Money Service Business (MSB)

Banking Vertical

ABA Stonier Graduate School of Banking
2021 Capstone Strategic Project

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March 1, 2021

Central Bank & Trust

A PART OF FARMERS & STOCKMENS BANK

EXECUTIVE SUMMARY

Critical to the success of CB&T's long-term strategic plan is strong and reliable core deposit growth. In 2018, the Bank and Holding Company Board of Directors approved a five-year strategic growth plan that called for the injection of capital, hiring of key executives, and expansion into the Denver market. In preparation for the expansion into Denver, CB&T management recognized the need to enhance their treasury capabilities in order to procure full depository relationships from their commercial clients. Historically, CB&T has struggled attracting low-cost core deposits and has relied on a retail funding strategy – whereas the Bank was forced to "pay up" for deposits. This approach led to a deposit portfolio that contained a high percentage of consumer money market accounts, CDs, and interest-bearing checking accounts, resulting in a cost of funds (COF) that was significantly higher when compared to peer group. A high COF inevitability results in elevated loan yields in order to achieve the target net interest margin (NIM). The Denver market is competitive and highly saturated, leading to more aggressive loan structures and lower pricing than in CB&T's other two markets. In order for the Bank to successfully expand into Denver, CB&T management knew that in order to position the Bank for future growth, they needed to address the COF issue, revamp the commercial treasury management platform, and build a deposit portfolio heavily weighted with low-cost deposits.

A commercial banking platform overhaul was necessary to achieve the future growth goals of the Bank. This overhaul included a technology-forward approach to products and services, along with a progressive deposit growth strategy. The strategy was straightforward – CB&T would not charge their commercial clients bank service fees. The strategic thought behind this approach was to remove all barriers to entry for commercial clients. If the treasury management platform was competitive and clients were not charged fees for the service, the Bank should be able to convert a large number of commercial operating relationships. These relationships result in core deposits that are low-cost and significantly impact the Bank's COF. The accelerated deposit build gives CB&T the dry powder to aggressively acquire market share with competitive loan pricing.

In theory, the above strategy is logical and straightforward. While the strategy supports strong deposit growth, it does not account for the increasing costs associated with client acquisition and increased service level volumes. While CB&T can raise deposit balances quickly, expense growth will follow the expanding balance sheet. With no offset to the increased expenses, there will be a drag on core earnings.

As CB&T's management weighed the pros and cons of the proposed strategy, they identified a solution that would allow them to move forward with the no-fee approach while addressing expense growth at the same time. The solution proposed identified a high-margin fee vertical that could compliment the deposit growth strategy and generate non-interest income. Identifying a high-margin fee vertical can give the Bank significant operating leverage in allowing them to grow low-cost core deposit and lower the Bank's COF, while offsetting some or all of the increased expenses generated from their core client base.

While assessing the high-margin fee vertical approach, Bank management reviewed many options, with Money Service Businesses (MSB) rising to the top of the list. MSBs are non-bank financial institutions that provide a number of financial services, including everything from check cashing to international money transmission processing. They range in size and complexity and play a vital role in many communities that lack access to financial services and typical bank branches. They are particularly important for individuals who may not have ready access to the formal banking sector, often referred to the “un-banked” and “under-banked.”

Bank relationships are crucial to MSBs. The nature of their business requires access to the payments system that a bank provides in order to process checks and transfer funds. This reliance is also the greatest threat to MSBs and their banking partners. Since the majority of their business involves the movement of funds, they are considered a higher-risk industry, which comes with enhanced compliance and monitoring from their bank partners.

The cons associated with banking MSBs include upfront and ongoing expenses, exposure to AML/BSA/KYC violations, enhanced compliance monitoring, and financial and reputational risk to the Bank. In order to stand-up the MSB platform, CB&T would realize $85,250 in one-time expenses and $88,388 in ongoing expenses. Additionally, they would be required to add staffing to their Compliance department and would need to engage in legal and consulting services, even before bringing on their first MSB client. Lastly, the Bank’s regulator would monitor the program closely and look for adherence to all regulatory guidance, internal policies and procedures, and compliance practices.

The pros associated with banking MSBs include significant revenue potential, an industry with relatively minimal bank competition, and most importantly, the support of the Bank's core deposit growth strategy. Even with the large upfront expense to erect the MSB platform, profitability can be achieved relatively quickly. The analysis shows the program breakeven is achieved in month six, with first-year profitability of $110,759, growing to $196,009 in years two and beyond. Risk mitigation factors are included in the analysis, which include staffing, consultant fees, legal expenses and enhanced compliance monitoring software. As the MSB banking division grows, profitability would increase as the fixed costs of the programs would stay relatively flat. CB&T could continue with their general no-fee approach while expanding the MSB program to generate significant non-interest income and offset expenses generated by their core client base. While a viable standalone vertical, the MSB banking division would complement the strategic growth plan of CB&T and position the Bank's infrastructure for long-term success.

If CB&T is committed to lowering its COF and driving deposit growth through a no-fee approach, the MSB banking vertical is a perfect complement to that strategy. The program is a worthwhile investment and will support the long-term growth, durability, and scalability of the Bank. It is without hesitation that CB&T management consider moving forward with the implementation of the MSB banking vertical.

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Part I: Introduction / Background

History

Central Bancorp, Inc. was formed in 2006 with one purpose in mind – to build a firm that positively impacts the personal and professional lives of its clients, its team members, and its community's residents. At the time of Central Bancorp's formation, the Colorado economy was seeing record growth and a massive influx of residents and business were relocating to the state. With growth came opportunity. Central Bancorp's leadership team saw the potential to combine a family of financial services businesses under the roof of a locally-owned, privately-held company. Colorado natives were able to identify with an organization that was local and had strong ties to the community, while also attracting the wave of new residents and businesses looking to establish roots with a local community bank.

In 2009, less than three years after Central Bancorp's formation, the leadership team looked to expand its suite of financial services with the acquisition of Farmers & Stockmens Bank (F&SB) based in Clayton, New Mexico. One year later, Central Bank & Trust (CB&T) opened its doors in downtown Colorado Springs as a branch of Farmers & Stockmens Bank. For the purpose of this Capstone Project, CB&T will be referred to as the primary institution even though CB&T is a part of Farmers & Stockmens Bank. For all intents and purposes, Farmers & Stockmens Bank continues to be managed by people who maintain business and family ties to Clayton, NM and the surrounding communities. Farmers & Stockmens Bank is a very important part of the Central

Bancorp family, but the primary focus is building and developing the CB&T brand in Colorado Springs with a heavy emphasis on the Denver market expansion.

Business Model

CB&T is a self-described "boutique commercial bank," which focuses on small business and lower middle-market clients (defined lower middle-market as clients with revenues from $5MM - $75MM). Historically, CB&T focused heavily on commercial real estate loan growth and became the preeminent SBA lender in El Paso County (Colorado Springs area). Deposit growth typically came in the form of interest-bearing deposits and consumer deposits (who are related to the commercial client base) and not the operating accounts of commercial loan clients. The Bank has done very little consumer lending, and the retail presence is rather limited. Online banking, mobile banking, and other financial technology products have not been a focus of CB&T up to this point, although each are offered in some capacity. Like many community banks, CB&T has relied on service and relationships as its primary acquisition and retention model.

