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The Optimal Level of Anti-Money Laundering Regulation for the UK Banking Sector. Banks' Cost of Compliance, De-risking Problem and How to Implement Effective AML Systems and Controls

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The Optimal Level of Anti-Money Laundering Regulation for the UK Banking Sector. Banks' Cost of Compliance, De-risking Problem and How to Implement Effective AML Systems and Controls.

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1.1.1 Table of Abbreviations

AML	Anti Money Laundering
AMLR	Anti Money Laundering Regulation
BBA	British Bankers' Association
BCBS	Basel Committee on Banking Supervision
BoE	Bank of England
CBR	Correspondent Banking Relationship
CDD	Customer Due Diligence
CTF	Counter Terrorism Financing
DFS	Department of Financial Services
EDD	Enhanced Due Diligence
EEA	European Economic Area
EU	European Union
FATF	Financial Action Task Force
FCA	Financial Conduct Authority
FCC	Financial Crime Compliance
FPC	Financial Policy Committee
FSA	Financial Services Authority
FSB	Financial Stability Board
FTR	Funds Transfer Regulation
GDP	Gross Domestic Product
IMF	International Monetary Fund
JMLSG	Joint Money Laundering Steering Group Guidance
MI	Management Information
ML	Money Laundering
MLR	Money Laundering Regulations
MLRO	Money Laundering Reporting Officer
MSB	Money Services Business
MTO	Money Transfer Operator
MVTS	Money or Value Transfer Services
NCA	National Crime Agency
OFAC	Office of Foreign Assets Control
PEP	Politically Exposed Person
POCA	Proceeds of Crime Act
PRA	Prudential Regulation Authority

RBA	Risk Based Approach
ROI	Republic of Ireland
SAR	Suspicious Activity Report
SDD	Simplified Due Diligence
UK	United Kingdom
UN	United Nations
US	United States
WBG	World Bank Group
1MLD	First Money Laundering Directive (EU)
2MLD	Second Money Laundering Directive (EU)
3MLD	Third Money Laundering Directive (EU)
4MLD	Fourth Money Laundering Directive (EU)

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Serious Crime Act 2015, (modifies Proceeds of Crime Act 2002, main changes include protection from civil liability for firms making authorised money laundering disclosures and improved ability for criminal assets recovery) <http://www.legislation.gov.uk/ukpga/2015/9/pdfs/ukpga_20150009_en.pdf> accessed 26 June 2017	18
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1.1.3 Table of Regulatory Fines and Settlements

Abstract

Lax regulation and weak legislation in respect to Anti Money Laundering (AML) and Counter Terrorism Financing (CTF) will almost certainly result in increased money laundering (ML) and terrorist financing (TF) at national and global levels. However, more stringent regulation and legislation is not the panacea for solving the complex AML/CTF related issues. In fact, excessive legislation and regulatory pressure can have a range of negative consequences for the general public. One of the collateral damages is de-risking, a practice referring to banks' strategies when exiting or refusing to enter into business relationships with certain categories of customers perceived as a high risk and high cost maintenance, or where banks are withdrawing their services from some jurisdictions or whole regions, or when withdrawing from entire business sectors.

De-risking adversely impacts society at two levels. First, a population left without banking services is forced to use underground methods for cross-border transactions, for example, sometimes whole regions in some parts of the world depend on the funds sent by their relatives who reside in countries with higher living standards, therefore cutting off or minimising this aid reduces the spending power of the local population, often directly affecting even basic living expenses such as food and medicines. The second aspect is that contrary to the regulators' fundamental goal for reducing the financial crime, excessive regulatory pressure on banks can ultimately generate undesired outcomes and, in fact, increase global ML and TF by inadvertently strengthening unregulated underground money transfer markets.

A logical response to the de-risking problem would be for the banks to implement a flexible AML/CTF strategy reinforced with effective AML/CTF systems and controls that support efficient Risk Based Approach (RBA) and proportionate allocation of their resources. This method will allow for implementing tailored risk assessment and risks management on individual basis, rather than opting for 'one size fits all' approach vis-à-vis whole categories of customers. However, in practice, the combination of the banks' high compliance costs and hefty non-compliance fines imposed by regulators directly impede the RBA and the shift away from blanket approach. Therefore, a more extreme regulation and excessive financial penalties strategy would appear to be counterproductive. Instead, close cooperation between the regulators and banking sector is required in order to challenge the status quo position and to finally arrive at a mutually acceptable solution for reducing the global ML/ TF levels, also accounting for the general public interest.

1. Introduction

Since the raised awareness from the early 1990's until today, combating the ML remains one of the top priorities globally, while the increase in terrorist attacks after the tragic events of 11 September 2001 brought to light another serious global problem which is the TF prevention. The banking sector is directly affected by both the ML and TF issues through criminals' constant attempts for integrating their illegally earned profits into the financial system and by the terrorist supporters using legitimately opened bank accounts in order to raise funds for their dreadful activities. While the quantification of amounts laundered through the financial system is not an exact science, the most recent estimates from reliable sources suggest that in 2009 around $1.6 trillion or 2.7% of the global GDP has been laundered worldwide.[1] Therefore, considering the scale of the problem, it is understandable why the Anti Money Laundering Regulation (AMLR) issue is topping governments' and regulators' programmes. Adding into the equation the hefty AML non-compliance fines imposed on financial institutions, further clarifies why the AML/CTF systems and controls score higher than ever on the banking sector corporate agendas.

AMLR landscape in the UK was significantly changed by the introduction of the first Money Laundering Regulations (MLR) in 1993. It is not a secret that since then there is constant tension between the regulated financial markets including the banking sector and their regulators, a situation described by the Professor Michael Moran as 'a constant battle of wits between the surveyors and the surveyed – a battle where rituals of verification abound, where enormous energy goes into those rituals and into their subversion'.[2]

The UK AMLR was further transformed when the Financial Services Act 2012 opened the way for implementing the intended regulatory changes by allowing for separation of Prudential and Conduct operations regulation and transferring from the Financial Services Authority (FSA) into the 'twin peaks' model via establishing two new bodies: Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA). In addition, the newly created Financial Policy Committee (FPC) within the Bank of England (BoE) assumed the overall financial stability responsibility. The new model was certainly not the only alternative but selected option can be seen as a political choice rather than being an inevitable outcome[3] and one may argue that the new

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[1] United Nations Office on Drugs and Crime, 'Estimating illicit financial flows resulting from Drug Trafficking and other Transnational Organized Crime' (Research Report) (October 2011) 5 < https://www.unodc.org/documents/data-and-analysis/Studies/Illicit_financial_flows_2011_web.pdf> accessed 29 August 2017.
[2] Michael Moran, 'The Frank Stacey Memorial Lecture: From command state to regulatory state' (2000) 15(2) Public Policy and Administration 11.
[3] Ellis Ferran, 'The break-up of the Financial Services Authority' (2011) 31(3) OJLS 455–480.

approach created additional regulatory burden for the financial industry, directly affecting the balance between delivering stability and facilitating the growth of individual financial institutions.

