Meeting the AML Compliance Challenge

A comprehensive, proactive approach

Nelson F. Everhardt

Summary

This paper reviews Anti Money Laundering (AML) compliance needs following the passage of new AML regulations worldwide and discusses the components needed to develop an effective, proactive and sustainable AML compliance program. Components of a successful program include:

- **Policy and Procedures** that encourage vigilance and a commitment to deterring the use of the company for criminal activity
- **Due Diligence and Customer Identification Program** for a full understanding of each customer
- **Risk Assessment** to understand customer, product and transaction risks
- **Suspicious Activity Monitoring** with advanced technology to detect any behavior within the organization that is unusual and analyze it for risk
- **AML Training**

Working together, these components make up a comprehensive AML compliance program that is both commercially reasonable and effective in ultimately reducing risk to the organization by preventing use of the institution for criminal activity.

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Introduction

The Financial Services Industry is coming under increased scrutiny from government agencies to take a leading role in the prevention of money laundering and potential terrorist funding. Only financial institutions have the ability to understand transactional behavior and truly know their customers.

The ability to detect and report suspicious activity is essential in combating money laundering. Governments are enlisting the Financial Services Industry (through new policy and law) to implement stringent new Anti Money Laundering (AML) programs to help maintain the integrity of our financial system and protect it against illicit use.

While legislative pressure has increased for financial institutions, the definition of money laundering has greatly expanded as well. Money laundering has traditionally addressed funds that are illegally acquired (often through money from drug trade, crime or corruption) and then 'washed' through a financial institution to appear legitimate. Today money laundering also includes the movement of legitimate funds through a financial institution to fund potentially illegitimate activity, such as terrorism.

Several high-profile examples of money laundering that have occurred within large institutions have caused the government to elevate its standards for AML compliance programs. Three such examples involved private banking activities, international correspondent banking and wire transfer operations. Collectively these situations led to highly publicized hearings in Congress, with testimony from the chairmen and top banking executives, creating what many would categorize as 'reputational damage.'

In October 2001, the USA PATRIOT Act was passed, substantially raising the bar with stringent new regulations and a stronger commitment to preventing money laundering.

The USA PATRIOT Act greatly expands the definition of financial institution beyond traditional banks and broker-dealers to now include insurance companies and money service businesses (wire transfer and traveler's check companies.) The Act was recently extended into other industries that previously had not been subject to AML compliance, such as dealers of precious metals, stones and jewels and eventually will include travel agents and car dealers.

A Comprehensive Compliance Program

A sound compliance program is a financial institution's best defense against criminal activity. Given the high priority of AML and corresponding new regulations, that defense must now include an aggressive offense to enable a more proactive approach. Financial institutions must be able to demonstrate to regulators that they have a commercially reasonable AML strategy, which has been implemented through efficient, documented, auditable enterprise-wide processes.

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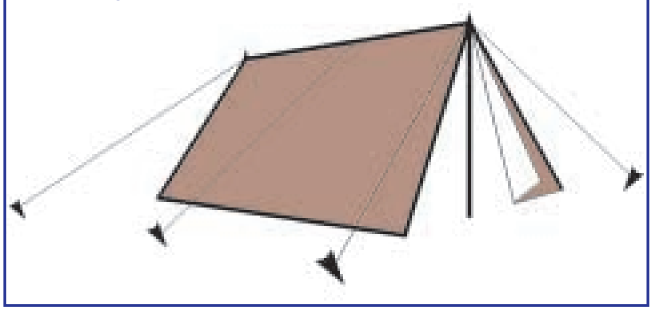
Financial institutions will be in a much better position if they take a holistic view of the risk to the organization and put forth the necessary effort early on to build a model process.

Financial institutions should have a plan in place that clearly demonstrates their progress in meeting their compliance objectives. Compliance program requirements fall into several categories. These include comprehensive policies and procedures, risk rating processes, a strong due diligence and Customer Identification Program, monitoring tools, training and processes for identifying and reporting suspicious activity. These compliance components must fit together like pieces of a puzzle.

The sheer volume and complexity of the transactions increasingly require the use of advanced technologies and robust sustainable processes. In addition, the internal audit department is expected to play a much more active role in identifying program deficiencies. Ultimately financial institutions, lawmakers and law enforcement must work together to successfully combat money laundering. Each financial institution must enact a sustainable process that enables cooperation and complies with the current regulations.

This is analogous to "pitching" a tent. A tent will only stay erect if it is firmly supported by stakes on either side. In this case, the tent symbolizes the overall AML process. Imagine that the laws, regulations and advisories comprise the stakes that anchor the left side of the tent. The components of the AML compliance program, including all of the regulatory obligations, make up the stakes on the right side. The center pole that runs along the top along with the supporting poles represent the overall process that keeps the tent in place. Without that sustainable process, supported by each of the stakes, the tent will collapse under its own weight and AML compliance requirements will not be met. This illustrates the importance of each component of the overall program and the full cooperation with regulators.

