INTEGRATING PROLIFERATION FINANCING INTO YOUR RISK AND CONTROLS FRAMEWORK

As regulations strive to match the pace of the threat of proliferation financing, so will enforcement. There is a continual need for regulated firms to prioritise their understanding of various risk types and take appropriate steps to mitigate those risks.

The consideration of proliferation financing (PF) risk exposure is not readily apparent in the risk and control frameworks of many regulated firms. However, in the past 5 years, several PF related guidance documents have been published which highlight this specific risk exposure and have thus driven the introduction of specific regulatory requirements.

From FATF recommendations on how to specifically assess proliferation financing risk to amendments to national regulations – proliferation financing is proving it's prevalence. Recent changes to the UK Money Laundering Regulations (MLRs) 2022 have indicated a shift in the way government bodies are addressing this risk, moving away from regionally focused sanctions to standardising requirements which considers this risk alongside that of money laundering and terrorist financing. These new amendments require all regulated firms to now consider the risk of proliferation financing in their business, augmenting their existing money laundering and terrorist financing risk assessment activities (regulation 18A). Furthermore, should a PF risk be identified, firms are required to implement specific policies, procedures, systems and controls to mitigate the risk (regulation 19A).

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The risk of PF isn't new, and yet it hasn't been mandated in previous regulations

Compliance teams have seen an increasing shift by regulators and non-governmental bodies to help regulated firms understand, identify and mitigate the risks of PF. Previous guidance focused on limiting the chemical, biological, radiological and nuclear (CBRN) capabilities of the Democratic People's Republic of Korea (DPRK) and Iran, but newer guidance has moved to include considerations of the wider, less direct PF risks and controls that regulated firms should bear in mind.

> These regulations took effect from August 2022 and as a result, regulated firms must have already acted and implemented appropriate measures. The FCA are unlikely to look kindly at regulated firms that have not addressed these requirements in the immediate future.

In the UK there had previously never been a specific PF mandate, however, in their 2018 FATF Mutual Evaluation Report, the UK was rated as 'partially compliant', which potentially served as the catalyst for the UK Government to enhance its regulatory framework. In September 2021, HM Treasury published their National Risk Assessment of Proliferation Financing, which focused on both the direct and indirect PF threats faced by the UK, as well as a number of CBRN risks and PF case studies known to UK law enforcement agencies. Given the UK's significance in the global financial system, as well as the transparency of the country's economy, the risk assessment acknowledges that the financial system in the UK is susceptible to PF threats, solidifying the need to include this threat in risk and control frameworks.

The publication of these risk assessments have ultimately culminated in the August 20222 update to the UK Money Laundering Regulations (MLR), which now places Proliferation Financing risk in the same regulatory context as Money Laundering and Terrorist Financing. These amendments, in effect, push regulated firms to reassess their potential risk exposures given this specific consideration[1].

For Compliance teams who seek clearer insight into the topic, there are a number of useful documents to consider. Guidance from the Financial Action Taskforce has arguably the most relevant, in particular their recently published 'Guidance on Proliferation Financing Risk Assessment and Mitigation'. Additional resources can be found in FATF's Recommendation 7 (on Targeted Financial Sanctions) and various FinCen advisories (although notably confined to DPRK).

Focus on MLR Regulation 18A

Regulation 18 at its root, focuses on risk assessments by relevant persons, with 18A then further specifying the focus on proliferation financing. This new addition both increases the burden on compliance teams conducting risk assessments, while also paving the way for regulated firms to incorporate PF into their existing Risk Assessment Methodology.

Regulated firms must consider not just the overall risk of PF exposure, but at a more granular level they must analyse the risk:

- across the regulated firm's customer base,
- the countries it is operating in,

[1] It should also be noted that the FATF have also recently published a statement relating to Russia's military invasion of Ukraine (FATF Public Statement on the Situation in Ukraine), which will also focus on the regulatory importance of limiting the risk exposure to PF.

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- the way that products & services could be utilised to facilitate PF,
- the transactions that could be exposing the firm to PF risk, and
- the nature of the products and services being offered via the different delivery channels.

Firms can gather this information by:

- Asking questions directly to the Business teams and colleagues in First Line of Defence that are responsible for relationships with customers
- Referencing existing Key Risk Indicators (KRIs) / datapoints that are already being gathered to analyse how these are applicable to PF risk
- Expanding the scope and gathering new KRIs / datapoints

Once all this data has been gathered, a direct analysis can then assess the impact and likelihood of Proliferation Financing risk and exposure.

Focus on MLR Regulation 19A

Regulation 19A requires regulated firms to 'establish and maintain policies, procedures and controls where exposure to PF risk is identified. This differs from other requirements, in that it is predicated on the mitigation of the identified risk. In other words, controls do not need to be established and maintained where no PF risk has been identified. This places increased importance on correctly identifying the inherent risk of PF through the Risk Assessment process.

