Opinion of the European Banking Authority on the risks of money laundering and terrorist financing affecting the European Union's financial sector

This paper summarises the main findings and the proposed actions related to Investment Firms and our point of view on the key considerations and practical steps firms should take to proactively address the findings in the joint opinion and pre-empt competent authority (CA) concerns.

Executive Summary

Article 6(5) of the EU's Fourth Money Laundering Directive (2015/849) (4MLD) requires the European Supervisory Authorities (ESAs) to issue their joint opinion on the risks of money laundering and terrorist financing (ML/TF) affecting the European Union's (EU's) financial sector every two years. On 3 March 2021, the European Banking Authority (EBA) issued the 3rd Joint Opinion. The EBA issued the joint opinion as part of its new mandate to lead, coordinate and monitor the fight against ML/TF in the financial system at the EU level. The European Securities and Markets Authority (ESMA) and European Insurance and Occupational Pensions Authority (EIOPA) were closely involved in the process.

The survey was informed by over 50 Competent Authorities (CAs) responsible for the AML/CFT supervision of credit and financial institutions. The joint opinion sets out proposed actions addressed to CA's, which are based on the detailed analysis and findings set out in the report. The key findings and proposed actions in relation to investment firms include:

It is recommended that CAs consider the following key findings in relation to Investment Firms (IF):

- CAs have rated the overall inherent risk of the sector as moderately significant. CAs indicated that a number of key controls for the sector, such as those related to ongoing monitoring and STR reporting, continue to be assessed as poor.
- The adequacy and the effectiveness of governance structures remain the least assessed controls in this sector.
- The most common types of breaches found in the sector identified by CAs in 2018 and 2019 related to customer identification and verification, ongoing monitoring, internal controls weaknesses (including overall AML/CFT policies and procedures), suspicious transaction reporting, customer risk assessment and weaknesses in the governance and compliance function.
- CAs expressed concern related to the extent to which firms' customers exposed firms to risks, both in terms of difficulties encountered in identifying and verifying customers' documentations and also in identifying the beneficial owners of complex corporate structures. The customer risk exposure appears to be further increased in view of the exposure to high net worth individuals and the difficulties that firms may encounter in understanding the source

of wealth and source of funds of customers, including customers who require such services for the acquisition of residence rights and citizenship.

- Similarly, the significant geographical risk rating has also increased since the Joint Opinion 2019. Such increase in rating may be attributed to customer funds generated by activities in high-risk jurisdictions and/or funds transferred from financial institutions in high-risk jurisdictions.
- As part of their identification of emerging risks, a number of CAs identified risks associated with FinTech and the greater role of technology in investment services as key in the sector. The increasing use of technologies in the sector enables a swift approach to processing transactions, which leads to high-frequency trading and may often cause challenges with the identification and verification of customers.
- A number of CAs have also raised concerns about innovation and new technologies linked to initial coin offerings and virtual currencies.

To mitigate supervisory concerns and demonstrate robust systems and controls, Plenitude recommends the following actions be proactively undertaken by Investment Firms:

- Ensure that AML/CFT policies, procedures and internal controls fully reflect applicable laws, regulations and guidance.
- Ensure the Board has clearly articulated its risk appetite in line with its business activities and key inherent risk drivers, ensuring risk exposure is regularly monitored.
- Review the current Management Information reporting suite in terms of existing Key Performance Indicators (KPI's) and Key Risk Indicators (KRIs).
- Conduct and evidence a formal annual review and gap analysis of the current AML/CFT Risk Assessment, in particular ensure that the methodology meets regulatory requirements with respect to risk factors (Customer, Products and Services, Jurisdiction, Transactions, and Delivery channels).
- Conduct and evidence a formal review and gap analysis of the Customer Risk Rating methodology to ensure it meets regulatory requirements, in particular ensure the methodology reflects all risk factors.
- Consider how attestations can be used effectively in gaining comfort over the operation of controls both internally and externally in relation to the financial crime risk.
- Reinforce roles and responsibilities across the Three Lines of Defence to drive the required 'culture of compliance' and more effective risk management.

1. Investment Firms

The EBA received responses from 34 CAs responsible for the AML/CFT supervision of Investment Firms for both years under review (2018 and 2019), covering a total of 3,130 Investment Firms under their supervision.

- *"The EBA notes that CAs have rated the overall inherent risk of the sector of Investment Firms as moderately significant. Overall, CAs have assessed the quality of controls within the sector as good. However, CAs indicated that a number of key controls for the sector, such as those related to ongoing monitoring and STR reporting, continue to be assessed as poor."*
- *"CAs indicated that AML/CFT returns were the most used supervisory tool in the sector and a small proportion of authorities indicated they did not carry out any off-site/on-site inspections in the period under review."*

2. Quality of Controls

Overall CAs assessed the quality of controls within the Investment Firms sector as good. This assessment is similar to the one of the Joint Opinion 2019. The EBA observes that more CAs carried out assessments of controls in the sector compared to the Joint Opinion 2019.