While the above-mentioned business model has worked successfully up to this point, in order to compete in a developed market such as Denver, CB&T's leadership knew they needed to enhance their product and service offering. The first step in this process was shift away from the previous funding strategy of using consumer deposits to fund commercial loans. CB&T invested heavily in a treasury management overhaul that gave its bankers the ability to target commercial operating depository accounts while driving down the Bank's cost of funds. This overhaul included a technology-forward approach to products and services as the Bank would operate with a limited footprint in the Denver market. Additionally, management believed in a minimalistic fee approach to commercial treasury services, as the critical factor to growth came in the form of core deposit acquisition. Denver is a competitive market with loan yields generally lower than what is seen in the Bank's other markets. In order to maintain the target net interest margin, lowering the Bank's cost of funds was priority number one.

As CB&T drives core deposit growth through commercial client operating business procurement, management has discussed the need to compliment that strategy and generate non-interest income. Identifying a high-margin fee vertical can give the Bank significant operating leverage. This approach should generate additional non-interest income, which compliments a low-fee strategy to traditional non-interest-bearing deposit clients, thereby lowering cost of funds on a net basis and driving core deposit growth.

Expansion

The five-year strategic plan approved by the Bank and Holding Company Board of Directors called for the injection of capital, branch expansion and hiring of key executives to grow the Bank to over $400MM in total assets by 2023. As part of the plan, the Bank chose to expand into the Denver Metro Statistical Area (MSA) with its second full-service branch in Colorado. The long-term objective of the Bank is to grow shareholder value by serving the commercial banking needs of the communities it serves through comprehensive banking services delivered with the conviction of local ownership and decision making.

Strategic growth is a competitive advantage to a bank. It allows for investment in the people, products and processes that are needed to meet ever-changing customer and regulatory expectations. CB&T has recognized an opportunity to profitably grow its total assets through an expansion into the Denver market. The opportunity is the result of the dislocation of customers and banking personnel caused by the acquisition of many of the Denver-based community banks by large out-of-market institutions. Through a combination of continued growth in the Colorado Springs market, the opening of a de novo branch in Denver in early 2020 and the expansion of its SBA lending platform, the Bank will grow total assets to more than $400MM by the end of 2023.

Market Analysis

Colorado is an actively growing market and continues to be a destination target for consumers and businesses alike. Population growth remains strong in the Denver

MSA. The United States Census Bureau estimated the population was 2,967,239 as of 2019, representing growth of 16.2% from 2010 to 2019.[1]

Banks that enter a new market generally do so through one of two routes: by organic growth or through acquisition. Figure 1, on page 6, shows the number of FDIC insured institutions and the number of FDIC insured offices in the Denver-Aurora-Lakewood-Colorado Springs Metropolitan Statistical Areas (MSA) has been on a steady decline over the past five years. At the start of 2015, the MSA had 92 FDIC insured institutions and 819 offices.[2] Over the course of five years, that number dropped to 84 institutions and 768 offices, declines of 9.5% and 6.6% respectively.[3]

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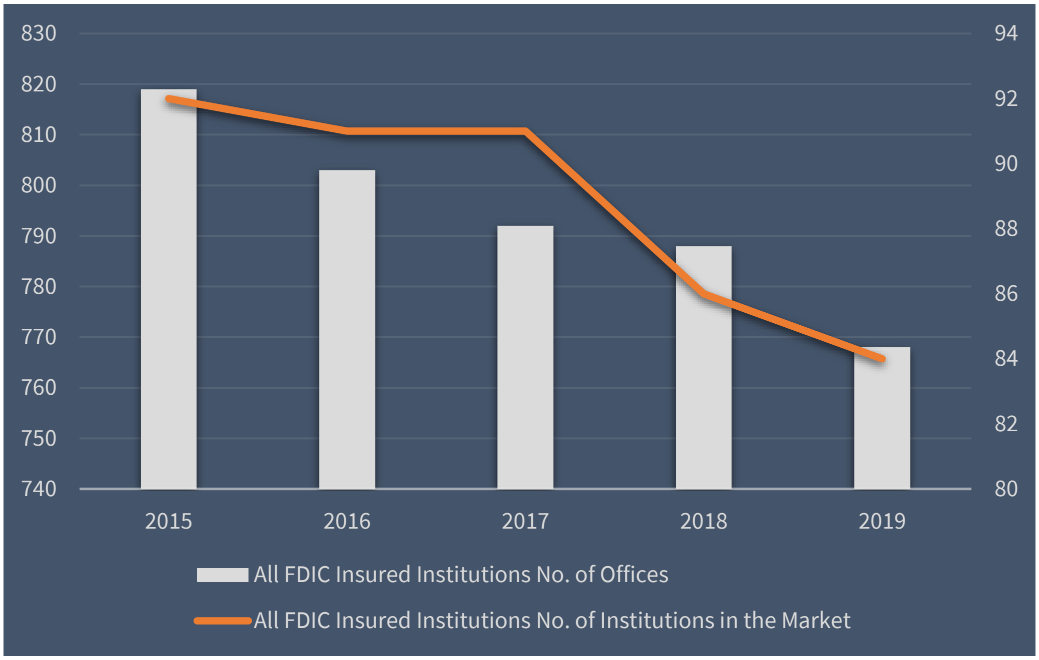
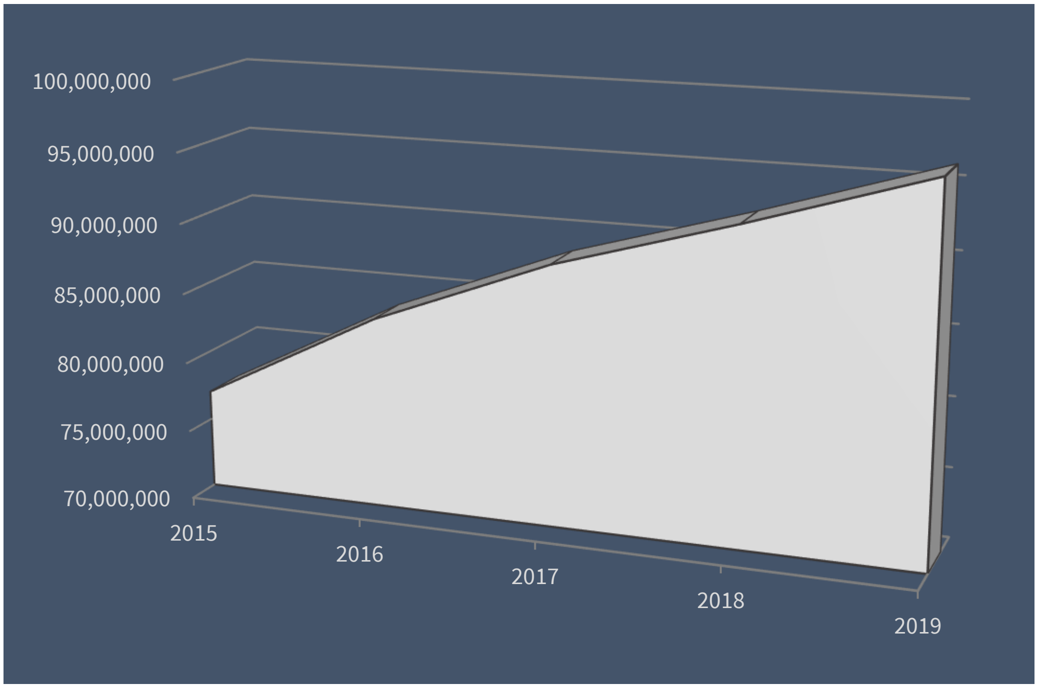
[1] U.S. Census Bureau, "Resident Population in Denver-Aurora-Lakewood, CO (MSA) [DNVPOP]," *FRED, Federal Reserve Bank of St. Louis,* https:fred.stlouisfed.org/series/DNVPOP (accessed November 8, 2020)
[2] Federal Deposit Insurance Corporation, "Deposit Market Share Report," www7.fdic.gov/sod/sodMarketRpt.asp?barItem=2&sZipCode=&InfoAsOf=2015&SortBy=Market%20Share&rerun=Y (accessed November 8, 2020)
[3] Federal Deposit Insurance Corporation, "Deposit Market Share Report," www7.fdic.gov/sod/sodMarketRpt.asp?barItem=&sCounty=all (accessed November 8, 2020)

