Linklaters

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FSA reports on how banks deal with high-risk customers, correspondent banking relationships and wire transfers

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1 Executive Summary

The FSA has recently published its review (the "**Bank AML Report**") into how banks manage situations where there is a high risk of money laundering, focusing on how banks deal with:

- politically exposed persons ("**PEPs**")[1];
- correspondent banking relationships; and
- wire transfer payments.

The Bank AML Report has suggested that a third of banks, including the private banking arms of some major banking groups, appeared willing to accept very high levels of money-laundering risk if the immediate reputational and regulatory risks are considered acceptable.

As a result of its review, the FSA has referred two banks to its enforcement division after identifying "serious weaknesses" in their systems and controls for managing high risk customers, including PEPs. The FSA is currently considering whether further regulatory action is warranted, other banks and additional cases may be referred to enforcement.

The Bank AML Report also outlined proposed guidance Financial Crime: a guide for firms ("**Proposed Guidance**"), in the form of examples of good and poor practice which the FSA will expect firms to take into account once the guidance is finalised. The Proposed Guidance sets out steps that firms can take to reduce the risk of being used to further financial crime and by doing so help themselves to meet relevant legal obligations. The FSA is currently consulting on the proposed guidance which is open for comment until 21 September 2011.

[1] PEPs are individuals whose prominent position in public life may make them vulnerable to corruption

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Key findings in the Bank AML Report:

- The FSA will use its enforcement powers to encourage banks and other regulated firms to strengthen AML systems and controls and deter firms from making decisions which do not take adequate account of money laundering risk. Arising out of the FSA's review, two banks have been referred to the FSA's enforcement division after the FSA identified "serious weaknesses" in their systems and controls.
- 75% of banks did not always manage high-risk customers and PEP relationships effectively. The FSA advised that these banks must do more to ensure they are not used for money laundering purposes. The FSA is concerned that there has been insufficient improvement in banks' AML systems and controls since a similar report conducted ten years ago in March 2001.
- Serious weaknesses in banks' systems and controls, as well as indications that some banks were willing to enter into very high-risk business relationships without adequate controls when there were potentially large profits to be made. Consequently, the FSA considered that some banks may be handling the proceeds of corruption or other financial crime.
- The FSA expects firms to consider its findings and translate them into more effective policies and controls where necessary.
- Firms should continue to adopt an appropriate, risk based approach to money laundering, taking into account relevant factors including their customer base, business and risk profile. Failure to do so may result in the FSA taking action.
- As a result of the FSA's findings, the management of high-risk customers, including PEPs will remain a significant focus of the FSA's anti-financial crime work for some time to come.

A brief summary of the Bank AML Report is set out below.

2 Background and objectives

The main objective of the FSA in undertaking its review was to assess whether banks had robust and proportionate systems and controls in place to identify, detect and prevent the misuse of correspondent banking facilities; meet the requirements to identify the originators of international wire transfers; and reduce the risk of corrupt PEPs and other high-risk customers misusing the UK banking system. In addition, the FSA aimed to identify good practice to share with the industry and highlight areas where improvement is required.

The FSA conducted visits to 27 banking groups in the UK with significant international activity exposing them to money laundering

risks arising from high-risk customers/PEPs, correspondent banking and wire transfers. The sample comprised eight major banks and 19 medium-sized and smaller banks, including banks from higher risk countries and private banks. The banks were chosen because they dealt in products, or with customers, likely to give rise to high levels of inherent money laundering risk. The FSA also visited several large banks' overseas centres to assess significant relevant outsourced functions such as payment processing and the initial assessment of transaction monitoring alerts.

3 High risk customers and PEPs

3.1 AML policies and procedures

The FSA noted that although all the banks visited had an AML policy document, some banks' policies were clearly out of date and had not been reviewed for some time. In addition, two banks were using an overseas group policy without having adapted it to UK legal and regulatory requirements or ensured that key UK staff understood it. Other banks had no procedures to identify PEPs.

3.2 Risk assessment

The FSA has found that a quarter of banks appeared more concerned that a PEP might be involved in a public corruption scandal than that they might be corrupt and/or laundering the proceeds of corruption. The FSA has emphasised that reputational risk and money laundering risk are not the same and steps to mitigate reputational risk will not always reduce the risk of money laundering.