Controls must therefore be able to monitor customer activity including transactional activity in relation to PF risk, and take appropriate actions when needed.

Unpacking the existing ML / TF Risk Assessment and Controls framework

Proliferation financing is a relatively new risk type for a number of regulated firms, but there is a chance that elements of this specific risk exposure may already be captured through existing risk indicators.

There are a number of identified typologies and risk indicators reported through Guidance published from bodies such as FATF. These typologies do traverse into higher risk indicators which may already be included in existing ML / TF risk assessments, for example:

- Where regulated firms offer Trade Finance products, which would typically be already considered a higher risk product, and
- Firms operating in the Marine and Shipping sector which may already be considered a higher risk Industry Sector

Where regulated firms already identify risk indicators in their existing assessment, these can also be used to help identify PF risk, serving as a potential 'quick win' for risk assessment teams looking to identify PF risk from their existing risk assessment framework. However, it should not be considered the entire solution.

In addition to individual risk indicators, the risk factors of customer, country, transaction, product and delivery channel will already be included in the existing ML/TF risk assessment framework:

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Customer Risk + **Country Risk** + **Transaction Risk** + **Product Risk** + **Delivery Channel Risk**

Customer Risk

- Legal Entity customer centric but some risk indicators directed at natural person customers
- Existing high risk customer KRIs
- Industry sectors as reflected by FATF and Plenitude's own Industry Risk analysis
- Focus on customers in the Maritime / Shipping sector

Country Risk

- Assessment of countries that the firm operates in
- Exposure to countries with an elevated Proliferation Financing (PF) risk concern where;
  - Customers transact via a country
  - Customers are resident or nationals
  - Shipments travel through, or are a destination

Transaction Risk

- KRI of high-risk customer cross border transactions
- Identify transactions that involved items controlled under dual-use or export control regimes
- Identify transactions that involved possible companies with opaque ownership structures, front companies, or shell companies

Product Risk

- Trade Finance
- Correspondent Banking relationships with exposure to countries with an elevated PF risk concern
- High risk products
  - complex
  - cross-border
  - easily accessible
  - attracts diverse customer base
  - offered by multiple subsidiaries or branches

Delivery Channel Risk

- Third party intermediaries including associated parties
- Focus on those with
  - exposure to countries with an elevated PF risk concern
  - the ability to offer high risk products and services
  - consideration of existing / previous view of financial crime risk exposure

These existing risk factors can be expanded as the above example shows to include consideration to PF inherent risk.

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Identifying inherent PF risk

An example of the approach to PF inherent risk identification across each of the risk factors is described below:

Inherent Risk

The Inherent Risk assessment measures the impact and likelihood of the gross risk before any controls or mitigation actions are applied.

Inherent risk is assessed based on specific questions and KRIs/datapoints analysing the impact and likelihood of the risks, for example;

Customer

At the end of the assessment period, how many customer relationships does the assessment unit have with customers operating in the Maritime Sector?

Country

At the end of the assessment period, how many customer relationships does the assessment unit have with persons connected with a country that has exposure to proliferation financing risk?

Transactions

During the assessment period, how many existing customer relationships conducted transactions that involved items controlled under dual-use or export control regimes

Products

During the assessment period, how many existing customer relationships were offered Trade Finance products and services?

Delivery Channel

How many third parties/associated parties who are operating/residing in overseas countries that have exposure to proliferation financing risk does the assessment unit engage with?

When assessing for potential inherent PF risk, there are several well documented typologies that should be considered:

- Dual Use Goods and the ability for these to be utilised in weapons development
- Correspondent Banking relationships where the correspondent's customers are exposing the firm to PF risk
- Trade Finance products facilitating the transit of goods which could be used in weapons development
- Customer exposure to North Korea (Democratic People's Republic of Korea) or Iran
- Certain Industry Sectors that could facilitate weapons proliferation

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Firms must also pay special attention to identifying not only the direct, but also indirect, financing risks through each of the risk factors mentioned above. Each factor presents the possibility of potential indirect risk exposure, which must be identified and assessed for their impact and likelihood in order to ensure a comprehensive risk assessment.

Executing the PF Risk Assessment – how best to approach

In the identification of inherent risk, and the subsequent assessment of the applicable controls, risk assessment teams must determine how best to execute the PF risk assessments.

Should PF be integrated into the existing ML/TF framework?

This decision will largely hinge on the existing ML/TF risk assessment framework and whether it is possible to integrate PF risk seamlessly. There are a number of potential challenges with this approach, such as ensuring the new risk type can be integrated into the Risk Assessment Methodology in a timely fashion, gathering the relevant risk indicators either through existing data capture, or by introducing new risk indicators, without complicating the existing scoring methodology.