Figure 1: Institution & Offices
Denver-Aurora-Lakewood-Colorado Springs MSA



Without context, the data alone appears to show a troubling trend. FDIC insured offices are closing, and FDIC insured institutions appear to be exiting the market. This could lead to the conclusion that the aforementioned MSA was shrinking, which would be a misinterpretation of the data. What the data fails to present is the increased merger and acquisition activity that has led to institution consolidation and redundant office closures. In fact, many banks and financial service companies are actively entering Colorado, which only intensifies the merger and acquisition activity. While the data may appear to show a negative trend, Colorado is experiencing tremendous growth in both population and business activity.

Figure 2: Market Deposit Growth
Denver-Aurora-Lakewood-Colorado Springs MSA



To further support the market growth claim, over the past five years, the Denver-Aurora-Lakewood-Colorado Springs MSA has seen in-market deposit growth of 24.9%.[3] As shown in Figure 2 above, market deposits grew from $77B in 2015 to $96.3B in 2019.

Part II: Strategy / Implementation

MSB Information & Background

Money Service Businesses (MSBs) are non-bank financial institutions that provide a number of financial services, including everything from check cashing to international money transmission processing. They range in size and complexity, from small, one-location storefronts, to multi-state sophisticated providers processing billions of dollars in micropayments every year. As defined by the Financial Crimes Enforcement Network (FinCEN), MSBs include five distinct types of financial services providers and the U.S. Postal Service.[4] They are:

1. Currency dealers or exchangers
2. Check cashers
3. Issuers of traveler's checks, money orders, or stored value
4. Sellers or redeemers of traveler's checks, money orders, or stored value
5. Money transmitters

MSBs play a vital role in many communities and provide convenient access to financial services in neighborhoods with few or no bank branches. They are particularly important for individuals who may not have ready access to the formal banking sector, often referred to as the "un-banked" and "under-banked." Recognizing

[4] Financial Crimes Enforcement Network, "Fact Sheet on MSB Registration Rule," fincen.gov/fact-sheet-msb-registration-rule (accessed December 4, 2020)

the importance of MSBs to the communities they serve, the FDIC has taken that position to urge financial institutions to take a risk-based approach in assessing individual customer relationships, rather than declining to provide banking services to entire categories of customers.[5]

Who Supervises MSBs?

Many States have regulations and enforcement responsibilities over MSBs. Federally, the Internal Revenue Service (IRS) has the authority to examine non-bank financial institutions (NBFI), which includes MSB compliance with the Bank Secrecy Act (BSA), the ability to investigate potential criminal BSA violations, and to collect and store BSA reported data by all financial institutions.[6] FinCEN in turn, oversees the administration of BSA by numerous agencies including IRS and the Federal banking agencies.

Registration Requirements with FinCEN:

Persons/entities defined as MSBs are generally required to register with FinCEN. Registration is required within 180 days after the day that the person/entity is

[5] Federal Deposit Insurance Corporation, "Financial Institution Letter FIL-5-2015, Statement Providing Banking Services," (January 28, 2015)
[6] Internal Revenue Service, "Internal Revenue Manuals: Part 4: Chapter 26. Bank Secrecy Act, Section 5. Bank Secrecy Act History and Law," (June 23, 2020)

established as an MSB.[4] Thereafter, the MSB must renew its registration every two years by December 31st for as long as the MSB continues to meet the MSB definition.[4]

The following MSBs are not currently required to register[4]:

- A business that is an MSB solely because it serves as an agent of another MSB.
- A business that is an MSB solely as an issuer, seller, or redeemer of stored value; and the U.S. Postal Service and agencies of the U.S., of any State or of any political subdivision of any State.
- Also, banks and persons registered with, and regulated or examined by, the Securities and Exchange Commission or the Commodity Futures Trading Commission are not defined a MSBs and are therefore not required to register.

<u>Bank Secrecy Act and MSBs:</u>

FinCEN and the federal banking agencies issued interpretive guidance on April 26th, 2005, to clarify the BSA requirements and supervisory expectations as applied to accounts opened or maintained for MSBs. With limited exceptions, many MSBs are subject to the full range of BSA regulatory requirements, including the anti-money laundering program rule, suspicious activity and currency transaction reporting rules, and various other identification and recordkeeping rules.[7]

The Relationship Between Banks and MSBs:

Due to the nature of MSB business activities, they require specific banking services. These services include the establishment and maintenance of a bank account, transaction processing and currency processing. MSBs may also require a variety of credit facilities, such as lines of credit for liquidity purposes.

The banking relationship is crucial to MSBs. They require access to the payments system that a bank provides in order to process checks and transfer funds. The relatively recent phenomenon of bank discontinuance is of concern to the MSB industry.

Bank Supervisory Guidance with Respect to MSBs as Bank Customers:

The due diligence for an MSB bank customer differs based on the risk posed. Based on existing BSA requirements applicable to banks, the minimum due diligence expectations associated with opening and maintaining accounts for MSBs are[7]:

- Apply the bank's Customer Identification Program (CIP).

[7] Financial Crimes Enforcement Network, "Interagency Interpretive Guidance on Providing Banking Services to Money Services Businesses Operating in the United States," (April 26, 2005)

- Confirm FinCEN registration, if required.
- Confirm compliance with state or local licensing requirements, if applicable.
- Confirm agent status, if applicable.
- Conduct a basic BSA/AML (Anti-Money Laundering) risk assessment to determine the level of risk associated with the account and whether further due diligence is necessary.
- If the bank determines that the MSB customer presents a higher level of money laundering or terrorist financing risk, some or all of the following actions may be performed as part of an appropriate enhanced due diligence review:
    - Review the MSB's BSA/AML program.
    - Review results of the MSB's independent testing of its AML program.
    - Review written procedures for the operation of the MSB.
    - Conduct onsite visits.
    - Review list of agents, including locations, within or outside the United States, that will be receiving services directly or indirectly through the MSB account.
    - Review written agent management and termination practices for the MSB.
    - Review written employee screening practices for the MSB.

FinCEN and the federal banking agencies do not expect banks to uniformly require any or all of the actions identified above for all MSBs.