- *"CAs appeared to be satisfied in particular with the controls related to the adequacy and effectiveness of record-keeping policies and procedures and the adequacy of customer ID policies and procedures. A significant number of CAs were on the other hand concerned about the extent to which STR reporting and ongoing monitoring were effective, and rated these as poor and very poor. This is an important increase compared to the Joint Opinion*

2019. The adequacy and the effectiveness of governance structures remain the least assessed controls in this sector."

3. Breaches Identified

- *"The most common types of breaches found in the sector identified by CAs in 2018 and 2019 related to the customer identification and verification, ongoing monitoring, internal controls weaknesses (including overall AML/CFT policies and procedures), suspicious transaction reporting, customer risk assessment and weaknesses in the governance and compliance function. However, the breaches found by CAs in the sector were, for a large part, minor breaches."*
- *"CAs most commonly followed up on the breaches identified through orders to comply, orders to implement specific measures or orders to put in place a remediation plan. These measures appear to be in line with the level of seriousness of the breaches identified in the sector."*

4. Inherent Risk

The majority of CAs have rated the overall inherent risk profile of the Investment Firms' sector as moderately significant. The sector's exposure to ML/TF risk has remained substantially unchanged since the Joint Opinion 2019, although a very slight decrease was observed in the number of CAs that assessed the sector as presenting significant ML/FT risk."

- *"The majority of CAs have rated the overall inherent risk profile of the Investment Firms' sector as moderately significant. The sector's exposure to ML/TF risk has remained substantially unchanged since the Joint Opinion 2019, although a very slight decrease was observed in the number of CAs that assessed the sector as presenting significant ML/FT risk."*
- *"The analysis of the individual risk factors shows that all categories of risks have been rated by most CAs as posing a moderately significant risk. However, when compared with the Joint Opinion 2019, customer risk rating has increased to significant. Investment Firms provide a great variety of services, for example the provision of investment advice, purchase or sale of financial products on an execution only basis, the provision of portfolio management allowing investment service providers discretion over the investments carried out, and dealing on own accounts. CAs expressed concerned related in particular to the extent to which firms' customers exposed firms to risks, both in terms of difficulties encountered in identifying and verifying customers' documentations and also in identifying the beneficial owners of complex corporate structures. The customer risk exposure appears to be further increased in view of the exposure to high net worth individuals and the difficulties that firms may encounter in understanding the source of wealth and source of funds of customers, including customers who require such services for the acquisition of residence rights and citizenship."*
- *"Similarly, the significant geographical risk rating has also increased since the Joint Opinion 2019. Such increase in rating may be attributed to customer funds generated by activities in high-risk jurisdictions and/or funds transferred from financial institutions in high-risk jurisdictions. On the other hand, significant risk exposure from the products offered by Investment Firms has substantially decreased since the last Opinion. This could be the result of Investment Firms limiting the provision of higher risk services such as execution only and nominee services. It is however uncertain if this trend is related to ML/TF risk mitigation efforts."*
- *"Most of the CAs assessed this sector as having moderately significant inherent exposure to ML/FT risks arising from cross-border activities. The main concern lies in the delivery channels and products/services which have the highest percentage of very significant inherent risk ratings, although it remains low."*

5. Overall Risk Profile and Emerging Risks

The vast majority of CAs assessed the overall risk profile of the sector as presenting a moderately significant level of risk. This shows an increase compared to the Joint Opinion 2019, with more CAs considering the sector as such.

- *"The overall risk rating provided by CAs was largely the same as the inherent risk, suggesting that the controls in place may not be sufficiently robust to effectively reduce the risks identified. A small number of CAs reported that the risk had increased, and this was due to poor controls in some key areas, including ongoing monitoring and STR reporting."*

- *"As part of their identification of emerging risks, a number of CAs identified risks associated with FinTech and the greater role of technology in investment services as key in the sector. The increasing use of technologies in the sector enables a swift approach to processing transactions, which leads to high-frequency trading and may often cause challenges with the identification and verification of customers."*
- *"A number of CAs have also raised concerns about innovation and new technologies linked to initial coin offerings and virtual currencies."*

6. Key Considerations for Investment Firms

The joint opinion clearly signals that CA's should apply a greater focus on the quality of controls in Investment Firms as part of their supervisory approach, including the review of AML/CFT returns and inspections. Separately the breach findings provide thematic considerations with respect to internal controls, AML/CFT policies and procedures, customer and business-wide risk assessments.

Based on Plenitude's extensive work across the sector and interaction with regulators, the following actions should be proactively undertaken by Investment Firms to mitigate supervisory concerns and demonstrate robust systems and controls:

- **Ensure the Board has clearly articulated its risk appetite in line with its business activities and key inherent risk drivers,** ensuring risk exposure is regularly monitored through agreed metrics and Key Risk Indicators linked to risk appetite statements. The Board should also consider conduct risk matters as part of its risk oversight responsibility.

