3MLD - The Regulator's Challenge

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On the 15 December we will wake up to a brave new world. No longer will our lives be governed by check lists, rigid processes and countless hours of form filling. Instead, we will be free thinking individuals applying our vast experience and knowledge of Money Laundering (ML) and Terrorist Financing (TF) threats towards a common sense approach to mitigating these risks. Somehow I do not think this will be the case.

The latest EU Directive on Money Laundering (3MLD) is laudable for its intent, whereby the onus of mitigating the ML and TF risks is rightly placed in the hands of those who manage the business. This mitigation must be risk-based and with a few exceptions, for high-risk scenarios, firms are free to consider what works best for them.

But behind this free thinking Directive lies "Regulatory Fear Factor". The questions: "what if the regulator does not think that this is good enough?";"what if we get fined?";"what if….?" are all being asked by Compliance Officers and Risk Managers throughout Europe. The greatest challenge in implementing 3MLD lies not with how firms are implementing it but how are regulators managing the expectations of firms.

It may be uncommon to have a regulator actively considering the expectations of firms, after all we sit in a privileged position of power, but if the right balance is not sought firms will be undertaking huge programmes in order to be able to prove to the regulator that they have done the right thing, at the risk of diverting resources from the coal face which is where they should be at.

Financial institutions are faced with the problem of ensuring that their AML/CFT programmes are understood and given effect by all of their staff. Most fail precisely because it is not always possible to translate high level mitigation to front line staff that may have joined them a few weeks ago. So firms turn to simplifying complex risk programmes to discreet sub-sets, with the end result inevitably being some form of check list or fixed process which leads the potential customer/money launderer through a given path in which handling the exception becomes an almost impossible task. Yet these same firms will be challenged even further with 3MLD as it is now necessary to demonstrate that the chosen path has been applied on a risk-sensitive basis.

Imagine then the challenge for the regulator who is charged with ensuring that each firm applies a risk-based approach to AML and CFT where the regulator itself no longer has a check list of "must haves" in order to determine whether a firm is compliant or not.

Compliance monitoring consists of elements of both off-site and on-site work, with validation forming the main part of the on-site work. Although some jurisdictions have chosen to be prescriptive about how firms need to adopt the risk-based approach, most have not, leaving it completely in the hands of senior management to implement such systems.

The regulator needs to understand the context under which a firm is exposed to ML or TF risks before it can attempt to put the adequacy of the risk framework into perspective. For this reason it is useful to continue with the Financial Action Task Force's recommendation for a national threat assessment and extend that same context to the firm. Once a firm has established this the risk-based approach it adopts will be guided by the risks it faces. With this in hand, the regulator will then have its benchmark and the effectiveness of a firm's system of control can be measured.

In the same way as a firm has to ensure that its mitigation is understood and given effect by the most junior of its staff, the regulator has the same challenge in ensuring that its assessment of a firm's systems is properly understood by those evaluating them. Regulators really need to ensure that all of its staff conduct their compliance assessments in a manner which is commensurate with the principles of a risk/principles-based approach.

The easiest thing for a regulator to do is to conduct an inspection visit to determine the number of times a particular process has not been complied with. It is much more difficult to determine whether the process in itself is fit for purpose. But how does a regulator adapt to this paradigm shift? How does the regulator take a subjective view of each different firm's adequacy of systems without falling to the lowest common denominator and thereby creating weaknesses in a jurisdiction's defences?

Regulators, like firms, need to make a determination that the main themes of any AML/CFT programme must contain effective measures that will address the following:

- **Senior Management Responsibilities.** It is no longer just the MLRO who shoulders the blame for AML/CFT programmes and their deficiencies. Senior Management and the Board in particular, must be accountable for the firm's systems. The regulator needs to ensure that the line of accountability can be traced all the way from front line staff to the top.
- **Risk-based Approach.** That the firm has given practical effect to the application of the concept at every level and that these measures effectively mitigate the risks which the firm faces. Firms will need to carefully document their methodology for risk-assessing customers, the product, and the manner in which the product is sold in order for the regulator to be able to determine whether or not the

methodology has been consistently applied. KYC Documentation will therefore now also include the basis on which a customer's risk-profile was determined.

- **Know your customer.** The mantra of every AML/CFT programme has been redefined by 3MLD. No longer should firms just be concerned with the source of the income or wealth but it is just as important to determine the destination and application of the funds in the context of corruption, terrorist financing and sanction busting. Transaction monitoring is no longer an option but a requirement. Regulators need to ensure that whatever systems are put into place they are vigorously tested and firms need to demonstrate that this is not their only source of STRs.
- **Internal Suspicious Transaction Reporting.** Firms need to ensure that there are clear mechanisms through which staff/systems can flag transactions considered or known to be related to ML or TF and these are properly scrutinised and escalated to the relevant Financial Intelligence Unit in a timely and accurate manner. MLROs have the added responsibility of documenting their thought processes throughout the process and how decisions to escalate internally or make a disclosure (or not to) to the FIU have been arrived at, whilst at the same time being required to feedback to the source of the disclosure the value of the original report. Regulators will be looking at how effective these mechanisms are.
- **Staff Training.** Training used to be an almost passive process which many forms used to satisfy through the annual trip to the lecture room to watch that video where the bad guy turns up with a suitcase of cash. How things have changed since then. Regulators should be looking at whether or not a firm is covering the following areas within their programmes:
  - o The legal and regulatory responsibilities of staff and the firm;
  - o Their role in handling criminal property and terrorist financing;
  - o How the firm manages their ML/TF risk;
  - o How to recognise ML/TF activities; and
  - o How the firm handles internal STRs.
- **Documentation.** Throughout the whole process, firms and regulators will need to ensure that they document every aspect of their methodology and more importantly how the established policy/requirements, considered and approved by the board, have been given effect on a practical and day-to-basis.

It is clear that if 3MLD is to have a real and practical effect on the mitigation of ML/TF risks, firms must move away from the "tick and bash" approach that we have all experienced as customers of financial services. What and how much we get asked for when requesting services must be tempered by the risk profile we present to the firm but in the effort to seem to be compliant I have the niggling suspicion that firms will want to replace form filling and documentary evidence requests with risk-profiling questionnaires and endless lists of questions. This might be great to satisfy the regulator, but does nothing to mitigate the risk.

It is up to the regulators to ensure that a firm's expectations of what will be required is laid out in a clear and unambiguous manner, so that the bureaucracy of compliance does not add to the already confused state of affairs. Fining firms or taking regulatory action for occasional breaches of their processes is not the way to do this.

Regulators need to ask themselves "is this fit for purpose?"

"The Introduction of a Third Money Laundering Directive"
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