It may be preferable for firms to execute a PF risk assessment in isolation from the ML/TF risk assessment in order to meet the immediacy of the new requirements and until proper integration can take place. This could be viable for year one (or later years as required) and will depend on the impact of changing the ML/TF design during the annual cycle of the ML/TF risk assessment.

Distinguishing between Sanctions and PF

As with ML/TF risks, sanctions risk also features a number of key risk indicators. Although there are many similarities in risk types, proliferation financing risks must still be treated as a distinct risk, which is not adequately captured in these assessments alone.

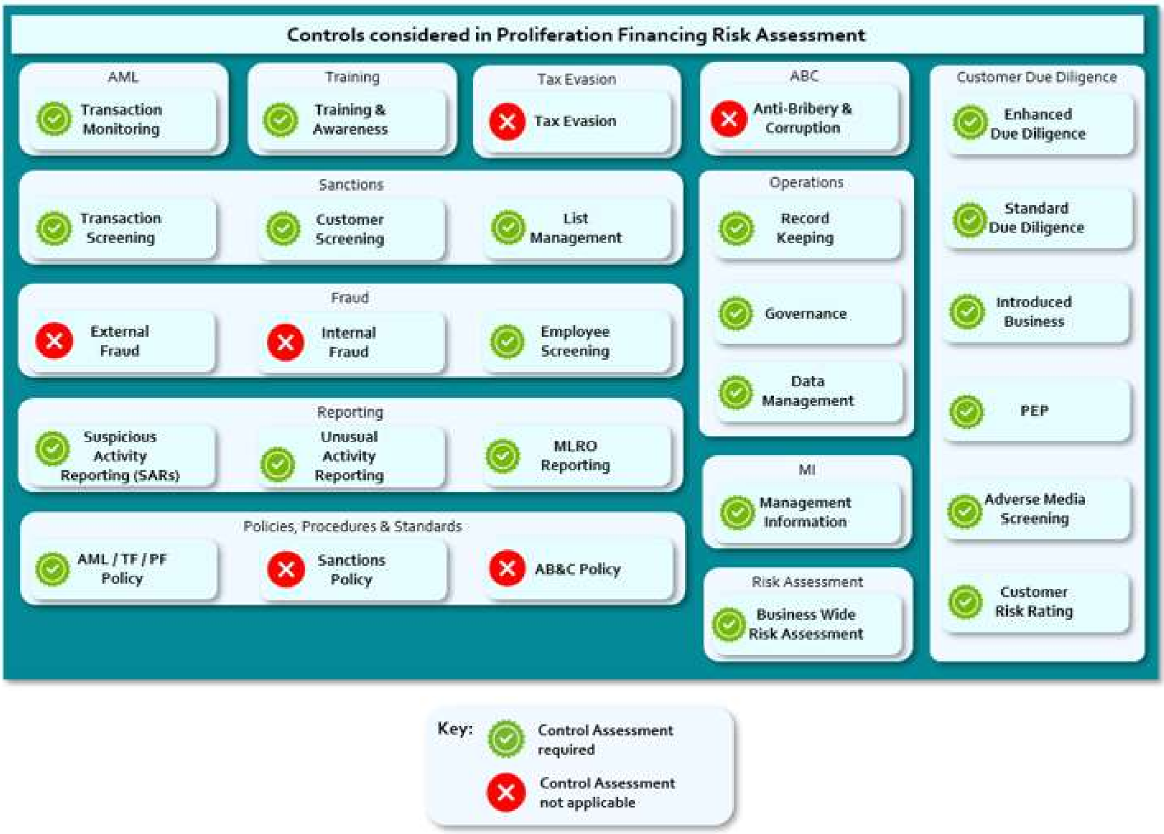
Whilst there are a number of risk indicators that can be applied to both Sanctions and PF risk (for example, where owners or senior managers of legal entities appear in sanctioned lists), there is a crucial distinction in the risk and control implications where the end result could be weapons proliferation.

Challenges with identifying PF exposure?

Most risk indicators will relate to Corporate entities, but there are some that are attributable to natural persons, however these tend to be quite specific to DPRK and Iranian nationals. As a result, many retail focused regulated firms will not have significant exposure to PF. These firms would then no longer be obligated to meet Regulation 19A which requires firms to establish and maintain policies, controls and procedures to mitigate the risks of PF.

Assessing PF Risk to your Business

Where PF exposure is identified, there are a number of controls implications that firms must take into consideration. In a typical Compliance Control framework this includes updates to existing controls, or implementing controls where they do not currently exist.



As part of risk assessment execution, controls should be assessed for PF risk mitigation. A 'Controls Assessment rating' can then measure the ability of controls to decrease the likelihood and/or impact severity of the associated PF risk based on their existence, design quality and operational effectiveness.

