AML Compliance: Risk Based Approach

It’s a Regulatory Requirement…
But does it help and what does this really mean?

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AML Compliance: Risk Based Approach

With an introduction from Andy Poprawa, CEO of DICO
Topics for today...

- Regulatory Action Headlines
- The Risk Based Approach ('RBA')
- Higher Risk Areas
- Higher Risk Members
- Other areas: Proposed changes to regulations and Privacy vs. PCMLTFA
- Questions to ask to ensure compliance/Key Takeaways
Regulatory Action …

Posted Penalties:

- March 22, 2012: FINTRAC issues an administrative monetary penalty against a credit union…Ottawa, March 22, 2012 …The penalty was imposed for violating the Proceeds of Crime (Money Laundering) and Terrorist Financing Act (PCMLTFA). A credit union in British Columbia, was issued a penalty of $40,520 on February 27, 2012, for committing eleven violations…
- A credit union in Ontario, was issued a penalty of $37,090 on February 2, 2011, for committing nine violations…

Violations include lack of or incompleteness of:

- Compliance program policies and procedures, training program, risk assessment
- Process for reviewing the compliance regime
- Transaction reporting failures (large cash, international EFT)
- Obtaining and keeping records, third party and politically exposed determinations
Regulatory Action …

• 13 MSB publicized penalties; high level of FINTRAC audit activity and violation letters
• 1 securities dealer publicized penalty; increasing level of FINTRAC audit activity and violation letters
• 2 real estate brokerages publicized penalties; increasing level of FINTRAC audit activity and violation letters
The Risk Based Approach

• As financial institutions, credit unions are required to develop and implement effective AML/ATF controls to manage their exposure to ML and TF risks

• “Control effectiveness” is a relative measure…
  – It depends on the level and type of inherent risk you are trying to mitigate and on your risk tolerance – what level of residual risk is acceptable to your organization

\[(\text{Inherent Risk}) + (\text{Control Effectiveness}) = \text{Residual Risk}\]

- Exit a riskier product or business
- Mitigating controls
Isn’t there some sort of manual?

• Given that credit unions and FIs can vary in terms of business activities, scope, complexity, client base, geographical reach, etc., there are no “one size fits all solutions”, including…
  – standard set of controls
  – “right way” to assess risk
  – universally acceptable risk tolerance

• But there are common factors to consider…
What is a risk based approach?

- Essentially, it is a process of identifying your exposures to money laundering and terrorist financing risk, and then allocating your resources commensurately to the assessed risk.
- Accepts that finite resources are available to mitigate risk, and enables you to focus more on the higher risk areas, and less on areas of lower risk.
- Provides opportunity to identify wasted efforts relative to level of risk identified and make better use of resources.
How do I start?

1. Identify the relevant criteria to measure potential ML/TF risks applicable to your business;
2. Conduct a risk assessment;
3. Implement *proportionate* measures and controls to reasonably mitigate those risks;
4. Repeat.

Hints:
- Document your approach
- Apply it consistently
- Ensure your program is aligned to your assessed risks
- Keep it current
Why conduct a risk assessment?

• Use operational risk management and measurement methodologies to empirically and objectively identify AML Risk
• Build organizational awareness, knowledge and understanding
• Take a proactive, risk-based approach to the design and management of an AML program
• Build more effective tools not generic solutions
• Meet regulatory requirements
• Protect your organization
Goal of the risk assessment

• Assist the organization to analyze, understand and document exposure to money laundering and terrorist financing risks;
• Design AML/ATF risk mitigation strategies;
• Facilitate decision making by Senior Management and Board of Directors
  – “Receiving sufficient briefing with respect to inherent risks and controls so as to have an adequate level of understanding about AML/ATF matters”
  – “The CAMLO and the Auditor have adequate resources in terms of people, data management systems and budget to implement and administer the AML/ATF program requirements effectively and to offer objective opinions or advice to the Board and Senior Management”
It really needs to be the foundation of your Compliance Program