Opportunity & Strategic Vision

Central Bank & Trust is exploring entering the MSB banking business. As detailed in the Bank Supervisory Guidance listed above, offering banking services to inherently higher risk industries comes with its own unique set of pros and cons. While the Bank Secrecy Act, FinCEN and Federal Banking Agencies do not require nor do they expect banking institutions to serve as the de facto regulator of the MSB industry, banks are understandably cautious when it comes to these relationships. MSBs are losing access to banking services as a result of concerns about regulatory scrutiny, the risks presented by MSB accounts and the costs and burdens associated with maintaining such accounts. With growing public demand for non-bank money transmitters and a bank industry reluctant to service the MSB banking vertical, it appears that this is an industry segment that has growth potential and minimal competition.

As a component of the larger vision of CB&T, management has enacted a strategy that leverages a no-fee approach to commercial banking while delivering sophisticated banking technology, combined with first-in-class client service. The single greatest threat to the success of CB&T's strategic growth vision is the acquisition and retention of core deposits. It is this threat that led CB&T management team to form an unconventional commercial banking approach in not charging bank service fees to their commercial clients. While a no-fee approach to banking is not unheard of, it is unusual for a commercial bank for a number of reasons:

- First, commercial clients are used to paying fees and are generally familiar with their accounts being placed on account analysis. When accounts are placed on account analysis, clients earn a credit for the non-interest-bearing balances they keep at the bank. This credit is called an Earnings Credit Rate (ECR). The ECR is used to offset the bank fees that accumulate over a set period of time, typically one month. At the end of that month, the client's bank fees are totaled, and the earnings credit allowance is applied to fee total. If the earnings credit allowance is less than the total fees, the client is responsible to pay the difference. This is a common practice and most commercial clients expect this from their bank.
- Second, commercial clients often have significant transaction volumes that can result is high fees – both from a revenue and expense perspective. From a revenue perspective, commercial clients with high bank activities tend to pay for their bank services, thereby generating non-interest income and having a positive effect on a bank's P&L. From an expense perspective, there is a cost to the bank to these provide services. This results in clients with many accounts using multiple bank products and services costing a bank more than a lower usage client, such as a typical consumer account. By not charging bank service fees, CB&T is unable to directly offset the costs associated with their commercial account clients, which means expenses go up and there is no direct revenue to offset those expenses.

- Lastly, non-interest income is an important revenue component for any bank. Commercial bank service fees are generally a significant source of non-interest income and can have a material impact on a bank's P&L. Non-interest income is exceedingly more important in a low or declining rate environment as the largest revenue generator (interest income) takes a hit as interest rates drop. For an asset-sensitive bank like CB&T, earnings are negatively impacted due to lower interest income being generated. Banks will offset the decline in earnings by focusing on other revenue streams, often by way of non-interest income. As we are currently in a low rate environment and the rate forecast shows us remaining low for the foreseeable future, most banks are putting an emphasis on generating more bank service fees.

As mentioned previously, the single greatest threat to CB&T reaching its growth potential comes in the form of deposit acquisition and retention. Historically, CB&T has funded their commercial loans through a retail deposit strategy. This created an environment where the Bank would pay a higher than market average on their deposit accounts in order to generate deposit growth. In turn, the Bank had to compensate for the higher cost of funds by pricing their loans higher than market in order to maintain the target net interest margin. Up to this point, the Bank has been able to achieve higher yields without taking unnecessary credit risk. As CB&T enters a larger and more competitive market in Denver, achieving a premium on loan rates without jeopardizing the health of the loan portfolio will be a challenge.

Herein lies the origin of the idea behind the no-fee approach put forth by CB&T's leadership team. By focusing on shifting from a retail deposit growth strategy to a more conventional commercial bank approach, the Bank should be able to generate sizeable core deposits, lower their cost of funds and in turn, maintain market competitiveness from a loan yield perspective. By giving up potential non-interest income revenue for CB&T's core commercial client base, the idea is that the Bank will be able to acquire and maintain low/no-cost deposits while expanding the liabilities-side of the balance sheet.

Conceptually, the idea is great. It is well known that bank customers, regardless of segment, do not like paying bank fees. Whether it is a consumer client being charged a $2.00 ATM fee or a corporate client being assessed thousands of dollars in analysis fees, the overwhelming attitude is negative when it comes to bank fees. By eliminating fees altogether, irrespective to balance minimum requirements, CB&T is able to capitalize on this emotionally charged topic and convert deposit clients at a higher rate than their competition.

Where the no-fee strategy falls short is when it comes to revenue and expenses. As CB&T grows and acquires new client relationships, there are fixed costs associated with each new relationship. For example, there are costs required to open accounts, maintain them on the core banking system, and online and mobile platform costs. In addition to the fixed costs that come along with every relationship, there are variable costs that are based on product usage and volume. A title company that sends 1,000 wire transfers per month has a much higher variable cost than a dry cleaner who uses minimal commercial banking services. As CB&T grows, this is an expense that will grow as well and by not charging fees, the Bank will assume the full liability of these costs. In a typical bank, these fixed and variable costs would be offset by bank service charges. Additionally, banks generally mark-up their fees and can not only offset their costs but generate income straight to their bottom line.

This Capstone Strategic Project will evaluate whether adding an MSB business line can work as a compliment to CB&T's core strategy for traditional commercial bank clients. As detailed in the Financial Impact section of this Capstone, MSBs generate significant fee income. This Capstone Strategic project will explore whether CB&T can continue to acquire and retain commercial deposit relationships through an aggressive no-fee strategy while offsetting its fixed and variable costs through a high-fee, MSB banking vertical. As CB&T grows, it will need to find ways to offset the cost of doing business as expenses will grow concurrently with asset growth. The no-fee strategy is working now but it will not work forever. CB&T will need to either start charging their core commercial clients bank service fees or pivot to an alternative fee strategy to help offset the anticipated expense growth.

Considerations & Project Manager Role in the Process

An MSB banking vertical would be a direct compliment the Bank's current growth strategy, which focuses on commercial client acquisition and retention through a no-fee approach. A major part of the Project Leader's role as CB&T's Executive Vice President, Director of Treasury & Commercial Services, is the responsibility to grow and retain core deposit growth. This position made the Project Leader an integral part of the leadership team that designed and implemented the no-fee strategy. The Project Leader's role in the MSB banking vertical analysis will be to serve as the Project Manager, outlining the opportunity, impact, departments/personnel impacted, and the financial and non-financial impact to the Organization. Should CB&T decide to move forward, the Project Leader would lead the initiative along with a project team, including individuals from Compliance, Operations, Finance and Treasury. CB&T does not currently maintain any MSB depository relationships nor do they actively solicit for new MSB business. While CB&T policy does not prohibit banking MSBs, they are considered undesirable and any opportunity needs BSA Officer and Compliance Officer approval prior to account opening.