Increased regulatory burden and strengthened AMLR trigger higher AMLR compliance costs which in turn often prompt banks to opt for refusing to enter into a business relationship with or to close existing bank accounts of the customers perceived as high cost maintenance, with the Correspondent Banking Relationships (CBRs), Money Services Businesses (MSBs) and Politically Exposed Persons (PEPs) being noticeable examples. This practice is known as 'de-risking'.

As a result, in addition to the evident unfair treatment of law abiding customers, the withdrawal of banking services may ultimately result in deterioration of the living standards of the population relying on foreign payments aid. Furthermore, considering that affected population will seek new ways for sending funds abroad, the banking services termination of regulated CBRs and MSBs in one or more jurisdictions will result in shift towards the unregulated funds remitting sectors, which in turn creates conditions for increased Ml and TF as transactions will occur under the monitoring radar. Therefore the de-risking practice ultimately adversely affects the society as a whole.

There is no doubt that FCA and PRA are making significant efforts to stop de-risking by constantly highlighting the unfairness of this practice to the banks. However, the high AML related monitoring costs coupled with the hefty non-compliance fines imposed by the very same regulators, often leave the banks with a very little room for manoeuvre and abandoning the high cost maintenance relationships appears to be justified from a purely business perspective, although the practice is indeed questionable from an ethical perspective.

Therefore, the optimal level of AMLR can be thought as being the point where maximum social benefits are achieved, for example, the ML is kept as low as possible, whilst at same time society is not adversely affected and individual rights remain unrestricted. However, proportional AMLR can only be achieved in a situation where the regulatory and supervisory bodies have carried out sensible cost-benefit analysis/ projections by considering the wider AMLR impact and taking into account the input from the financial industry and field experts, while also ensuring sufficient transparency in respect of how the regulations are created and applied across the UK banking sector. Nevertheless, even after a quarter of century since the first serious AMLR attempt, it would be still very difficult to justify the argument that the current AMLR in UK is at its optimal level.

In this paper, following this short introduction, in Part II and Part III, I analyse the current UK AML/CTF regulatory climate and banks' AML compliance costs respectively. In Part IV, I focus on the de-risking practice and its consequences in more detail, while in Part V, I have produced practical guidance about how banks can efficiently tackle ML/ TF through robust governance and appropriate AML/CTF systems and controls, which *inter alia* has the potential for addressing the de-risking problem. Part VI is a theoretical debate which considers the consequences of both extreme situations: maximum AMLR and non-existence of AMLR and here I have examined the conflict between the AMLR objectives and factual outcomes, in an attempt to define the conditions that will allow for the optimal AMLR to emerge.

2. The Current AMLR Climate

2.1 Existing UK AML regime landscape

The complexity of the current UK AML regime derives from the legislation and regulation diversity with the directly applicable EU Regulations and transposed EU Directives feeding into the existing UK primary and secondary legislation, a situation that is further complicated by the US extraterritoriality element which allows a range of US regulators to impose fines on UK banks.

The current UK legal AML framework encompasses a mixture of primary and secondary legislation, regulations, international standards and industry guidance but the milestones which shaped the UK AML/CTF landscape are surely the Proceeds of Crime Act (POCA) 2002 and the MLR 2007 (replaced by MLR 2017 since 26/06/2017), with the former covering the rules on proceeds on crime, for example, obligations and offences related to suspicious transactions reporting, and the latter focusing chiefly on Customer Due Diligence (CDD) measures, record keeping and powers of designated authorities.

From practical point of view, a very useful tool for banks in interpreting the UK AML/CTF legislation is the Joint Money Laundering Steering Group Guidance (JMLSG) which translates the legal framework into a practical guide for day-to-day use, although, of course, following this industry guide by itself does not remove banks' ultimate responsibility to comply with the AML/CTF legal and regulatory requirements.

2.2 RBA: Shift from Rules-Based to Principles-Based Regulation

The UK supervisory architecture redesign in accordance with the 2012 Act resulted with shifting from the rules-based method with its well determined laws and norms to a principles-based method whereby the financial institution is given the liberty to decide its own AML framework approach, as long as they can demonstrate compliance. Under such circumstances, the RBA which allows banks to allocate their AML combating resources in accordance with the perceived or identified risks in different areas, instead of applying a blanket approach, gains importance.

The RBA has its roots in the 2005 3rd EU ML Directive (3MLD) which consolidated the 1st EU ML Directive from 1991 and the 2nd EU ML Directive from 2001, the two directives that laid down the foundation for building strong secondary EU legislation in this field. Subsequently, the 3MLD transposition into the UK legislation resulted with the RBA being embedded in the MLR 2007. Internationally, the revised Financial Action Task Force (FATF) Recommendations from 2012 reinforced the RBA significance by highlighting the importance of ensuring that measures to prevent or mitigate ML/TF are proportionate to the identified risks.

However, the RBA flexibility which allows for plenty of space for manoeuvre in accordance with the 'comply or explain' logic is sometimes perceived as ambiguous. A good example of this vagueness is the subjectivity element in respect of suspicious activities reporting obligations, which means that some genuinely suspicious transactions may be interpreted by the bank as non-suspicions and therefore not reported to the authorities, hence potentially obstructing an important ML investigation. Such situations have prompted some scholars to favour the rules-based method because of its clear rules and high level of legal certainty.[4] However, the rules-based method is by no means a guarantee for efficiency. For example, the requirement for the US financial institutions to automatically report each customer's transaction of more than $10,000 daily aggregate amount in accordance to the Bank Secrecy Act of 1970, regardless if suspicious or not, in reality causes overflow of worthless reports[5], hence adding a huge burden to authorities' investigations.

Nevertheless, the over reporting problem can also be common in the jurisdictions that have adopted RBA, although the root cause for this tendency here is different and can be traced into the hefty non–reporting related fines imposed by regulators when, for example, a subsequent investigation proves that criminal activity has taken place through bank's accounts. This drives banks towards the 'play safe' approach and defensive reporting of less suspicious transactions in order to reduce the possibilities for being fined. This excessive reporting has been well analysed by the economist Elod Takats who in order to describe this phenomenon coined the term 'crying wolf' in this context.[6]

[4] Brigitte Unger and Frans van Waarden, 'How to Dodge Drowning in Data? Rule and Risk-Based Anti-Money Laundering Policies Compared' (2009) 5(2) art 7, Review of Law &Economics.
[5]Mark Pieth and Gemma Aiolfi, 'Anti-Money Laundering: Levelling the Playing Field' (2003) Basel Institute of Governance.
[6] Elod Takats, 'A theory of "Crying Wolf": the Economics of Money Laundering Enforcement', IMF, WP/07/81 (2007) 1-50.

Despite its drawbacks such as the over reporting issue, the level of uncertainty or the practical implementation difficulties, the RBA can still be an efficient tool for combating ML/TF risks. In fact, it would appear that since its implementation, the UK banks have significantly strengthened their AML frameworks. For example, the RBA also means that banks and their senior management are held directly responsible for identifying, assessing, mitigating and monitoring bank's ML/TF risks by constantly ensuring that adequate systems and controls for effective management of these risks exist at all times. Therefore, the RBA is not a soft option but it is indeed a dynamic system which provides banks with the opportunity for effective allocation of its resources, permitting sufficient flexibility for the senior management regarding proportionate approach on ML/ TF controls in accordance to the specific circumstances, for example, by allowing differentiation of customers based on anticipated risks levels.

