation may be different than the one conducted for a related retail operation, just as it would be different for the community operation.

Policy and Procedure Manuals

Once the appropriate Risk Assessments have been conducted, only then should the policy and procedure manuals be constructed. Those constructing these manuals should be aware that these are not intended to just be something that "sits on a shelf waiting for a regulator to arrive" but rather "living and breathing documents" that actually create the means by which the employees of the organization achieve compliance. While they must cover all of the expected areas of policy, the procedures by which those policies are carried out must be ones the employees can and will utilize, and they must be effective.

- The Policies must be adequate and they must cover all aspects of the compliance issue from a legal point of view.
- The Procedures must be practical and usable and understandable by the level of employee that is expected to accomplish the assigned tasks. They must also be effective in accomplishing the stated goals.
- The selection and appointment of Compliance Officers is critical as they are the ones ultimately responsible for the compliance mission and effort. If they lack experience and training but have the potential to be effective and reliable in their position, they need to be supplied with the appropriate training with a goal of certification of standing with regulators.

Employee Training

When the Policy and Procedure Manuals are finished, the next step in the process is to train all the responsible employees (including ownership and top management) in both the policies and procedures developed. The level of training will depend on their position and responsibilities in the organization and should be developed and administered according to the responsibilities assigned to them. As an example:

- The Compliance Officer themselves will need extensive and documented training not only on the policy and procedures, but also on real understanding of the regulations and how to conduct themselves with the regulators.
- The highest authority in the entity must have not only an underlying understanding of the compliance issue, but should also be educated in the consequences and risks to the entity and to management itself in compliance breeches.
- Personnel that do not deal directly with the public may need somewhat different training depending on their positions and responsibilities than those who interact with the public on a regular basis.
- Personnel who are most likely to be the first encounter employee and their direct supervisors need highly specialized training and possibly role-playing with specialized tools to help them fulfill their responsibilities.

All training done must be comprehensive and effective and should strongly indicate the entity's commitment to achieving consistent and effective compliance. All training should include motivation for the employees to achieve compliance as well as an understanding of consequences for failure to perform as directed. It is a must to have these employees sign and date affidavits that the entity supplied training and that the employee believes they have a good comprehension of the material and their responsibilities.

Audits

A compliance management system designed to achieve federal compliance requires periodic audits by personnel not under the direction or influence of the Compliance Officer or compliance staff. Simply put, the fox cannot guard the hen house as far as federal regulators are concerned. While the option exists for internal audit, from a practical point of view, it is almost impossible for smaller and mid sized operations in manufactured housing to meet the criteria for an objective audit. Larger firms may not choose to conduct internal audits because of the increased risk associated with them. Most small and midsize banks and credit unions routinely utilize third parties who have the qualified auditors available to conduct their audits.

Whatever method is chosen, it must be thorough and well organized. A written report is necessary and that report should contain the following:

- An outline of the methodology utilized and a detailed description of each area of compliance checked.
- An observational overview of the effectiveness of the compliance management system followed by specific written observations and suggestions for greater effectiveness.
- A written and detailed plan to correct any deficiencies noted.

It should be observed that regulators will read any report written for clues of problems to look for. Not sharing these reports is not an option. Most experienced and savvy third party consultants will have their auditors also give a detailed and exhaustive oral report to the highest authority of the entity as well.