<u>Future Opportunities</u>

With any new business endeavor, it is generally wise to start slowly and attain proof of concept before deploying significant time and resources to a project. Launching an MSB banking vertical is no different. In fact, due to the regulatory oversight of the banking business, rolling out an MSB banking vertical should be done with the blessing, or at least the acknowledgement of the FDIC (CB&T's regulator). The discussion with the FDIC would include CB&T's business plan and Compliance oversight for MSBs to include AML, BSA and Know Your Customer (KYC) policy and procedures. It would be advisable to start by focusing on one of the five distinct types of MSBs and limit the geographic footprint to a manageable area. For example, CB&T would focus its efforts on money transmitters, who are located within the Bank's footprint and only transmit funds domestically. This would allow the Bank and the FDIC to get comfortable that the policy and procedures put into place are working and scalable. At such a time that both parties feel that the Bank is capable on expanding their focus, CB&T would then be able to move into other types of MSBs or expand its offering with the money transmitter segment.

CB&T currently operates in Colorado and New Mexico, with no immediate plans to expand outside of those two states. As of October 24th, 2020, there are 750 MSBs registered with FinCEN in Colorado and New Mexico.[8] Stated previously, there are not many banks that are actively pursuing MSB relationships. When looking at future opportunities, the list of registered MSBs on FinCEN's website would be a logical place to start. Included on the list is the name and location of the MSB as well as its approved MSB activities (which of the five distinct types of MSB services they are able to provide), states of activity and number of branches. This information can be filtered to target specific MSBs with the desired geographic footprint and specified approved

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[8] Financial Crimes Enforcement Network, "MSB Registrant Search," fincen.gov/msb-registrant-search (accessed October 24, 2020)

activities. With minimal competition and a list of prospects provided my FinCEN, it seems like the future business opportunities would only be limited to the prospecting efforts put forth by CB&T sales personnel.

Implementation Schedule

Below is an outline of the MSB implementation schedule. With an emphasis placed on compliance, the schedule will evolve based on the pace where CB&T can comfortably move forward after each stage of implementation. This will include updated policy and procedures, updated monitoring software and enhanced due diligence, both during account opening and on an on-going basis thereafter.

Implementation Schedule		
Action Plan, Project or Activity	**Deadline**	**Responsibility**
Initial business case of MSB opportunity presented to CB&T's executive leadership team for approval.	June 29, 2020	Steve Shear
Upon approval, design a project management timeline with deliverables at each stage of the project plan.	August 30, 2020	Steve Shear
Review and assess CB&T's current policy & procedures as they relate to MSB clients.	September 30, 2020	Steve Shear & *Cheryl Dukeman
Engage legal and/or audit council on policy & procedure findings. Update and implement requested changes.	November 30, 2020	Steve Shear & Cheryl Dukeman
Identify compliance software to assist in AML & BSA monitoring of MSB activity.	November 30, 2020	Steve Shear & Cheryl Dukeman
Hire a Full-Time BSA Officer	February 1, 2021	Cheryl Dukeman
Implement, test and deploy chosen compliance monitoring software.	February 28, 2021	Steve Shear & Cheryl Dukeman
Identify internal MSB team that will be responsible for the sales, operations and compliance for MSB relationships.	March 31, 2021	Steve Shear & Cheryl Dukeman
Present finalized business case, compliance procedures, MSB monitoring software and internal team to FDIC for approval.	April 30, 2021	Steve Shear & Cheryl Dukeman
Upon regulatory acceptance, refine FinCEN list of registered MSBs to the approved MSB types and create a calling campaign to targeted MSB relationships.	May 31, 2021	Steve Shear & **Courtney Mimmo
Onboard first MSB relationship.	July 30, 2021	Steve Shear
Monitor relationship closely to ensure appropriate controls and in place and policy and procedures are working as designed.	September 30, 2021	Steve Shear & Cheryl Dukeman
Begin to expand MSB relationships, which may include other MSB segments.	December 31, 2021	Steve Shear
Create a marketing campaign to get our name/brand out to the market that we are actively seeking MSB relationships.	December 31, 2021	Steve Shear & Courtney Mimmo

*Cheryl Dukeman – EVP, Bank Operations/Compliance Officer
**Courtney Mimmo – Director of Marketing

Part III: Financial Impact

Project Scope

Adding a Money Service Business banking vertical requires an initial financial investment, as well as on-going compliance monitoring and human capital. At a minimum, in order to adequately launch this vertical, CB&T would need to invest in a compliance monitoring software platform. Additional considerations to a successful launch are an add-to-staff in the form of a full-time Bank Secrecy Act (BSA) Officer, legal counsel review of documents/forms/regulator assistance and hiring an AML consultant to establish and/or review internal processes and procedures.

Software[*]:

At the recommendation of legal counsel, CB&T has engaged *REDACTED* for the enhanced MSB compliance monitoring software. *REDACTED* offers two compliance and monitoring services that CB&T would need in order to move forward with the MSB vertical implementation. Those services are:

Service 1: helps financial institution comply with the requirements of the Office of Foreign Asset Control, the USA PATRIOT Act, the Bank Secrecy Act including risk scoring, risk management, suspicious activity alert detections, case

[*] Due to a Non-Disclosure Agreement (NDA) signed between CB&T and the vendor, the vendor name has been redacted.

management and filing of Currency Transaction Report (CTR) and Suspicious Activity Report (SAR).

Service 2: helps financial institutions discover hidden information about customers and beneficial owners, receive early warnings about financial crimes, prevent criminals from opening accounts, identify Politically Exposed Persons, Domestic Political Figures, and Negative-news Exposed Persons and prevent financial crimes.

Service 1 has a one-time implementation fee of $4,000 and an annual fee of $10,500. *Service 2* has a one-time implementation fee of $2,000 and an annual fee of $4,950. Total fees for *REDACTED* are a one-time implementation fee of $6,000, with recurring annual fees of $15,450. It should be noted that while the implementation of *REDACTED's* software would be to support the MSB initiative, there is an application for its use within CB&T's conventional compliance practice.

Staffing:

Presently, CB&T's BSA Officer is also a Branch Manager, with the latter taking up the majority of the individual's time. Due to the increased compliance required for MSBs, having a part-time BSA Officer could open up CB&T to potential scrutiny from their regulators and could jeopardize the integrity of the vertical in the event of customer BSA violations.

The average BSA Officer in the U.S. makes $106,372 per year, while BSA Officers in Denver make $107,029 per year, averaging total compensation 1% greater than the U.S. average.[9] In addition to base salary, CB&T contributes on average an additional $28,469 per employee for benefit contribution. Using the Denver market average for BSA Officer salary, combined with CB&T benefit contribution, the total annual expense for the MSB personnel request is $135,498 per year.

As discussed in Part II: Bank Supervisory Guidance with Respect to MSBs as Bank Customers (page 11), the BSA requirements and minimum due diligence expectations associated with opening and maintaining accounts for MSBs are extensive. Bank due diligence in addition to the obligations set forth by FinCEN are dictated by the level of risk posed by the individual MSB customer. Not all MSBs present the same level of risk, so the level of due diligence required will change by customer type and risk rating. This presents a unique challenge when an initial risk assessment determines the bank due diligence for new client acquisition. Having an experienced, full-time BSA Officer is imperative to MSB banking vertical assessment.

[9] Comparably, "BSA Office Salary," comparably.com/salaries/salaries-for-bsa-officer (accessed December 28, 2020)

Legal Services:

While challenging to forecast legal expenses related to the MSB banking vertical launch, expenses should be anticipated during the initial buildout and on-going thereafter. Early in the process, legal counsel will be engaged to assess MSB new client documentation and forms, as well as to assist planning and preparing for regulatory acknowledgement for the new service offered. CB&T has been advised to prepare a presentation for their regulators to disclose their new MSB venture, outlining the size and scope of the MSB initiative.