2.3 AML related costs and fines

Banks are often penalised by the regulator not because of facilitating concrete ML but rather for not having adequate AML systems and controls in place. For example, in 2012 Coutts & Company was fined £8.75m by FSA 'for failing to take reasonable care to establish and maintain effective AML systems and controls relating to high risk customers including PEPs'. Sometimes, even firms' employees performing certain roles can be the subject to fines - also in 2012, Habib Bank AG Zurich and its former Money Laundering Reporting Officer (MLRO) Syed Hussain were fined £525,000 and £17,500 respectively 'for failure to take reasonable care to establish and maintain adequate AML systems and controls'. Recent trends indicate that AML fines' severity appears to be on constant rise, for example, the 'inadequacy in managing PEPs' triggered hefty £72m FCA fine for Barclays in 2015 which was the UK largest AML/ financial crime related fine at the time, only to be overtaken fairly recently in January 2017 when the FCA fined Deutsche Bank £163m 'for serious AML controls failings'. Of course, the level of subjectivity in respect of regulator's perception about what constitutes 'adequate AML systems and controls' remains significantly high as the quantification of such matters is rather difficult, perhaps bordering the impossible.

The AML related fines and the level of AML compliance costs have became important elements in the banks' overall business strategy and this should be taken into consideration by the regulator in all instances when regulatory reorganisation or amendments is intended. It has been recognised in the past that there exist a strong case for paying greater attention to the costs, both direct and indirect, of any reform proposals.[7] In that respect, from UK perspective the new 'twin peaks'

[7] William Niskanen, 'The Total Cost of Regulation' (1991) 14(3) Regulation 23.

model was expected to lessen the regulatory burden and therefore also reduce the AML compliance costs in the banking sector.[8] Nevertheless, the lack of clarity still exists regarding the extent of the cost-benefit analysis carried out prior to transition into the new model.

The fact that AML compliance costs are in constant rise is supported by a number of researches carried out in last decades. For example, KPMG's findings indicate that globally the AML compliance costs soared 58% on average between 2004 and 2007.[9] Since the 2012 UK regulatory reforms, KPMG estimated the annual AML costs to be approximately £90m in 2014,[10] while the British Bankers' Association (BBA) referred to its members spending at least £5bn annually collectively.[11] The Home Office 2014 research which estimated the UK social and economic costs linked to organised crime to be at least £24 billion a year, offers an excellent insight into the bigger picture of this issue.[12]

However, despite the enhanced AMLR focus, there is a lack of clear evidence to support that the strengthened AMLR and related increased AML expenditures have indeed contributed for lowering the ML levels. In fact, the BDO 2014 Fraudtrack Report[13] found an increase of 309% in ML related and fraud offences, a surge which attracted significant international attention with inquires from overseas authorities investigating ML soaring to 12% most recently (June 2017).[14]

2.4 Recent UK AMLR developments and their effects on the UK banking sector

The recent UK AML legislation developments place even more regulatory burden on the banking sector. The MLR 2017 which repeals and replaces MLR 2007 through transposing both EU's Fourth Money Laundering Directive (4MLD) and Funds Transfer Regulation (FTR) (although the latter as being a regulation does not necessarily require transposition into UK law) implies an even

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[8] FSA,'Financial Risk Outlook 2006' (2006) 93.
[9] KPMG, 'Banks battle against money laundering as market complexity increases', *Marketwire* (9 July 2007) <http://www.marketwired.com/press-release/kpmg-banks-battle-against-money-laundering-as-market-complexity-increases-spending-up-749240.htm > accessed 10 August 2017.
[10] KPMG, 'Review of the regime for handling Suspicious Activity Reports' (Report of Recommendations) (2003) JO/FH/519 16.
[11] BBA, 'Response to Cutting Red Tape Review the Effectiveness of the UK's AML Regime' (Executive Summary) (2015) 2.
[12] Hannah Mills, Sara Skodbo and Peter Blyth, 'Understanding organised crime: estimating the scale and the social and economic costs' (Home Office Research Report 73) (2013) 11.
[13] BDO, 'BDO Fraudtrack Report reveals sharp increase in money laundering in the UK', *BDOUK* (20 January 2014) <https://www.bdo.co.uk/en-gb/news/2014/fraudtrack-report-increase-in-money-laundering-uk> accessed 30 June 2017.
[14] Caroline Binham, 'Foreign money laundering inquiries to UK leap 12%', *Financial Times* (11 June 2017) <https://www.ft.com/content/5271e7f8-4b86-11e7-a3f4-c742b9791d43?mhq5j=e1> accessed 30 June 2017.

more stringent approach. For example, the 4MLD eliminates the distinction between domestic and foreign PEPs, which in turn means that Enhanced Due Diligence (EDD) and senior management sign off is now applicable to both categories, thus removing the option of keeping the current approach applied by some smaller UK banks for less rigorous treatment of their domestic PEP customers (bigger banks have been generally treating both the domestic and foreign PEPs the same even before the 4MLD). Similarly, the 3MLD Simplified Due Diligence (SDD) approach which allowed for less thorough CDD on certain customers' categories, for example, regulated financial institutions, is now restricted to case-by-case basis and only if strong rationale is demonstrated for applying SDD. In addition, the beneficial ownership rules are redefined with the 25% share now only considered as an indicative parameter rather than a definitive threshold, thus implying again case-by-case analysis. Of course, this means more thorough investigations which in turn require more staff and more sophisticated systems for managing customers' databases.

Furthermore, the 4MLD via MLR2017 place obligations on the banks (and other financial institutions) for carrying out annual AML and TF Risk Assessments (additional obligation for each EU member state and the EU at supranational level who now also need to complete this type of Risk Assessment), 4MLD also changes the record keeping requirements allowing for maximum of five years documentation retention which in practice conflicts with the Data Protection Act 1998 (although in such scenario the latter trumps the former). Equally, FTR requires more detailed information to be obtained on the payer before executing any payments and also more rigorous due diligence on various parties, depending on their role in the transaction, for example, whether acting as payee's, payer's or intermediary bank.

All these changes mean that banks must ensure that they have adequate measures and resources in place, while their processes, policies and procedures will require review and updating, staff will need to be trained in line with the MLR 2017 (4MLD and FTR) but banks will also have to undertake significant remediation work in respect of reviewing the existing customer records and bringing these in line with the new requirements.

Nonetheless, at the same time one may argue that some AML costs will actually be reduced with the 4MLD. For example, the introduction of the Beneficial Ownership Register may cut some costs for the banks when checking the persons with significant control, although it is also fair to say that UK was already a step ahead vis-à-vis other EU members as this information was publicly available via Companies House website long before the 4MLD. In addition, the reliance on third parties, although not ultimate as the bank remains responsible for its CDD obligations can help banks to certain extent, for example, if cooperating with EEA obliged entities. However, these two advantages are too little to outweigh the regulatory and financial burden brought by MLR2017/4MLD/FTR.