- A solid risk assessment enables you to:
  - Develop a compliance program that is generally effective in detecting and deterring money laundering and terrorism financing
  - Act as the foundation against which the institution can demonstrate program adequacy (procedures, training, transaction monitoring, etc.)
  - Prioritize resources, investments, and implementation schedules
  - Enable risk-based differentiation with respect to due diligence, training and procedures contents, as well as various timelines (testing, member account review, file refresh, etc.)
  - Identify gaps within the existing program
Practical implementation of model

- Identify inherent risk characteristics related to member accounts, geographies, products/services, delivery channels, and business relationships, among other factors.
  - Both internal and external information should be used to determine the levels and sources of inherent risk
  - Use research from key industry groups, organizations involved in the pursuit of AML, as well as your organization's own specific assessment and experience

- Analyze inherent risks on a qualitative basis to determine which represent higher risk. Where appropriate, analyze the organization's past experience (member accounts, transactions) to assess risk.
  - Compliance staff working with knowledgeable operational staff
Customer Characteristics

• Member characteristics provide useful information in assisting to identify the ones that pose higher risks to the business.

• Examples include:
  – Politically Exposed Foreign Persons
  – Non face-to-face relationships
  – Members listed in applicable controls/higher risk lists
  – Organizations with various/complex legal structures
  – Geography
Geographic Characteristics

- Countries differ in the level of corruption seen as acceptable, criminal activity, maturity of markets, and attractiveness for terrorists.
- Members may reside (part time) in these markets, transfer money to/from these markets or do business in these markets. Further, markets may have exchanges that business is conducted through.
- Countries identified as corrupt, tax havens, or non-compliant with international AML efforts, are more likely to pose a risk to the organization.
The different types of products, services and channels offered have differing likelihoods of being used to generate or launder illegal funds or to channel terrorist finances.

- Cash deposit services
- Wire transfers, international remittance of funds
- Electronic payments and transfers amongst accounts
- Third party deposits
- Non-face to face access channels
Relationship with the member is critical to controlling risks

Factors such as the length of time they have been a member, or if their transactions have exhibited red-flags for money laundering in the past, or if our records of them are out of date, are important to evaluating our risks. Analyse the available account transaction detail and information. Supports your risk assessment.
Applying the Results

- Assess higher risks against controls designed to mitigate them
- Confirm if risks are lowered to acceptable level; identify and remediate areas of any excess risk
- Document assessment
- Update and align policies, procedures, controls, monitoring strategies and training as needed
  - Risks may be reduced through deterrent, preventative, detective, reporting and remediation measure controls
- Report to Senior Management and the Board
Questions?
Is your assessment of risk well supported?

- Assessment of risk needs to be supported
- Likely that your first assessment of risk is not perfect… not expected to be…but the expectation is that your assessment is evolving and on-going
- How is your assessment being re-visited/updated?
  - Analysis of actual transaction, service/products, types of members, experience
  - Analysis of actual member KYC/DD experience: What is member turnover? What is source of new members? Face to face or not relationship?
- Completion of substantive analysis demonstrates understanding and provides basis to support your assessment
Not a one-time exercise...

- Risk Assessments should be conducted on an ongoing basis.
- Typically scheduled on a periodic basis supplemented by trigger events like:
  - Acquisitions
  - Entry into new markets, new services
  - Material change in targeted membership base or product offered

- Assessment of risk and supporting documentation needs to be reviewed and updated regularly to reflect any changes to the organization’s risk profile.
The risk based approach applies to members, too

- Consolidate a list of key risk characteristics
- Assess each of the characteristics as posing a low, moderate, high (or very high) risk rating to determine which risks are of a higher nature and require a documented enhanced due diligence / risk mitigation strategy.
- Identify higher risk members and implement appropriate risk mitigation strategy and associated controls congruent with the organization’s risk appetite
- Put in place a documented process to ensure unacceptable levels of risk are not on-boarded [new members] or are exited [existing members] as appropriate
Does it work?