Supporting the AML process



Policies and Procedures

An effective AML compliance program begins with support from the top of the organization and a corporate policy that outlines compliance principles. Executive sponsorship from the highest level is critical to the overall success of the program. (In fact several countries, including Canada and Germany, have passed legislation that imposes personal fines and even jail time for executives who do not enact appropriate AML programs.)

Corporate policy should clearly encourage vigilance and a commitment to deterring the use of the company for criminal activity while reaffirming a policy of cooperation with government regulators and law enforcement agencies.

Executive management must proactively demonstrate support for such policies through its behavior that strict adherence is demanded throughout the enterprise. This should include a clear statement to acknowledge that non-compliance could lead to civil and criminal penalties for the financial institution and its employees.

Procedures customized by lines of business and operating activities that support the corporate policy should be in place across the franchise. It is critical that procedures be comprehensive, up-to-date and deployed at the desktop level.

Procedures should also be sustainable ensuring that adherence does not break down over time. Under the new level of expectations from regulators, auditors, and examiners you can expect a detailed review of procedures and the processes that are in place to determine that they are adequate and consistently followed on a day-to-day basis.

Due Diligence/Customer Identification Program

Financial institutions are required to perform due diligence and have a Customer Identification Program (CIP) in place. An effective AML compliance program includes due diligence around the account opening process that meets requirements identified in the CIP. Customer files should include documentation that clearly indicates the steps taken to know the true identity of the customer and include the beneficial owner, if different from the account holder.

The nature and purpose of the relationship should be determined and should include expected activity; frequency of cash deposits and withdrawals; funds transfer activity and international activity, for example. In essence, a profile should be established for anticipated account activity. This profile should make sense when compared to the customer's business and the geographic markets where the customer transacts business.

Reviewing account names against the Office of Foreign Assets Control (OFAC) and Government Control Lists is also required. Regulators typically begin their reviews by examining these processes. Without robust due diligence and documentation at account opening, the AML compliance program will be deemed deficient and subject to regulator criticism.

The account opening process should be customized to fit individual lines of business and reflected in the daily operating procedures. Domestic laws and regulations, as well as foreign and privacy laws, must be taken into consideration when operating in a global environment. Once in place, the compliance, audit, and internal control areas must ensure the due diligence process is consistently applied on a continuous basis and is thoroughly documented and is current.

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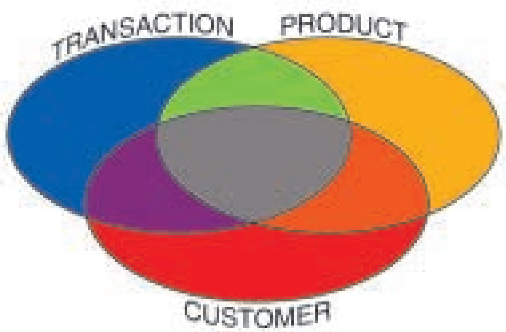
Assessing Risk

A sound compliance program will include a process to evaluate the risk associated with money laundering and terrorism financing. It may be appropriate to divide risk into three categories; customer risk, product risk, and transaction risk. Customer risk tells us characteristics about each individual (who the customer is and who the customer tells us that he or she is), which is then verified by the financial institution as part of its due diligence process. Product risk refers to the products and services that the customer purchases. Transaction risk represents the daily transaction activity that takes place on the various products and services.

These three areas of risk naturally overlap. It is important to understand the dynamics and the interrelation of these risks.

The three types of risk



The characteristics of a customer tend to be rather static and do not change frequently. The products and services that a client uses change over time but still at a relatively slow pace. Transaction risks, however, are very dynamic and change occurs on an ongoing basis as account activity is processed through various channels.

A thorough understanding and evaluation of these risks as they relate to each other will provide an awareness of which customers and products represent the highest risk for money laundering and terrorist activities. This is obviously a moving target and can only be accomplished by an intelligent system as it monitors across these three categories of risk.

An effective monitoring system will constantly monitor daily transaction activity to establish what the customer is actually doing while taking into consideration customer characteristics and the products that they use.

Suspicious Activity Monitoring

Given the sheer volume and increased complexity of transactions, suspicious activity monitoring requires an automated, technology-driven approach. The need to profile and monitor the behavior of every customer and every transaction has never been greater. Traditional monitoring systems utilize a rules-based approach, engineered to detect fraudulent activity rather than suspicious patterns of behavior.