If on top of everything we also add the US extraterritoriality's long reaching arm and their hefty fines, for example, when in addition to the £163m FCA fine in January 2017 Deutsche Bank was also fined by the US regulator the New York Department of Financial Services (DFS) for $425m, it is certain that the trend in future will be for the banks to invest in human capital but also in AML/CTF systems and controls enhancements to ensure efficient risk management. Of course, this means increased costs which will be ultimately transferred to the banks' customers but also increase potential for de-risking.

2.5 AMLR cost-benefit analysis, secondary effects of a rigorous AMLR and optimal AMLR

Achieving optimal regulation would certainly mean creating a regime where the benefits derived from AMLR outweigh the costs of its implementation and maintenance, which in turn implies undertaking a cost-benefit analysis as otherwise the regulations are at risk of being unsuitable and burdensome.[15] Furthermore, the wider effects of the AMLR on society including human rights and other values must also be considered. This is because looking at the matter only through the economic prism and under assumption that purported benefits from the given AMLR level are superior vis-à-vis the alternatives does not adequately address certain areas of law which are either inherently non-economic or the economic analysis is only of marginal relevance, for example, where notions such as rights, fairness and general welfare must prevail over any possible economic considerations.[16]

The impact of stringent AMLR on the wider society must also be taken into consideration in attempting to arrive to optimal AMLR. Whilst the maximum AMLR may in theory be an attractive approach for reducing ML and some elements may also indicate positive results under some circumstances from a domestic jurisdiction perspective, the effects at global level must also be considered, for example, the indirect impact on some jurisdictions or industry sectors and whether the overall benefits achieved by maximum AMLR will indeed overweigh the adverse impact on some segments of society at global level. Therefore, performing a cost-benefit analysis by the

[15] Mahmood Bagheri and Chizu Nakajima, 'Optimal level of financial regulation under the GATS: a regulatory competition and cooperation framework for capital adequacy and disclosure of information' (2002) Journal of International Economic Law 3.

[16] Megan Richardson, 'Book Review: Economic Analysis of Law' (1993) 19 Melbourne University Law Review 481-482.

regulator will certainly be a step forward towards achieving optimal AMLR. Regulators should constantly review the effects of their actions taken against banks and the unintended consequences, assessing whether the regulation actually benefits or perhaps potentially hurts the public.[17]

Another aspect of AMLR is how its effectiveness is perceived by the main stakeholders such as the regulated sector and general public, regardless of its real terms efficacy. For example, the Corporation of London 2005 survey found that the very high AML compliance costs may in fact reduce the AMLR effectiveness perception, with many AMLR professionals believing that increased regulatory expenditures are unlikely to yield great effectiveness in deterring ML but instead raising the perceived likelihood of being caught and strengthened awareness of severe punishments, for example, through more frequent prosecutions and asset seizures are actually more likely to reduce ML in practice.[18] In fact, governments are placed in a good position for assisting ML combating through introducing and implementing efficient legislation, while the effectiveness perception can be enhanced by focusing on certain segments such as increased seizing powers and easier recovery of illicit assets.

In the UK, the Serious Crime Act 2015 which *inter alia* allows for easier criminal assets freeze and recovery allows for more successfully completed ML cases to emerge which can be then presented to general public via increased media visibility, while the main stakeholders such as banks can be kept constantly informed, for example, through providing positive feedback on submitted SARs that led to successful prosecutions. The Criminal Finances Act 2017 also has the potential for further improvements in that respect.

[17] Cass R.Sunstein, *The Cost-Benefit State: The Future of Regulatory Protection* (American Bar Association, Chicago, 2002).
[18] Mark Yeandle and others, *Anti-Money Laundering Requirements: Costs, Benefits and Perceptions* (issue 6, Z/Yen Limited and Corporation of London, London, 2005) 44-47.

3. The Costs of AML Compliance

3.1 How AML compliance costs impact UK banks

Calculating the AML compliance related costs in order to measure against the achieved or projected benefits is not straightforward and there is very little evidence to indicate that any significant efforts have been made in that respect at any level. The House of Lords Report on ML and TF from 2009[19] denotes in paragraph 124 that the received evidence does not indicate that 'any cost-benefit analysis has been carried out by anybody at any level: not by the FATF, not by the EU, and not by any department or agency within the UK', with the caveat that the same Report in the paragraph 129 recognises the EU Commission review from 10 June 2009 of the financial services regulation cost of compliance.

However, despite the costs quantification challenges, some fairly close estimates indicate enormous compliance expenditures of the large international banks, for example, following the hefty forfeit totalling $1.9bn from 2012, HSBC estimated annual compliance expenditures between $750m to $800m which was an equivalent to one quarter of its entire US operating budget.[20] In addition, HSBC has increased its compliance staff headcount by another 5000 employees, with $300m paid in wages between 2012 and 2015.[21] In fact, HSBC's AML compliance costs are likely to rise further, considering the current FCA AML investigation into their AML controls following the completion of the 2016 FCA's ordered review known as the 's166 skilled person report'.[22]

Consequently, due to significantly increased compliance costs, HSBC reported 62% slump in the annual pre-tax profits from $18.9bn to $7.1bn year-to-year 2015 vs. 2014, resulting in a 7% slide in the bank's share price.[23] This is an excellent example of how AML compliance costs can directly impact bank's profits and their share prices.

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[19] House of Lords, 'European Union Committee - Nineteenth Report Money laundering and the financing of terrorism' (Report) (July 2009) <https://www.publications.parliament.uk/pa/ld200809/ldselect/ldeucom/132/13202.htm > accessed 01 July 2017.
[20] Martin Arnold, 'HSBC Wrestles with Soaring Costs of Compliance' *Financial Times* (4 August 2014) < https://www.ft.com/content/0e3f0760-1bef-11e4-9666-00144feabdc0> accessed 01 July 2017.
[21] Laura Noonan, 'Banks Face Pushback over Surging Compliance and Regulatory Costs' *Financial Times* (28 May 2015) < https://www.ft.com/content/e1323e18-0478-11e5-95ad-00144feabdc0 > accessed 01 July 2017.
[22] FCA,"Skilled persons' report" (Annual Report 2013/14).
[23] Ben Martin, 'The Telegraph Business HSBC faces FCA probe into anti-money laundering controls as profits plunge' *The Telegraph* (21 February 2017) < http://www.telegraph.co.uk/business/2017/02/21/hsbc-profits-slump-volatile-year> accessed 01 July 2017.

3.2 How the costs are ultimately passed to end customer

The economic logic and trade-off rules imply that increased AML expenditures would mean fewer funds available for the bank's fundamental purpose of acting as an intermediate between customers in need of borrowing and customers investing their money into savings or investment products, hence the bank will ultimately end up with reduced leverage in performing its basic function. Furthermore, observing the matter through the economics lens again, these compliance costs have to be somehow recovered. Therefore, it is not difficult to conclude that these costs will be ultimately passed to end user, the bank customer.