CB&T's legal counsel charges between $405 - $450 per hour, depending on the attorney. For the sake of the financial impact analysis, CB&T anticipates ten hours of legal work to review client documentation and to assist in the preparation of regulatory disclosure. Using a midpoint of $425 per hour and ten hours of anticipated legal work, the initial legal services expense will be $4,250.

Consulting Services:

CB&T has engaged an AML Services Firm to assist with the tuning & optimization of the *REDACTED*[**] software system's Transaction Monitoring rules to align with applicable AML/BSA/OFAC requirements, the Federal Financial Institution

[**] Due to a Non-Disclosure Agreement (NDA) signed between CB&T and the vendor, the vendor name has been redacted.

Examination Council's BSA/AML Examination Manual (FFIEC), the Bank's Enterprise Wide Risk Assessment (EWRA) and other applicable guidance. For the purposes of the financial impact analysis, CB&T estimates 250 hours of Consultant work at a blended rate of $150 per hour. Total expense for consulting services using these parameters is $37,500.

Expense Analysis

Expenses will be reviewed on a one-time and recurring basis. The initial capital investment is the first hurdle to determining CB&T's appetite into the MSB space. Recurring expenses will be weighed against the on-going revenue potential generated by MSB clients. Recurring expenses include both fixed and variable costs, including allocation of salary expense. Assumptions were made in the modeling to most accurately anticipate activity and time allocation, which is notated below. CB&T management will need to analyze the amount of time needed to breakeven on the initial capital investment to determine whether this initiative will move forward.

Expenses	One-Time	Recurring
Compliance Software	$6,000	$15,450
Staffing	$37,500	$62,500
Legal Services	$4,250	$1,063
Consulting Services	$37,500	$9,375
Marketing	-	$2,000
Administrative	-	$15,000
Total Expenses	**$85,250**	**$88,388**

Assumptions:

- Staffing (One-Time): assumes 30% recruiter fee on $125,000 base salary
- Staffing (Recurring): assumes 50% of BSA Officer's $125,000[***] base salary
- Legal Services (Recurring): assumes 25% on-going legal expense
- Consulting Services (Recurring): assumes 25% on-going consulting expense
- Marketing (Recurring): assumes $500 quarterly marketing budget
- Administrative (Recurring): assumes 25% of Compliance Analyst's $60,000 base salary

Revenue Analysis

Revenue figures are much more difficult to analyze, as bank service fees are variable and based on client activity. Assuming risk-rated account analysis pricing, the MSB fee schedule would be priced higher than standard client pricing. Additionally, it is common for banks to charge MSB clients a monthly compliance monitoring fee, which varies between $1,500 - $5,000 per month. Due to the arbitrary nature of this analysis, a sample MSB Account Analysis Statement is presented in **Appendix 1**. The information presented in **Appendix 1** are treasury management services and account

[***] Although the average salary for a BSA Officer in Denver is $107,029, a salary of $125,000 was used in the financial assumptions.

activity volumes taken from an actual MSB client. The Earnings Credit Rate information used in the example is current to CB&T at the time of this Capstone.

Based on the sample Account Analysis Statement, this particular MSB would generate $23,700 per month in treasury management revenue. Annualized, this sample client would generate $284,397 in revenue. Both figures are net of an earnings credit allowance, so the stated amounts would be realized revenue.

As previously stated, it is difficult to analyze the revenue impact of an MSB banking vertical buildout since each client will generate varying amounts of revenue based on numerous variables. In the sample case listed above, this would be considered an upper middle-market MSB client and while larger than most, not unreasonable to assume a target client of CB&T.

Risk Evaluation

Undoubtedly, the primary risk in deploying an MSB banking vertical would be exposure to AML/BSA/KYC violations. This would most likely result in enforcement actions by the FDIC. According to the FDIC Enforcement Decisions & Orders website, "the FDIC pursues enforcement actions against…entities for violations of laws, rules, or regulations, unsafe or unsound banking practices, breaches of fiduciary duty, and violations of final orders, conditions imposed in writing or written agreements. In addition, the FDIC has the statutory authority to terminate the deposit insurance of any insured depository institution for violation of a law, rule, regulation, condition imposed in writing, or written agreement, or for being in an unsafe or unsound condition or engaging in unsafe or unsound banking practices."[10] Additional risks considered are operational risk, reputational risk and financial risk. Risk mitigation factors would include the following:

1. Disclosure of intent meeting with FDIC prior to MSB banking vertical launch:
    a. The purpose of this meeting would be for CB&T's management team to lay out their intent to bank MSB relationships. As part of the meeting, CB&T would identify the parameters at which they approve an MSB client. The intent of the MSB banking vertical launch would be to start small, establish a baseline of volume transactions and monitor those transactions closely. This would give CB&T the ability to test their process, procedures and compliance monitoring software while getting their regulators comfortable with their new initiative. If all goes as planned, CB&T would be able to add additional MSB client types and/or clients that fall outside of the initial defined criteria. Items covered in this meeting would include:
        i. Limiting the acceptable MSB client type to Money Transmitters only.

[10] Federal Deposit Insurance Corporation, "FDIC Enforcement Decisions and Orders (WD&O)," orders.fdic.gov/s/ (accessed December 18, 2020)

ii. Accept only new MSB relationships that have a geographic presence in CB&T's footprint.

iii. Only domestic Money Transmitters would be approved, international Money Transmitters would be prohibited.

iv. Establish volume thresholds for early clients into the program.

2. BSA Officer ownership of MSB program:

    a. Often, MSB programs share ownership between Operations, Compliance and Sales. This can lead to divided ownership where neither department has full oversight into the program. Shared responsibility leads to a lack of accountability and that can prove disastrous in a higher-risk banking vertical. By hiring a full-time BSA Officer who maintained ownership over the MSB program, CB&T could avoid the risk of shared responsibility and have a program that was built with a compliance-first approach.

3. Identify a beta MSB client:

    a. CB&T's management has identified a beta client who is an ideal client in their target market. This client has agreed to be the first MSB client for the Bank and understands the CB&T is in the process of building out their MSB platform. The client fits the parameters outlined in the risk mitigation factor #1 listed above. This client would allow CB&T to demonstrate proof of concept with the MSB banking vertical buildout, both internally as well as with their regulators.

Financial Justification of MSB Banking Vertical

Looking strictly at the financial analysis in the MSB example used above, it is clear that the business of banking MSB clients can be extremely profitable. The example shows profitability of $110,759 in Year 1, which includes all one-time fees along with recurring fees. In Year 2 and beyond, the profitability grows to $196,009. The example uses a larger than average MSB client, although not out of the realm of a target client of CB&T, and only takes into consideration a single client in the analysis. While mentioned previously, a risk mitigation factor would be to slowly roll out the MSB client acquisition strategy. This explains why only looking at one client in the first scenario is a reasonable assumption. As the program expands, it would be appropriate to include more clients in the profitability analysis.