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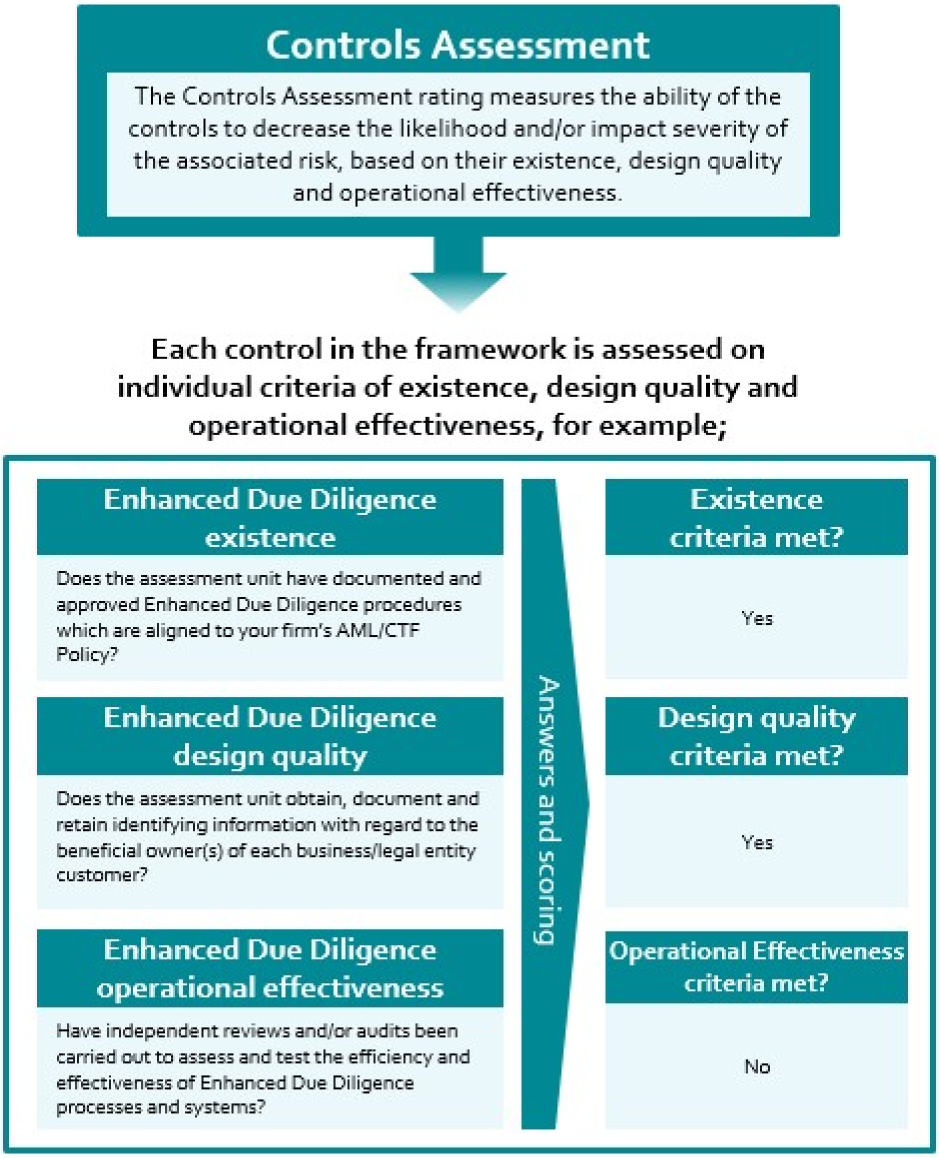
Controls Assessment example



Once the inherent risk has been identified and all controls have been assessed, then a firm will be able to determine a residual risk view of their PF exposure.

Conclusion

With all UK regulated firms now required to identify, assess, and mitigate their related risk exposure, proliferation financing has never been more important to fully understand.

While many regulated firms will be able to fully and accurately identify their PF risk exposure, not all will. By conducting a thorough and considered assessment of each of the risk factors that have been set out in the Money Laundering Regulations, entities will be able to demonstrate, to both internal and external stakeholders (including regulators and where relevant external auditors), that the appropriate risk identification steps have been taken.

Ultimately, the responsibility lies with regulated firm to ensure that they have established or enhanced the proper controls, in order to not only assess for proliferation financing risk, but to also determine that the controls themselves are continuously assessed for effectiveness.

In today's uncertain global environment, regulated firms must play their part ensuring that threats to the UK and other countries are reduced where possible.

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If you would like more information as to how Proliferation Financing risk can be assessed, we would welcome the opportunity to discuss this further.

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