Take for example a typical mortgage customer. This applicant prior to being on-boarded by the bank will be the subject to extensive identification and verification measures including examination of customer's sources of funds and overall wealth where applicable, research of media via publicly available and subscription paid sources in order to identify potential ML red flags, etc. If everything has been assessed to be in a good order, then the customer will be on-boarded but now the customer's mortgage repayment transactions must be monitored in order to ensure that the on-going funds are in line with the expectations and do not derive from illegitimate sources. Any inconsistency will be further investigated by bank's staff specialised in this type of investigations and where necessary, for example, if any suspicious arise during the investigation, in accordance with POCA 2002 the suspicions will be reported to the authorities by submitting a Suspicious Activity Report (SAR). Of course, all these activities bear certain costs which banks will then pass to the customer as much as possible, for example, by transposing these into higher mortgage administration or product fees or increased interest rates.

This is no different to any other costs passed to the end consumer, for example, an analogy would be the situation where the fees that banks charge assets managers for placing trades and for access to their analysts' researches are ultimately passed on the assets managers' clients.[24]

3.3 Effects of the AML compliance costs on the society

The impact of the increased AML compliance costs on society and its individual members is two-fold. In addition to the obvious financial dimension and the direct costs being ultimately absorbed

[24] Chloe Cornish, 'Banks charge asset managers $75,000 a year for research' *Financial Times* (9 April 2017) <https://www.ft.com/content/4ccffb7c-1aae-11e7-bcac-6d03d067f81f?mhq5j=e1 > accessed 01 July 2017.

by banks' customers, certain customer segments can also be indirectly affected by being denied banking services through the practice known as de-risking.

Preventing entire customer categories from certain products and services (PEPs, MSBs, or CBRs) or creating market entry barriers, generates additional adverse effects on society by hindering economic development and growth. Whilst, from the regulator's perspective theoretically the maximum AML controls and implementation could seem an attractive option for reducing the ML, in practice, the enhanced AMLR can be counterproductive as the increased AML compliance costs may force banks to withdraw their services from certain jurisdictions or entire customer categories, which in turn is prompting affected customers to seek alternative banking methods. This means shifting a whole range of transactions under the regulatory radar, which opens the door to criminals for easier laundering of their illicit funds through the inherently ML vulnerable unregulated banking sector, thus ultimately resulting in increased rather than reduced potential for ML.

Observing the de-risking phenomenon from a purely commercial perspective may lead us to conclusion that this practice is justified considering that banks certainly have the right to decide themselves about how to manage their own business, which then implies their own decision a propos with whom to enter or maintain a business relationship. However, the situation is rather problematic from a treating customers fairly aspect. Unsurprisingly, de-risking practice has not been perceived as acceptable approach by the regulator and as a result FCA has been heavily engaged in finding a solution for this problem.[25] However, imposing hefty AMLR breaches related fines to banks on the other hand, sometimes even when no actual ML has taken place but simply because of the potential for this to hypothetically happen due to bank's 'inadequate' AML systems, means that many banks will remain extremely wary of entering or maintaining AMLR high risk business relationships.

De-risking can have substantial impact on the country's economic growth. It is not a secret that some small businesses such as Money Transfer Operators (MTOs) and MSBs are the usual de-risking targets. However, small businesses often play crucial role in the country's economic development. For example, in 2016, a record of 5.5 million private sector businesses with 99.3% of

[25] FCA, 'FCA Research into the issue of de-risking' *News Stories* (24 May 2016) <https://www.fca.org.uk/news/news-stories/fca-research-issue-de-risking > accessed 01 July 2017.

these being small businesses was registered in the UK.[26] Furthermore, some forecasts have estimated £217bn contribution into the UK economy by 2020 coming from small businesses.[27]

In addition to the direct impact on the country's economy, many small businesses also play a specific role by serving the local population thorough sending and receiving funds within the AMLR regulated sector, therefore it is clear that business discouragement via banking barriers or ceasing the trade will adversely impact the economy and wider society. Adverse effects on society in such environment also come to light through the hindered business innovation which in turn further slows down the economic growth.

Whilst regulators' logic that stringent AMLR and bigger investment in AML compliance should reduce ML and other financial crime may hold true theoretically, at same time the experiences show that AML efficiencies can only be achieved if the AML compliance costs are proportional to the achieved benefits. In practice, reaching the optimal level of AMLR seems to be an unrealistic task if prior cost-benefit analyses have not been carried out. The regulator should perform qualitative and quantitative analyses before any material changes take place in AMLR policy by taking into account the wider society interests and no regulatory action should be undertaken 'unless the potential benefits to society for the regulation outweigh the potential costs to the society'.[28]

4. De –risking problem

4.1 What is de-risking

As a result of rising AML compliance costs and regulators' fines becoming heftier, increasing numbers of financial institutions including banks are adopting the strategy of not offering products

[26] Department for Business, Energy & Industrial Strategy, 'Business Population estimates for the UK and Regions' *Statistical Release* (13 October 2016) BEIS/16/34 1-3 <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/559219/bpe_2016_statistical_release.pdf> accessed 01 July 2017.

[27] Hampshire Trust Bank, 'SMEs forecast to contribute £217 billion to UK economy by 2020' *Latest News from Hampshire Trust Bank* (03 November 2016) < https://www.htb.co.uk/news/details/articleid/197 > accessed 01 July 2017.

[28] Lanier Saperstein, Geoffrey Sant and Michelle Ng, 'The Failure of Anti-Money Laundering Regulation: Where is the Cost-Benefit Analysis?' (2015) 91(1) art 4 Notre Dame Law Review Online 1 <http://scholarship.law.nd.edu/ndlr_online/vol91/iss1/4> accessed 01 July 2017.

and services to entire categories of customers, which practice is known as de-risking. By not on-boarding, or exiting existing business relationships deemed as a higher risk category from ML perspective, certain customer categories such as CBRs, MSBs, MTOs, charities, financial technology, virtual currency operators, or PEPs are denied access to the financial system without any wrongdoing on their part. Furthermore, banks sometimes decide to cease their presence in certain jurisdictions or regions. Therefore, the de-risking can be based on product type, geographies, nature of customer's business, or on the perceived higher ML and corruption risk due to the prominent political positions held by some individuals.

Surely, one may argue that this strategy can be seen as a reasonable business decision made by banks after assessing the regulatory landscape and completing their cost-benefit analysis in respect to risk and reward from a purely commercial perspective. The bank can legitimately decide that it is economically viable to avoid certain types of customers in order to save on AML compliance costs, technology purchases or upgrades, and on staffing and tailored training within the organisation for managing these customers. However, whilst this tactic may appear as an attractive option for cutting bank's expenditures short term, in the long run this also could mean missed opportunities for growth through turning down potentially profitable businesses. In addition, the de-risking practice can also have adverse effects on wider society through ultimately increased potential for ML, while some segments are directly impacted by being denied banking services for sending and receiving funds.