The FSA is concerned at the lack of bespoke training provided to staff directly involved in dealing with high-risk customers.

The FSA has identified serious weaknesses in some banks' risk assessment policies and processes. A third of banks failed to review their risk assessment regularly and to take account of significant new developments and insights, such as new evidence of country risk or displacement of criminal activity to other products or services.

Examples of poor practice by some banks included:

- not updating their risk assessment to take into account FATF's (the Financial Action Task Force) current list of countries with strategic deficiencies;
- allocating inappropriately low risk weightings for high risk factors to avoid having to conduct enhanced due diligence on much of their business and failing to take into account well known high risk indicators such as links to certain business activities or adverse information from a variety of sources;

- scoring risks in a way that, in practice, it was almost impossible for a relationship to be classified as high risk; and
- failure to update customer risk assessment during ongoing monitoring of the relationship.

3.3 Customer take-on

Customer take-on describes the process during which a bank applies customer due diligence measures ("**CDD**") and decides whether to establish a business relationship. In general, the FSA found most banks took steps necessary to meet their customer identification and verification obligations under the ML Regulations. However, the FSA had a number of concerns. Some banks were unable to prove that they had obtained meaningful evidence of identity. Examples of poor verification practice included banks' over reliance on undocumented "community knowledge" and personal acquaintances, for example where a bank's CEO had personally introduced a customer.

The FSA found that some banks were relying on intra-group introductions even where they could not be satisfied that verification had been carried out to UK-equivalent standards or where they knew that underlying CDD information was inaccessible due to legal constraints in the jurisdiction where this information was held.

More than half of banks failed to review regularly and, where necessary, update customer information. Failure to keep CDD information up to date was of particular concern where the risk associated with the relationship had changed, for example, where transactions on the account were incompatible with the CDD information on file.

The FSA was not satisfied that all banks understood their legal CDD obligations in relation to their customers' beneficial owners. A third of banks failed to take adequate measures to understand and verify their customers' ownership and control structure.

3.4 Source of wealth/funds

The FSA has reported that three quarters of banks failed to obtain adequate information about their customers' source of wealth and the source of funds to be used in the business relationship. In half of banks, the FSA found that information provided by customers, however questionable, was accepted at face value. Even where relevant information about a customer's source of wealth or funds was obtained, nearly three quarters of banks did nothing to verify this and too much reliance was placed on the word of customers or relationship managers, even where there were serious allegations of criminal conduct about the customer.

3.5 Enhanced due diligence

Banks must apply enhanced due diligence ("**EDD**") measures where the risk associated with the business relationship is increased. The FSA found that although several banks gathered additional due diligence information from a variety of sources, a third of banks failed to analyse this information properly and reflect the findings in their risk assessment.

Some front-line staff, particularly relationship managers dismissed or even withheld negative information where banks stood to profit significantly from the business relationship. The FSA has emphasised that banks should take very seriously adverse allegations against their customers in order to meet their legal and regulatory obligation to identify, assess and mitigate money laundering risk effectively. Where a bank is not satisfied that it has applied all CDD measures in accordance with its legal obligations, the bank must not proceed with the business relationship.

3.6 Risk appetite, culture and resources

The FSA was not satisfied that all banks had adequate risk management systems in place effectively to mitigate the money-laundering risk they were prepared to take on. The FSA found that the risks banks sought to mitigate were of limited relevance to AML in more than one quarter of banks.

At nearly half of banks, a poor AML compliance culture and an apparent lack or leadership on AML issues from senior management were accompanied by a lack of senior management involvement in PEP and high risk customer sign off processes. Generally MLROs at larger banks had developed more specialist knowledge on AML requirements as they spent most of their time dealing with AML issues. However, the FSA found that at around a fifth of banks, Group MLROs were too remote from their business units and sometimes had a poor awareness of the group's highest risk relationships.

3.7 The relationship between criminality risk and reputational risk

The FSA was concerned that at nearly a quarter of banks, money laundering risk was viewed as a reputational risk only. In these banks, the FSA considered that senior management attached greater importance to the risk that a customer might be involved in a public scandal, than to the risk that the customer might be corrupt or otherwise engaged in financial crime and using the bank to launder criminal proceeds. At around a third of banks, serious allegations against customers were often discounted where criminal charges were unlikely to be brought, for example because the customer maintained good relations with allegedly corrupt regimes. As a result

senior management were willing to take on extremely high risk customers as long as they judged the immediate reputational risk to be low.