Rules-based systems normally use pre-established thresholds and call for certain classes of activity to be monitored. This approach does not work well in detecting money laundering activities and

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generally produces a high number of false positives, creates increased staffing levels and adds management oversight.

New AML regulations require a more effective system with true analytics capabilities to find unusual transactions and determine organizational risk. Criminals are becoming more creative and sophisticated; rogue activity can occur anywhere in the chain irrespective of dollar amount or number of transactions. To be effective, AML programs need to go beyond finding pre-determined behavior through rules-based technology.

A new breed of AML software has emerged that incorporates the rules-based approach with more sophisticated Pattern Detection and Adaptive Profiling technology. This enables a financial institution to detect any behavior within the organization that is unusual and analyze it for risk.

These "best-in-class" solutions combine rules and advanced analytics to provide the most effective way to comply with new regulations and protect against reputational damage. Pattern Detection techniques allow financial institutions to find known patterns of behavior that could represent money laundering. These techniques are particularly effective in isolating predictable behavior, but will not assist in the discovery of new criminal behavior.

Adaptive Profiling provides further analysis and allows a financial institution to discover previously unknown patterns of behavior through a complete knowledge of customer activity. This enables continuous analysis and has the ability to learn and understand each individual customer profile. It can even detect suspicious links between seemingly unrelated accounts.

A financial institution, for example, can compare transactions against an account's history – and against a representative peer group. This provides a rich, contextual understanding of each transaction and helps the organization weigh potential risk.

Adaptive Profiling combined with Pattern Detection provides the full benefit of deploying advanced analytics to the business problem.

Solutions such as those offered by Searchspace, a company providing intelligent transaction monitoring software, deliver a "best-in-class" approach with true Adaptive Profiling. The solution applies self-learning technology across the enterprise with the ability to monitor both small and large dollar transactions and detect unusual activities across business lines and geographic regions.

Finally, efficient workflow and case management is critical in achieving a total solution. This process must be flexible, auditable, and have the ability to maintain, retrieve and report case management activities. The presentation of unusual or suspicious activity in an organized and easy-to-use format is crucial. There is a strong need to maintain centralized information, yet have the ability to have open and free routing capabilities across financial operating units and unilateral business lines. To maintain the integrity of the Financial Services

Industry and protect against reputation damage, financial institutions will need an advanced technology approach that combines rules, Pattern Detection and Adaptive Profiling with a seamless link to workflow and case management capabilities. This combination of comprehensive monitoring, case management and suspicious activity reporting provides the best line of defense against money laundering and the most effective way to meet compliance of new regulations.

AML Training

A successful AML staff training program is a key component that must be in place to ensure compliance. Training should cover all of the compliance policies and procedures, account opening due diligence, the risk assessment process, and suspicious activity monitoring and reporting.

Traditional methods of training delivery have included videos, classroom training, CD-ROM and even PowerPoint presentations. In today's rapidly changing regulatory environment, these delivery channels often fall short. Internet-based training (IBT) has emerged as a more effective model for AML training. IBT enables training programs to remain current with the latest information according to the latest regulations.

Training should begin with new associates as part of new employee orientation and continue at regularly scheduled intervals. Associate participation should be mandatory with attendance tracked to ensure an audit trail for the regulators. The audit and compliance areas should oversee the training process to guarantee consistency of the program across lines of business and product offerings. Areas identified as high risk for money laundering activities should receive extensive training related to their job functions.

It is extremely important that employee training clearly demonstrate executive commitment to the program ensuring that associates clearly understand the risk to themselves and the institution for becoming wittingly or unwittingly involved in a money laundering or terrorists financing scheme.

Conclusion

AML compliance today is an arduous task that will only become more challenging. The stakes have never been higher. Clearly a close partnership between government, law enforcement and the financial institutions is needed to effectively address crimes, such as money laundering and terrorism funding, and help maintain the overall integrity of the financial services industry.

Each financial institution needs to develop a comprehensive AML compliance program that will incorporate advanced technology as part of the overall process to understand customer behavior and identify risks to the organization.

A proactive approach that puts forth the necessary effort to build a model AML compliance program is clearly the best line of defense in preventing fines and penalties as well as reputational damage from money laundering.

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The author, Nelson F. Everhardt

Nelson F. Everhardt

Nelson F. Everhardt is President of Everhardt & Associates, LLC, an independent consulting firm specializing in proactive compliance solutions for the financial services industry. A recent Senior Vice President and Corporate Compliance Executive for Bank of America, his responsibilities included the corporate-wide administration of the Bank Secrecy Act (BSA), Office of Foreign Assets Control (OFAC) and Escheatment Compliance Programs. While at Bank of America, Everhardt served the role of liaison with the bank regulators on bank information technology issues. He can be reached at neverhardt@carolina.rr.com