4.2 Tackling de-risking

In the UK, the regulator has recognised the significance of the de-risking phenomenon and FCA continuously sends strong messages that instead of blanket approaches, banks are expected to distinguish different AML risk levels specific to individual business relationships within the same customer category, implying that allocated resources for mitigating these risks will vary and should be proportionate to the level of risk exposure in respect to that particular customer. FCA recognises that the ultimate decision remains with the bank and the commercial element is crucial when deciding whether or not to commence, or retain a business relationship but nevertheless, FCA also makes a clear point that declining customers because of the AML requirements should be an exception rather than the rule. FCA is currently exploring the potential impact of de-risking strategy on the consumer protection and market power abuse/ competition related matters. This implies awareness of the de-risking impact on wider society which once again means that the effects of maximum AMLR and controls should be analysed in more detail and through the lens of the ultimate results affecting society.

In order to gain better understanding regarding de-risking practices, FCA instructed John Howell & Co Ltd to research this phenomenon. John Howell & Co Ltd report from February 2016 suggests that de-risking is driven by a complex set of factors, implying that instead of looking for a straightforward solution for this problem, the efforts should be focused towards mitigation of the issue by balancing the costs and risks between banks and high risk sectors, and crucially more tailored approach in understanding of how to measure ML and TF risks on a 'case-by-case' basis[29].

The magnitude of the de-risking phenomenon has been also recognised globally. In November 2015, the Financial Stability Board (FSB) presented the G20 leaders with four points Action Plan for addressing the decline in correspondent banking[30] highlighting the necessity of (1) further examination of scope and impact of de-risking; (2) clarification of regulatory expectations and more guidance from FATF and Basel Committee on Banking Supervision (BCBS); (3) domestic capacity-building in home jurisdictions of affected respondent banks and (4) enhancing correspondents' banks due diligence tools. This was followed by FSB reiterating the importance of de-risking in its End-2016 Progress Report[31] and defining the 2017 deliverables which include FSB publishing its survey findings and setting out a process for on-going monitoring of correspondent bank trends. However, whilst in theory the FSB' approach appears to be sensible, as of the date of writing of this paper, there is no evident progress in respect of FSB's recommended actions.

In line with FSB's de-risking battle calls, in June 2017 BCBS published its revised guidelines, although the added value of the update does not appear to be significant as the guidance simply once again underlines the RBA importance, re-emphasising that not all CBRs bear same level of risk and that the blanket approach is not the answer but banks should rather follow the Committee's updated risk indicators when carrying out their risk assessment.[32]

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[29] David Artingstall and others, 'Drivers &Impacts of Derisking' *A study of representative views and data in the UK, by John Howell & Co. Ltd. for the Financial Conduct Authority* (February 2016) <https://www.fca.org.uk/publication/research/drivers-impacts-of-derisking.pdf> accessed 01 July 2017.

[30] FSB, 'Report to the G20 on actions taken to assess and address the decline in correspondent banking' (Report) (November 2017) 1-2 < http://www.fsb.org/wp-content/uploads/Correspondent-banking-report-to-G20-Summit.pdf> accessed 01 July 2017.

[31] FSB, 'FSB action plan to assess and address the decline in correspondent banking' (End-2016 progress report and next steps), (December 2016) < http://www.fsb.org/wp-content/uploads/FSB-action-plan-to-assess-and-address-the-decline-in-correspondent-banking.pdf> accessed 01 July 2017.

[32] Basel Committee on Banking Supervision, 'Sound management of risks related to money laundering and financing of terrorism' (Guidelines) (June 2017) < http://www.bis.org/bcbs/publ/d405.pdf> accessed 01 July 2017.

Previously, the de-risking practices wider impact on society has been recognised by World Bank Group (WBG). Following the field work focused on CBRs withdrawal and MTOs account closures, the WBG produced its World Bank Fact Finding Summary from November 2015 which re-confirmed the de-risking practice adverse effects on specific countries, regions and financial services.[33] More important, the WBG recognised that in respect to the CBRs de-risking, in addition to business decisions based on purely economic factors, the regulatory and risk related concerns also played a crucial role in banks' decisions to withdraw their services.

Similarly, in its latest report from March 2017, the International Monetary Fund (IMF) has recognised that banks' decisions to restrict or withdraw from CBRs have been shaped by the changing regulatory, supervisory and enforcement environment in the post-global financial crisis and the resulting increases in overall compliance costs.[34] Previously, in June 2016 IMF called for policy action as the CBRs withdrawal in some regions reached critical levels with the developing economies in Africa, Central Asia, the Caribbean and Europe being notable examples.[35]

Both IMF and WBG findings clearly suggest that the maximum AMLR is correlated to de-risking effects on society, similarly to some other findings such Oxfam's research from 2015 which points to the direct links between de-risking practices and the regulatory pressure.[36] Equally, FATF's new 2016 Correspondent Banking Services Guidance which demands softer due diligence approach from the global correspondent banks vis-à-vis their respondent banks, in particularly in respect of respondent banks located in developing countries, also implies recognition of the indirect impact of maximum AMLR on society and individual rights.

Many AML experts have pointed that FATF findings set in the guidance are just the tip of the iceberg. Daren Allen, partner at Dentons reiterates that regulators' stance creates risk-averse approach rather than positive conditions for RBA, thus prompting the de-risking strategy. Similarly, Guy Wilkes, a partner at Mayer Brown, has pointed that FCA's significantly increased

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[33] The World Bank Group, 'Fact-Finding Summary from De-Risking Surveys: Withdrawal from Correspondent Banking - Where, Why, and What to Do About it and Report on the G20 Survey On De-Risking Activities in the Remittance Market' (Report) (November 2015) 101907 <http://documents.worldbank.org/curated/en/534371468197058296/pdf/101097-WP-Box393255B-PUBLIC-Fact-Finding-Summary-from-De-Risking-Surveys-November-2015.pdf> accessed 01 July 2017.

[34] IMF,'Recent Trends in Correspondent Banking Relationships: Further Considerations' (Executive Summary) (March 2017) < http://www.imf.org/en/Publications/Policy-Papers/Issues/2017/04/21/recent-trends-in-correspondent-banking-relationships-further-considerations> accessed 01 July 2017.

[35] IMF, 'The Withdrawal of Correspondent Banking Relationships: A Case for Policy Action' (Staff Discussion Note) (June 2016) < https://www.imf.org/external/pubs/ft/sdn/2016/sdn1606.pdf> accessed 01 July 2017.