The FSA has stated that an exclusive focus on reputational, regulatory or credit risk rather than a money-laundering risk is unlikely to be conducive to banks understanding and effectively managing their money laundering risk.

3.8 Enhanced monitoring of high risk relationships

The ML Regulations require banks to conduct ongoing monitoring of their business relationship with their customers and enhanced monitoring for PEP customers.

The FSA is of the view that relationship managers should be a bank's first line of defence in managing and controlling money laundering or terrorist financing risk. Banks should, however, ensure that relationship managers do not become too close to the customer or motivated by financial incentives which may compromise a bank's ability to meet its AML obligations. At more than a third of banks, the FSA found that compliance staff did not sufficiently challenge relationship managers or customers and often accepted poor explanations of potentially suspicious activities.

In some cases, relationship managers appeared to be too close to the customer to take an objective view of the business relationship and many were primarily rewarded on the basis of profit and new business, regardless of their AML performance. As a result, safeguards in place to mitigate relationship managers' conflicts of interest were inadequate.

Nearly half the banks failed to review high-risk or PEP relationships regularly. "Relevant review forms often contained recycled information year after year, indicating that these banks may not have been taking their obligation to conduct enhanced monitoring of PEP relationships seriously enough."

4 Correspondent banking

Correspondent banking is defined in the JMLSG Guidance as the provision of banking services by one bank (the "**correspondent**") to an overseas bank (the "**respondent**") to enable the respondent to provide its own customers with cross-border products and services that it cannot provide itself, typically because it lacks an international network. Correspondent banking activity can include establishing accounts, exchanging methods of authenticating instructions (e.g. by exchanging SWIFT keys) and providing payment or other clearing-related services.

The FSA has found that some banks conducted good quality AML due diligence and monitoring of relationships, while others, particularly smaller banks, conducted little and, in some cases, none. In several smaller banks, a tick-box approach to AML due diligence was noted. Many (especially smaller) banks' due diligence procedures resembled a 'paper gathering' exercise with no obvious assessment of the information collected; there was also over-reliance on the Wolfsberg Group AML Questionnaire which gives only simple yes or no answers to basic AML questions without making use of the Wolfsberg Principles on correspondent banking. The FSA found that when reviews of correspondent relationships were conducted, "they were often clearly copied and pasted year after year with no apparent challenge".

Some banks did not carry out due diligence on their parent banks or banks in the same group, even when they were located in a higher risk jurisdiction or there were other factors which increased the risk of money laundering.

The FSA has noted that a more risk-based approach is required where PEPs own, direct or control respondent banks. The FSA found there was a risk that some banks' respondents could be influenced by allegedly corrupt PEPs, increasing the risk of these banks being used as vehicles for corruption and/or money laundering.

The FSA has acknowledged that transaction monitoring of correspondent relationships is a challenge for banks due to often erratic, yet legitimate, flows of funds. Banks ultimately need to rely on the explanations of unusual transactions given by respondents and these can be difficult to corroborate. However, there were some occasions where the FSA felt banks did not take adequate steps to verify such explanations.

The FSA was dissatisfied by the lack of evidence of assessment by internal audit of the money-laundering risk in correspondent banking relationships given the high money-laundering risk which is agreed internationally to be inherent in correspondent banking.

5 Wire transfers

The FSA in its review found no major weaknesses in banks' compliance with the Wire Transfer Regulations.

6 Examples of good and poor practice

The Bank AML Report included a table setting out consolidated examples of good and poor practice which forms part of the Proposed Guidance. A link to the table is available here. The FSA is currently consulting on the Proposed Guidance in CP11/12 which is open for comment until 21 September 2011.

7 Conclusions

In its Bank AML Report, the FSA has sent a clear message of its intention to focus on enforcement where relevant, to reinforce the need for banks to improve AML systems and controls. In particular, the FSA's concern that little improvement has been made in banks' AML systems and controls over the last decade, combined with the FSA's increased focus on intrusive, principles-based regulation suggests that money laundering regulation may be an area of future regulatory focus for the FSA.

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