As the MSB banking division grows, profitability would increase as the fixed costs of the program would stay relatively flat. The program would be scalable and would require additional personnel once the client levels go to be large enough to warrant additional staffing support. By leveraging automated compliance monitoring software, CB&T can limit the number of full-time employees dedicated to MSB compliance support.

If the risk mitigation factors can be met, the program is a worthwhile investment strictly looking at the financial impact to CB&T. Assuming all variables remained constant, the relatively large upfront one-time expenses are absorbed by the example client quickly and breakeven is achieved in month six.

	1	2	3	4	5	6
One-Time Expenses	$85,250	-	-	-	-	-
Recurring Monthly Expenses	$7,366	$7,366	$7,366	$7,366	$7,366	$7,366
MSB Client Revenue	$23,700	$23,700	$23,700	$23,700	$23,700	$23,700
Net profit (loss)	**($68,916)**	**($52,583)**	**($36,249)**	**($19,915)**	**($3,581)**	**$12,752**

	7	8	9	10	11	12
One-Time Expenses	-	-	-	-	-	-
Recurring Monthly Expenses	$7,366	$7,366	$7,366	$7,366	$7,366	$7,366
MSB Client Revenue	$23,700	$23,700	$23,700	$23,700	$23,700	$23,700
Net profit (loss)	**$29,086**	**$45,420**	**$61,754**	**$78,087**	**$94,421**	**$110,755**

Part IV: Non-Financial Impact

Project Considerations

When exploring a new or refined business strategy, the non-financial impact is often much harder to measure and plan for than the financial analysis of the project. The math is easy when it comes to the financial component; one must figure out the fixed and variable costs of a project along with the expected revenue, from there it can be quickly determined if that project will be profitable. Once profitability is determined, it is easy to back into the amount of time the revenue will exceed expenses and cover up-front costs, thereby establishing a breakeven point. This gives the project manager enough data to determine if the project should move forward, if costs and/or timing needs to be adjusted, or if the proposal should be declined. Non-financial measures and not nearly as black-and-white. It is hard to measure the gray area where non-financial measures often fall and can be an exercise in art as opposed to science. Modeling for non-financial scenarios needs wider variability in assumptions. Hitting on the financial projections but missing on the non-financial considerations can lead to disastrous results and failed project. The project may make money, but in doing so, other areas of the organization suffer.

The risk appetite of CB&T's leadership needs to be addressed and monitored throughout the duration of the MSB banking vertical project. It is easy to overlook potential pitfalls if the financial measures are the sole focus of the decision-making team. Hiring a full-time BSA office will help quell some the risk anxiety that leadership will face throughout the duration of the MSB banking vertical project, however it is not an end-all solution. Regular check-ins with leadership will be necessary, as will building up the MSB client base slowly over time. A qualified BSA Officer will be able to put policies and procedures in place to mitigate the risks associated with MSB clients, yet there should be some anticipated heartburn with the new banking vertical. Through a deliberate compliance approach and strong internal controls, the risks can be minimized and should not hinder the success of the program.

On the opposite end of the spectrum of risk mitigation is sales. Client acquisition is a threat to any successful project that requires client-driven revenue. In the case of the MSB banking vertical, competition from other banks is minimal. Stated previously in this Capstone Project, few banks participate in an active MSB program. While competition is minimal, it does not mean that it is non-existent. Industry reputation, especially in a tight-knit space such as the MSB community, can be a positive or negative. Industry peers will occasionally discuss vendors and partners that exceed expectations, while almost always disclosing those who have created a poor client experience. This can and should be viewed as an opportunity to build a solid brand reputation and drive additional sales opportunities. A bank can quickly become a niche operator through positive industry feedback and brand reputation should be a closely monitored metric. On the other hand, a poor experience or approach can lead to a negative industry reputation and make sales efforts increasingly challenging. Negative brand reputation happens quicker and often easier than a positive brand reputation. A business can lose creditability and reputation through one undesirable experience, while it can take years to build a positive market reputation. In the MSB industry, a negative experience shared from one MSB can spread to other MSBs rapidly. CB&T must be intentional with their client service approach to the MSB industry, while continuing to offer cutting-edge financial technology. Through their existing service model and high-touch approach, CB&T can leverage this positive attribute into a successful MSB servicer reputation.

Overall Bank Strategy

The single greatest non-financial impact of the MSB banking vertical is the supplement to CB&T's overall deposit growth strategy. While attractive, the revenue opportunity from MSB clients is secondary to the low cost DDA growth of CB&T's core commercial client base. The shift from a "pay up" for deposit strategy, which led to a higher than average cost of funds and a disproportionate percentage of deposits in interest-bearing accounts, to a focus on non-interest-bearing DDA deposits will benefit the long-term financial performance of the Organization. Historically, CB&T has had a higher balance sheet percentage composition of money market deposit accounts relative to their peer group, as seen in the UBPR graph below.[11]

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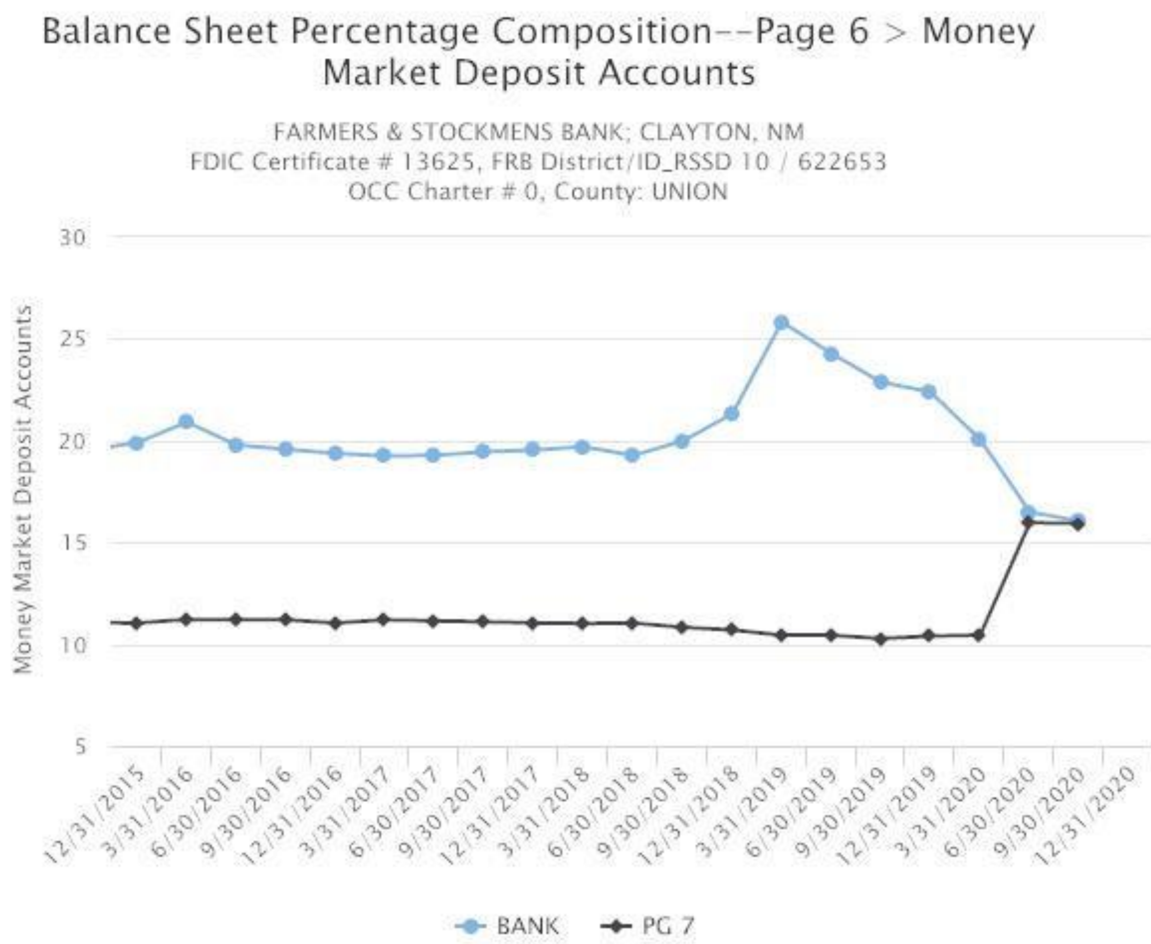
[11] Uniform Bank Performance Report, "Balance Sheet Percentage Composition—Page 6 > Money Market Deposit Accounts," cdr.ffiec.gov/Public/Reports/UbprReportGraph.html (accessed January 8, 2021)