[36] Oxfam International, 'As the Cycle of Crisis Continues in Somalia, Vital Remittance Pipelines Risk Being Cut' *Press Release* (19 February 2015) < https://www.oxfam.org/en/pressroom/pressreleases/2015-02-19/cycle-crisis-continues-somalia-vital-remittance-pipelines-risk > accessed 01 July 2017.

penalties in recent years and even heftier US regulators' fines which can be imposed on any bank processing US$ payments, led to banks' decisions for restricting or withdrawing correspondent services. From the banking sector perspective, the practical obstacles often revolve around the lack of clarity on 'know your customer's customers' rules, an ambiguity which has been further increased with the 4MLD changes regarding reduced SDD application, as highlighted by Bovills' consultant Colin Darby.[37]

Directions and recommendations from different national and international bodies are certainly welcome for tackling the de-risking issue but at same time the guidance must not be ambiguous. For example, although created with best intentions, FCA's 2015 de-risking statement was found by BBA membership as being of little value with FCA confusing a number of issues and some members pointing to the undermined RBA flexibility.[38] Unfortunately, the updated FCA statement on de-risking from 2016 did not add any clarity despite the previously pointed banking sector concerns via BBA.[39]

In addition to the lack of clarity, it also appears that banks are receiving mixed signals considering that although they are encouraged by the regulator to abandon the de-risking practices, in parallel the same regulator often imposes hefty fines for having the 'wrong' business relationships. In that respect, the level of AMLR should be proportional to the benefits achieved, with regulators taking into account that de-risking practice could ultimately create more risk within the financial system, for example, by shifting towards alternative/ shadow banking. Therefore, the imperative for all stakeholders is to identify the middle ground in respect to the AMLR.[40]

4.3 Shifting towards shadow banking

The term 'shadow bank' was coined in 2007 by the economist Paul McCulley[41] in an attempt to explain the risky off-balance-sheet vehicles created by banks in order to allow them selling loans repackaged as bonds. Whilst the phrase is often used to describe dubious lending and borrowing practices under the regulators' radar, perhaps a better description is that the shadow banking rather

[37] Bovill, 'Fines and compliance costs drive de-risking, says FATF' *Press release* (3 November 2016) <https://www.bovill.com/fines-compliance-costs-driven-de-risking-says-fatf/> accessed 01 July 2017.
[38] BBA (n11) p5.
[39] FCA, 'De-risking: managing money-laundering risk' *News Stories* (20 May 2016) <https://www.fca.org.uk/firms/money-laundering/derisking-managing-risk> accessed 01 July 2017.
[40] Teresa Pesce, 'AML and the De-Risking Dilemma' *KMPG* (2015) <https://assets.kpmg.com/content/dam/kpmg/pdf/2015/09/aml-foreword.pdf> accessed 01 July 2017.
[41] Laura E Kodres, 'What Is Shadow Banking?' *IMF Finance &Development* (June 2013) <http://www.imf.org/external/pubs/ft/fandd/2013/06/pdf/basics.pdf> accessed 01 July 2017.

relates to certain activities performed outside the regulatory boundaries, for example, financial intermediaries that conduct maturity, credit, and liquidity transformation without access to central bank liquidity or public sector credit guarantees.[42] However, the term shadow banking nowadays is used more loosely to cover all financial intermediaries that perform bank-like activity but are not regulated, for example, mobile payment systems, pawnshops, peer-to-peer lending websites, hedge funds and bond-trading platforms set up by technology firms.[43]

In our scenario, from de-risking perspective, important intermediaries are the alternative remittance systems such as the Money or Value Transfer Services (MVTS) as per FATF's Guidance on MVTS. As with the other shadow banking institutions, MVTS in reality directly help certain categories of consumers, hence arguable they do serve a purpose in the economic system. However, at the same time, considering the fact that shadow banking has grown to an estimated $127 trillion in assets held by non-bank financial intermediary institutions[44], it is clear that these activities have potential for creating systemic risk.

The ultimate danger deriving from the de-risking practices is that customers denied mainstream banking are left with no other option but to shift towards shadow banking by carrying out activities in unregulated sectors, thus in reality increasing the potential for facilitation of ML and TF. For instance, termination of all CBRs from one particular geographical area can lead to increased ML activities as the exited customers and business partners will almost certainly seek out new relationships within the unregulated sector, hence making the detection and reporting of potentially suspicious activity more difficult.[45] A small regional bank left outside the international banking mainstream will lose access to foreign currency and being unable clear and handle cross-border transactions becomes even more dependent on alternative liquid capital sources which may carry greater risks. De-risking also has a social dimension due to the impact on the exited bank' customers ranging from a simple inconvenience to the life important matters, for example, when entire countries which citizens are dependent on funds received from relatives aboard are being cut off.

The impact of the de-risking at global level is evident considering that between 2009 and 2016, CBRs were reduced globally by 25% according to recent Accuity's research which study also

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[42] Zoltan Pozsar and others, 'Shadow Banking' (Federal Reserve Bank of NY Staff Report No 458) (July 2010) 2.

[43] A.A.K, 'How shadow banking works' *The Economist* (2 February 2016) <http://www.economist.com/blogs/economist-explains/2016/02/economist-explains-0> accessed 01 July 2017.

[44] FSB, 'Gobal Shadow Banking Monitoring Report 2016' (Report) (10 May 2017) 4 <http://www.fsb.org/wp-content/uploads/global-shadow-banking-monitoring-report-2016.pdf> accessed 01 July 2017.

[45] Sven Stumbauer, 'The (Not So Obvious) Top 3 Cost Drivers of Anti-Money-Laundering Compliance' *International Banker* (13 June 2017) < https://internationalbanker.com/finance/not-obvious-top-3-cost-drivers-anti-money-laundering-compliance/> accessed 01 July 2017.

contains its Global Head of Strategic Affairs Henry Balani's excellent analogy between de-risking practices and global travel who says that allowing de-risking to continue unfettered is like living in a world where some airports don't have the same levels of security screening – before long, the consequences will be disastrous for everyone.[46]

FATF's President Roger Wilkins, using precisely the term 'shadow banking', has raised his concerns underlining that de-risking would undoubtedly drive the development of alternative financial markets and unregulated payment mechanisms. In addition, he has also warned banks that the de-risking practices blanket approach is not the solution pointing to three main factors to be carefully considered by banks before deciding to terminate a business relationship: (1) the reputational risk in de-banking essentially poor countries or people; (2) the commercial risk element as withdrawing from doing business opens the door for other players and (3) new technologies element as failing to invest in new ways of doing banking can result in other technology advanced players such as Google or Apple taking over customer relationships[47].

In respect of finding solution for this growing problem, Wilkins underlines that while definitive conclusion on de-risking is unlikely, clarifying issues about the dangers of driving illicit markets and financial exclusion is realistic, acknowledging banks' need for more helpful guidance in that respect and recognising the necessity of communication of more flexible regulatory practice and standards, and more refined, intelligent assessment of risk.[48]

4.4 The concrete dangers of de-risking

Increased AML compliance costs and regulatory pressures contribute to banks' decisions to withdraw their products and services from certain customer categories or geographical regions. For example, firms' estimated global AML compliance costs were projected to grow to more than $8bn by 2017[49] while the regulatory pressure translated in fines means that banks have paid $321bn globally between 2008 and 2016 for various regulatory failings including ML and TF.[50] Facing

[46] Accuity, 'Accuity Research Shows 25% Drop in Global Correspondent Banking Relationships Linked to De-risking' *Accuity Press Room* (8 May 2017) < https://accuity.com/press-room/accuity-research-shows-25-drop-global-correspondent-banking-relationships-linked-de-risking/> accessed 02 July 2017.