- **Ensure and evidence that AML/CFT policies and procedures fully reflect applicable laws, regulations and guidance** by conducting a formal gap analysis against a comprehensive Obligations Register (such as Plenitude RegSight), across each of its product offerings and across delegated activities such as third party or in-sourced providers.

- **Conduct and evidence a formal annual review and gap analysis of the current AML/CFT Risk Assessment**, in particular ensure that the methodology meets regulatory requirements with respect to risk factors (Customer, Products and Services, Jurisdiction, Transactions, and Delivery channels); and consider control effectiveness and quality incorporating consideration of its third party or in-sourced providers. As required, the approach and methodology should be enhanced and executed across all AML/CFT controls for relevant supervised entities.

- **Conduct and evidence a formal review and gap analysis of the Customer Risk Rating methodology to ensure it meets regulatory requirements, in particular ensure the methodology reflects all risk factors i.e. Customer Characteristics, Countries/Locations, Products, Distribution Channels and Transactions/Operations**; and has an appropriate weightings applied to determine the overall risk score. Supporting risk lists should also be reviewed on a regular basis to ensure they meet regulatory requirements and evolving risk indicators.

- To mitigate the risk associated with perceived vulnerabilities in relation to Customer Due Diligence (including ongoing monitoring)**, conduct and evidence a review of the first line controls assurance process and/or second line existing monitoring and controls testing plan to ensure that it provides appropriate coverage across all Customers, Beneficial Owners and related AML/CFT controls**, and determine whether current testing is appropriate and meets regulatory expectations.

- For ongoing monitoring of transactions, **ensure that the controls related to ongoing monitoring of transactions are effective by amongst other things: including mechanisms to identify and implement relevant risk typologies into the ongoing monitoring of transaction, using sources such as the latest EBA Guidelines on ML and TF risk factors** and calibrate and test any transaction monitoring systems on an ongoing basis so that they remains aligned to AML/CFT risk assessments and regulatory requirements.

- To mitigate the risk of the increased use of FinTech and RegTech **firms must seamlessly align and integrate all associated business processes, data systems, and technical architectures. There should be a documented methodology (where appropriate) to ensure firms can evidence they understand the configuration and operation of the solution,** with regular reviews to ensure alignment with evolving regulatory requirements.

- Consider broader training and awareness activity with 1st and 2nd Line staff across all financial crime controls to raise awareness of ML/TF risks using specific examples, being aware of current trends and typologies, **reinforce roles and responsibilities across the Three Lines of Defence to drive the required 'culture of compliance' and more effective risk management**.

- For STR reporting, consider the requirement to file a report with the domestic FIU in relation to funds that are related to the proceeds from criminal activity or terrorism. **Putting in place a STR training regime, as part of the overall training and awareness programme, helps to raise awareness for staff reporting suspicion and ensures firms have the ability, competence and resources to identify and report suspicious activity promptly.**

- **Review the current Management Information reporting suite in terms of existing Key Performance Indicators (KPI's) and Key Risk Indicators (KRIs).** Candidate metrics relating to quality of controls include: QC pass rates for CDD and EDD, Transaction Monitoring (TM) alert volumes and ageing, QC pass rates for TM, STR filings, including 1st Line of defence escalations to AML/CFT teams responsible for STR filing. These should also be considered for Risk Appetite metrics and Conduct Risk oversight and be presented on a regular basis to appropriate governance forums and senior management; Data on rejected business should also be maintained to evidence how the Board/Risk committees are maintaining risk exposures.

- **Consider how attestations can be used effectively** in gaining comfort over the operation of controls both internally and externally in relation to the financial crime risk.

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ABOUT PLENITUDE

Plenitude are Financial Crime, Risk and Compliance specialists, offering advisory, transformation services and innovative cloud-based RegTech subscription products. We help our clients meet their regulatory obligations and reduce their financial crime risk exposure by providing deep subject matter expertise, advisory and transformation services. Our RegTech subscription products which are used by leading financial institutions, offer clients enhanced insight into the vast array of FCC laws, regulations, guidance and risk indicators globally.

Plenitude has extensive experience of assisting Investment Management firms and other financial institutions with assessing and improving their financial crime controls and have a proven suite of assets and deliverables developed specifically for the Investment Management sector that can be rapidly deployed and customised for client's needs. This includes a multi jurisdiction FCC Obligations Register (RegSight), benchmark Policies and Procedures, Customer Risk Rating methodologies, Financial Crime Risk Assessments and Monitoring and Controls Testing Plans covering all AML/CFT controls, which fully reflect the requirements of the 4th/5th Money Laundering Directives and ESA Risk Factor Guidelines.

Our consultants come from a variety of backgrounds and disciplines across consulting, in-house financial crime compliance, regulators, government and law enforcement. As experts in financial crime compliance, we fully understand the financial crime compliance challenge, and have the expertise and skills to design and implement effective programmes or initiatives.

To find out more go to: www.plenitudeconsulting.com