CB&T has invested heavily in their commercial treasury management platform over the past few years. From the graph above you can see a steady decline in the percentage composition of money market deposits accounts, beginning in the third quarter of 2019. An interesting trend to note is the continued decline on money market deposit account percentage composition during the first, second, and third quarters of 2020. During the COVID-19 pandemic, banks have experienced all-time highs in deposit balances and liquidity. The rush to safety has inflated bank balance sheets and even though rates have declined during this time, interest-bearing deposits have grown. This is seen in the peer group performance on the graph above, which is representative of the banking industry as a whole. What is unique is that CB&T has grown overall deposits during this time but continues to reduce the percentage of interest-bearing deposits on the balance sheet. This is not only a result of the treasury management platform that CB&T has so heavily invested in, but also the no-fee banking approach that was discussed in Part II: Opportunity & Strategic Vision (page 13). Client acquisition is happening with a high percentage of success. Non-interest-bearing DDA balances are growing as a result of the success of the no-fee deposit acquisition strategy. While proof of concept has been met, the balance sheet success only shows one side of the story.

Missing from the balance sheet analysis is the impact to CB&T's income statement. While client acquisition is at an all-time high and deposit growth is heavily weighted on core DDA deposits, the negative effects of this strategy can be seen in flat non-interest income and increased operating expenses. At the heart of the MSB business case is the supplement to CB&T's core commercial client acquisition strategy, which is a no-fee banking approach. By supplementing the increased expenses of the core banking clients, the MSB banking vertical would be used as a way to generate fees at or above the total operating expenses of all CB&T clients. This strategy should lead to continued success in core client acquisition, increased DDA as a percentage of total deposit composition, a lower overall cost of funds, while targeting a net-neutral service fee expense outcome. If successful, CB&T can address their greatest threat to growth – deposit acquisition – while minimizing the negative impact to the income statement.

Long-term, this strategy will positively impact the overall profitability of the Bank. Cost of funds will be reduced, thereby increasing the net interest margin to the Bank if existing loan yields are maintained. As rates start to rise, this will be even more meaningful to the profitability of CB&T. Additionally, by lowering their cost of funds, CB&T can be more competitive on loan pricing while still maintaining their target net interest margin. Through this unique approach, CB&T will position themselves for long-term growth, durability, and scalability. Most importantly, a deposit base that is heavily weighted with DDA deposits will build franchise value. Increasing franchise value directly impacts shareholder value and gives CB&T additional strategic options as the Bank grows.

Conclusion

The MSB banking vertical project is a complex and time intensive undertaking, the pros and cons of which need to be carefully considered before a decision can be made. The revenue potential is significant, however, so are the added compliance and operational duties that go along with servicing this industry. If Central Bank & Trust is committed to growing their low-cost core deposits through a no-fee approach to their standard commercial banking clients, the MSB banking vertical initiative is a perfect compliment to that strategy. Since proof of concept with the deposit growth strategy has been realized, it should be without hesitation that Central Bank & Trust leadership move forward with the MSB banking vertical initiative.

APPENDIX 1
Sample MSB Client Account Analysis Statement

Central Bank & Trust

A PART OF FARMERS & STOCKMENS BANK

Balance Information

Average Ledger Balance	$4,026,615.25
Less Average Float	$0.00
Average Collected Balance	$4,026,615.25
Average Collected Balance	$4,026,615.25
Less - DDA Balance - Reserve Requirement (10%)	$402,661.53
Average Available Balance	$3,623,953.73
Average Available Balance	$3,623,953.73
Balance Equivalent Total Service Charge	$65,634,038.35

$2,616.49 in Investable Balances Offset $1.00 of Total Fees for all Analysis Based Services

Settlement Summary

Earnings Credit	$1,385.05
Less Total Analyzed Fees	$25,084.79
Total Charge	$23,699.74

Service Line Description

Description	Volume	Unit Price	Service Charge	Balance Equivalent
Account Services				
Compliance Monitoring Fee	1	$5,000.00	$5,000.00	$13,082,437.28
Electronic Debits Transactions	12	$0.24	$2.88	$7,535.48
Commercail Deposits	430	$0.52	$223.60	$585,046.59
Deposit Adjustment	3	$11.00	$33.00	$86,344.09
Composite Group	1	$0.00	$0.00	$0.00
Standard Confirmation	1	$55.00	$55.00	$143,906.81
Paper Analysis Statement Fee	198	$2.30	$455.40	$1,191,548.39
Unencoded Items Deposited	373	$0.16	$59.68	$156,151.97
Monthly Maintenance	198	$35.00	$6,930.00	$18,132,258.06
Paper Account Statement Fee	47	$4.75	$223.25	$584,130.82
Paper Item Admin Fee	45	$0.02	$0.90	$2,354.84
Wire Incoming Non-Structured	1	$21.00	$21.00	$54,946.24
Wire Incoming Structured	45	$17.00	$765.00	$2,001,612.90
ACH Credit Received	152	$0.09	$13.68	$35,793.55
ACH Addenda Received	152	$0.03	$4.56	$11,931.18
Deposit Administration Fee	5201	$0.12	$624.12	$1,633,002.15
ZBA				
ZBA Parent Account	1	$55.00	$55.00	$143,906.81
ZBA Sub-Account	193	$5.00	$965.00	$2,524,910.39
ACH				
ACH Returned Transaction	12	$2.55	$30.60	$80,064.52
ACH Online Monthly Fee	1	$45.00	$45.00	$117,741.94
ACH Debit Originated	1246	$0.22	$274.12	$717,231.54
ACH File Processed	25	$1.00	$25.00	$65,412.19
ACH Return Report	1	$11.50	$11.50	$30,089.61
Wire				
Online Wire Outbound Domestic	118	$28.75	$3,392.50	$8,876,433.69
Online Wire Outbound USD Intl	88	$66.75	$5,874.00	$15,369,247.31
TOTAL CHARGE FOR SERVICE			**$25,084.79**	**$65,634,038.35**

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