- Risk-based due diligence prevented a prospective bad client
  - Based on a high risk factor (type of business/industry) background check at time of up front client due diligence identified past criminal activity of one of the owners. (MSB)
  
  - Based on enhanced due diligence performed on a prospective client flagged as having a higher risk business type, a determination was made that the prospect’s articulated business model and expected transactional activity did not align with the stated business type; prospect was later implicated in a Ponzi scheme. (Bank)
Does it work?

- Risk-based client due diligence identified a riskier client that was closely monitored resulting in relevant detection
  - Based on high risk factors (complexity of business/corporate organization and some geographic locations) client was identified up front as higher than normal risk; transactions reviewed/screened regularly; identified suspicious transactions regarding the movement of funds in and out of the accounts (Securities Dealer)

- Based on high risk factors (non-residence status, connection to a sanctioned country), heightened due diligence identified a proposed credit transaction as one posing a high risk of violating an economic sanction (Bank)
Does it work?

- KYC that did not identify a client as higher risk, but where ongoing monitoring uncovered a higher risk
  - Transaction monitoring, specifically for structured transactions—same customer making remittances overseas to same country; accumulating to over $10K within one to two week period. Suspicious transaction reports filed. (MSB)

  - Transaction monitoring for large volumes of in-and-out wire activity identified a client moving funds among higher risk jurisdictions. Suspicious activity reports filed, and high risk client model updated to reflect a new category of higher risk client based on actual experience (Bank)
Higher Risk Areas

• Determining higher risk members/relationships
  • Need to make determinations and document; if you really don't have higher risk relationships- prove it

• Monitoring high risk accounts
  • Need a process and it likely needs to be automated

• Third party determinations

• Beneficial ownership

• Politically exposed foreign customers

• Intended use of accounts
Higher Risk Members

- MSB services have been identified by regulators and governmental authorities as being high risk for money laundering or terrorist financing activities
- DICO Operational Risk Advisory #2- Potential Risks Associated with Providing Banking Services to Money Service Businesses
- Other high risk- precious metal dealers, securities dealers, realty brokers
- Why:
  - International remittance transfer service (EFT) has a significant money laundering risk associated with it
  - Currency conversion has a high risk for money laundering although (likely less than remittance transfer services, still high)
  - “Precious metals, precious stones, and jewels are easily transportable, highly concentrated forms of wealth, serve as international mediums of exchange and can be converted into cash anywhere in the world. Actively traded market, can be melted into various forms, leaving them virtually untraceable.

Protect your organization: due diligence and independent compliance program reviews
Be aware of...

- Proposed Changes to Regulations
- Privacy vs. PCMLTFA
Questions to Ask…

• Who are our higher risk members and why? How are we monitoring?
• What services do we provide that are higher risk and why?
• How is our assessment of risks supported? Probe/query the support, make sure you understand it.
• How many LCT reports filed? Nature of these transactions and relationship with the member? How are these transactions being monitored?
Questions to Ask…

• How many unusual/suspicious transactions were identified internally? How many reported externally? Understand the difference. How does this link to our risk assessment?

• How is our compliance program reviewed? Independent vs. internal? What were the results? Obtain and review actual copy of the report and probe/query the action plan for any deficiencies/recommendations.

• This is really all about knowing members and source of funds…
Key Points to Take-Away

- Regulatory action is increasing, need to think about your organization, also membership base.
- RBA is foundational to your program. Needs to be detailed, document mitigating controls. No and/or all low risk is really not credible.
- High risk members- need to understand what and who is higher risk, ultimately this is about the source of funds that your credit union accepts.
Key Points to Take-Away

• High risk compliance areas:
  • Program needs to be integrated: risk assessment, policy and procedure, training, monitoring and training, feedback process...
  • Need to make use of information collected and available; intended use of account needs to be integrated into monitoring process for example
  • Know Your Member- Up front and on-going due diligence
  • Corporate/Entity Members- beneficial ownership, third party, business type, source of funds, geographies
  • Individual Members- politically exposed, third party, source of funds, intended use of accounts
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