

## Financial crime – raising the bar



### The Deloitte Compliance Forum

*New lines of thought*

When considering activities such as fraud, laundering the proceeds of people-trafficking, drug trafficking and other crimes, illegally dealing with sanctioned companies or individuals, bribery and corruption, or the financing of terrorism – financial crime is far from being a victimless practice. What's more, the true annual cost of financial crime is, by its nature, something that is notoriously difficult to define, but it is estimated to cost businesses and taxpayers billions of pounds each year. The International Monetary Fund has estimated the scale of global money laundering to be the equivalent of 2 to 5 per cent of worldwide Gross Domestic Product.

Detecting and preventing financial crime is a constantly challenging and evolving problem, as criminal organisations have vast resources and skills to outwit those tasked with detecting and preventing their activities. In recent years, there has been a general move by regulators to implement a risk based approach to combat money laundering in line with the revised Financial Action Task Force 40 Recommendations, which suggest that financial institutions implement a risk based approach to Customer Due Diligence (CDD). As regulators and investigative bodies begin to shift their focus in line with this risk based approach, some key questions arise, which are considered in this point of view:

- Are regulators and investigators raising the bar in respect of requirements and standards firms need to meet in order to address financial crime?
- What should firms do to resist the rising tide of financial crime? And how can firms manage the increasing number of measures required to combat it?
- What can the financial services industry do collectively to address this pressing issue?

#### **Raising the bar**

A key challenge for firms is that different areas of financial crime are managed by different regulatory regimes with varying requirements, with a split between risk based and zero tolerance approaches.

Regulation to address money laundering has shifted towards a risk based approach and continues to evolve, particularly on where firms need to allocate their resources proportionately to CDD procedures. CDD typically involves identifying and verifying (ID&V) customers, understanding the expected nature of the client relationship (Initial Due Diligence) and reviewing the ongoing activity of the client to ensure it accords to the anticipated nature of the client relationship (Ongoing Due Diligence). However, financial sanctions regulation and compliance activities tend towards a 'zero tolerance' regime, where the discovery of sanctioned individuals or entities on your books (or who you are making payments to or from) can result in significant fines, remediation work and reputational damage.

In theory, the USA operates a risk based approach, but in practice it seems their approach to combating financial crime is more like that of 'zero tolerance'. Their regulatory and investigative bodies, such as the US Treasury's Office of Foreign Asset Control (OFAC) are stepping up their activities, so that the existing rules based regime for US financial institutions is now being overlaid by heavy risk based regulation, creating little scope for movement or interpretation. At the present time, the following commentary is said to sum up the situation at various US Anti Money Laundering (AML) offices: "When is a risk not a risk? When it's a rule".

In 2005 the US regulators said a Dutch bank failed to meet the necessary controls on money, and the US Department of Justice brought a case against the bank which resulted in a \$80million fine. The financial crime requirements in the US are arguably higher than those that apply in Europe and the UK in certain areas, for example sanction compliance, and are driven primarily in response to the events of September 11 2001.

Of course, this is not to say that UK and Europe have been inactive in fighting financial crime. The UK Parliament passed the Terrorism Act 2000, and since the events of September 11, the UK has passed the Proceeds of Crime Act 2002 (POCA). The Serious Organised Crime Agency (SOCA) was created in April 2006 with a mission to reduce harm caused by serious and organised crime, and the EU's Third Money Laundering Directive was implemented across the European Economic Area in December 2007. In addition, the FSA's Outlook 2008 published earlier in the year noted the following warning signal, indicating a rising bar in this area.

"The increasing emphasis on sanctions, both domestically and internationally, could lead to a renewed focus by governments on what financial services firms are doing to comply. The UK Government has increased the resources it allocates to this issue and created a dedicated Asset Freezing Unit. The number of individuals and entities on the UK's consolidated sanctions list increased from 1,642 to 1,738 during 2007 and is expected to increase further in 2008.

We are seeing increasing evidence of attempts by firms and individuals of questionable integrity, often from jurisdictions for which it is difficult to undertake effective due diligence, either to take control of UK financial services firms or to list on the UK's markets. This could increase the risk of financial crime being committed in the UK and present a threat to the integrity of the UK's financial system."

As relevant authorities in the USA, the EU, and the UK all announce and enact sterner measures to combat financial crime, the question arises as to whether a risk based approach can meet the challenges of anticipated changes in the focus on sanctions.

As we have seen with SEC-registered companies, European financial institutions which operate in the US must follow US policies in respect of sanctions compliance, because they have large businesses there, but will the bar also be raised for other European financial institutions?

The key points are:

- How does a firm balance an AML risk based approach with the more onerous sanction compliance requirements?
- What can the financial services industry do to address the issues that will continue to impact us in all areas of financial crime?

### Prevention is better than cure

Applying a risk based approach to combating financial crime will no doubt ensure that firms allocate resources to the areas of greatest risk. However financial crime risk, by its very nature, is dynamic and constantly changing. The application of a risk based approach needs to reflect this, and needs to be an ongoing rather than an annual process.

In their March 2008 Review of firms' implementation of a risk based approach to AML, the FSA pointed to some examples of good and poor practice. They stated: "The broad intention of the guidance is to encourage firms to adopt a risk based approach by focusing their financial crime resources on areas of higher risk. That does not detract, however, from the need for firms to do their own analysis of where their risks lie, in order to make a risk based approach effective. Such an approach will, for example, ensure that lower risk customers do not suffer from unduly burdensome procedures and requirements. And, on the other hand, it will ensure that firms undertake enhanced due diligence whenever that is required, i.e. for customers and business lines that pose higher risk."

In addition to adopting a risk based approach, Deloitte is of the view that firms should focus heavily on implementing more preventative measures to address the risk of financial crime. Two examples of preventative measures are procedures around initial customer due diligence and staff training.

### Initial customer due diligence

To avoid the risk of transacting with a bad apple, firms should ensure that the upfront measures during the initial customer due diligence phase are sufficiently robust. Not letting the customer onto your books from the outset will result in avoiding the substantial effort of exiting relationships and the risk of fines, remediation effort and reputational damage that firms incur when money launderers or sanctioned individuals/entities are later identified.

Naturally, the first priority for financial institutions should be to truly understand their customers, shifting their focus from merely identifying the customer, to undertaking customer due diligence where financial institutions really 'Know Their Customers' from an AML and sanctions perspective. AML and sanctions are very different areas of regulation with different stakeholders; however, the Know Your Customer (KYC) process is the one area where they come together. Robust and detailed KYC processes will meet the needs of both areas for AML and Sanctions purposes, as good KYC practice allows financial institutions to a) determine if the AML risk of the customer is unacceptable and b) allows financial institutions to perform in-depth screening on prospective clients to ensure they are not sanctioned individuals or companies.

This means, in order to implement effective KYC procedures, financial institutions need to rapidly acquire better in-depth knowledge of their customer base (i.e. where does their customers' money come from, and what do they do with it?). This effort should be co-ordinated with other customer-focussed initiatives in the organisation to ensure any investment yields the greatest impact – for instance enhanced KYC may overlap with efforts to obtain a single view of the customer, and ongoing CDD could complement TCF requirements to monitor the customer relationship.

Financial institutions also need to know what the next step in the chain is (i.e. who are their customers' customers, and what do they do?), and must identify information on known undesirables, making sure they have up-to-date data.

In short, executives need to be asking themselves deceptively simple questions: who are our customers? How do we know this? What are they up to? What are their customers up to? What information do we have on them? Is the information up to date?

### Staff training

In practice, breaches are often driven by staff failing to execute procedures correctly. Designing and implementing effective and appropriate AML and sanction staff training is another preventative control measure that firms can implement to adopt a more effective approach to financial crime. Is training sufficiently tailored for individual business areas and risk areas? AML and sanctions regulation and legislation is extremely complicated, and the frontline staff should not be expected to know the specifics of AML regulation or the latest entry on a sanctions notice. Nonetheless, they should have training delivered to cover the key principles supported by a 24-hour hotline to address questions of uncertainty. Institutions should employ real-life case studies to provide staff with scenarios for which they should be on the look-out, in particular on sanction compliance.

### So now what do we need to do?

The big question for the UK financial services industry is should financial institutions be working more closely together to address financial crime? There is no doubt that, to some extent, the financial services industry already works together through various groups such as the British Bankers Association (BBA), the Wolfsberg Group and Joint Money Laundering Steering Group (JMLSG).

But could industry be doing more to discuss and share actual good practice in combating AML? Should financial service companies put aside the issue of competition, and work even more collaboratively to regularly share common practice on problem areas or sponsor industry initiatives? For example, firms could work together on areas such as:

- centralising customer ID&V authentication;
- sharing screening standards and methods; and
- working with payment bodies to increase transparency of payment details to support screening quality.

As an example, the screening processes adopted by firms can be onerous, to say the least, and so financial services institutions should consider collaboration as an industry, to put a stop to unnecessary ‘noise’, created by searches. This sometimes occurs on a payment sheet, where the acronym ‘ETA’ will almost certainly refer to the Estimated Time of Arrival, and will not refer to the Basque separatist terrorist organisation. However, as things stand, a payment with ETA on it will frequently be automatically stopped and need to be investigated.

In terms of applying and adhering to regulation, one possible counter-argument is that the UK financial industry does not need to concern itself unduly with practices in America, as UK financial institutions are regulated by Whitehall and Brussels, not the SEC. But, as the old adage has it, when the US sneezes, everyone else catches cold. In the case of financial crime, Britain’s close political and military alliance with America means we will likely need to adopt similar practices to the USA in order to deal with the issues around prevention of funding for terrorism, for the foreseeable future.

So, in summary, the bar is being raised around what must be done to fight financial crime, and the demands on firms are becoming more complex and are sometimes contradictory in their approach. The situation continues to evolve, and we should expect more regulation and scrutiny around financial crime issues for years to come.

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