[47] Roger Wilkins, 'The danger of driving both illicit markets and financial exclusion' (FATF 6th Annual International Conference on Financial Crime and Terrorism Financing, Kuala Lumpur, 8 October 2014) < http://www.fatf-gafi.org/publications/fatfgeneral/documents/danger-illicit-markets-financial-exclusion.html> accessed 01 July 2017.

[48] Wilkins (n 47).

[49] Christopher J Pelaez, 'AML Compliance Costs – How Much is Enough?' *Global Radar* (25 August 2016) <https://www.globalradar.com/aml-compliance-costs-how-much-is-enough/> accessed 02 July 2017.

[50] Gerold Grasshoff and others, 'Staying the Course in Banking' (Report) (2 March 2017) Boston Consulting Group 5,16.

increased AML compliance costs and hefty fines in one hand while also being the subject to regulators' close scrutiny and critics in respect to wholesale business withdrawals in the other, banks have found themselves in a rather difficult position, described by some as being between a rock and a hard place.[51]

However, the fact remains that the consequences of de-risking can be significant. Terminating all CBRs within given geographical area strengthens the position of the unregulated MVTS which AML controls can be often rather lax, thus making ML detection much harder. In addition to increased potential for ML and TF, the shift of international payments towards the underground payment remittance systems can also affect the stability and integrity of the financial system. Furthermore, abandoning entire business lines or regions means missed opportunities for additional profits for the banks, hence the de-risking practice ultimately hampers the economic growth. From individual rights perspective this means at least unfairness with citizens being denied normal banking and businesses being prevented from carrying out their day-to-day activities, thus implying adverse impact on society as a whole.

A good example of de-risking effects in practice is the abandonment of wire transfers to Somalia by the UK, US and Australian banks in order to avoid the risk of transfers involving terrorist groups.[52] This caused significant problems for the local population in Somalia as the annual overseas remittances sent by the Somali diaspora to their relatives and friends back home were estimated at $1.3bn.[53] This de-risking practice by the major banks led to humanitarian tragedy considering that approximately 40% of the Somalia population relied on these remittances from abroad, with many local Somalis being directly dependent on these funds in order to pay for food and medicines.

Following the withdrawal of the UK's last big player in 2013 when Barclays Bank decided to exit 75% of its MSBs, the Somali authorities sent a letter to Barclays in an attempt to reverse their decision informing them that in 2012 the estimated amount of $2bn, which is 33% of country's GDP, was channelled to Somalia through 'Hawala' or other small MSBs.[54] However, similarly to other major banks, Barclays concerns were revolving around the potentially weak AML controls of

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[51] Dawn Fisher, 'Banks – between a rock and a hard place?' *International Compliance Association Insight* (29 April 2015) < https://www.int-comp.org/insight/2015/april/29/banks-between-a-rock-and-a-hard-place/ >accessed 02 July 2017.

[52] Ali Gutale,' Life after losing remittances: Somalis share their stories' *The Guardian* (18 June 2015) <https://www.theguardian.com/global-development-professionals-network/2015/jun/18/life-after-losing-remittances-somalis-share-their-stories-somalia> accessed 02 July 2017.

[53] Oxfam, 'Hanging by a Thread: The ongoing threat to Somalia's remittance lifeline' (Joint Agency Briefing Note) (19 February 2015) 1-4.

[54] Mark Tran, 'Somalis fear Barclays closure of remittance accounts will cut lifeline' *The Guardian* (24 June 2013) <https://www.theguardian.com/global-development/2013/jun/24/somalis-barclays-remittance > accessed 02 July 2017.

the MSBs on their books, which can result in the MSB unwittingly facilitating ML/TF, thus bringing the bank providing services to the offending MSB into the regulators’ AML investigations, often followed by hefty fines and increased reputational risks. This is another example of how pushing the AMLR towards the maximal point can inadvertently affect the society by infringing its members’ basic rights.

Cutting off whole jurisdictions or regions from official payments systems will almost certainly lead to populations switching to alternative methods for sending funds back home, for example, using money transfers mechanisms such us “Hawala”, “Hundi,” “Fei ch ‘ien,” “Chit System,” “Poey Kuan” which usually work on principle of matching customers who want to send money in opposite directions, so the provider will credit and debit funds locally without using international wire transfers, therefore cash balances are moved with no cross-border transaction.[55] While following the terrorist attacks from 11 September 2001 the rules were strengthened requiring the alternative remitter to identify and where appropriate verify the parties in the transaction, in practice they are still fairly open to ML and TF risks. FATF recognises three major types of Hawala and other similar service providers: (1) pure traditional (legitimate) ones; (2) hybrid traditional (often unwitting) ones; and (3) criminal (complicit) ones, implying that different levels of ML/TF risks will apply to each.[56] Interesting enough, in the case of Somalia de-risking, some Somalis living abroad had even opted to engage third-party agents who were hired to physically carry the money in cash back to Somalia.[57]

Therefore, while banks might have avoided their own ML/ TF risks, money continued to flow via unregulated channel, thus opening better opportunities for the money launderers and terrorism financiers, which in turn underlines again the necessity of the regulators and banks finding the common ground for tackling the de-risking problem.

4.5 How can banks tackle de-risking? Good practice in addressing de-risking

[55] D.K., ‘How hawala money-transfer schemes are changing’ *The Economist* (16 October 2015) <https://www.economist.com/blogs/economist-explains/2015/10/economist-explains-12> accessed 02 July 2017.
[56] FATF, ‘The Role of Hawala and Other Similar Service Providers in Money Laundering and Terrorist Financing (Report) (October 2013) 14-15 < http://www.fatf-gafi.org/media/fatf/documents/reports/Role-of-hawala-and-similar-in-ml-tf.pdf> accessed 02 July 2017.
[57] Jamila Trindle, ‘Money Keeps Moving Toward Somalia, Sometimes in Suitcases’ *Foreign Policy* (15 May 2015) <http://foreignpolicy.com/2015/05/15/money-keeps-moving-toward-somalia-sometimes-in-suitcases/> accessed 02 July 2017.

It is encouraging that some major banks have recognised the magnitude of the de-risking problem. For example, Standard Chartered as one of the biggest correspondent banks has acknowledged that cutting off the smaller banks from the global correspondent banking network directly impacts the trade and commerce responsible for economic growth of the weaker sections of society.[58] In that respect, since 2015, Standard Chartered has implemented tailored training known as 'Correspondent Banking Academies'[59] for the clients and regulators in the country in which they operate the CBR, in order to exchange best practices on financial crime prevention matters. Standard Chartered also carries out so called 'deep dive' visits in which they objectively assess client's Financial Crime Compliance (FCC) framework including policies, screening procedures, organisational structure, governance and training, while advising on areas of deficiency and agreeing on ways for improvement.[60]

Whether Standard Chartered's approach will be widely replicated across the UK banking sector and globally remains to be seen but what is certain is that in tackling the problem, bank's senior management involvement is crucial, both from perspective of achieving a robust AML/CTF framework within the bank and from aspect of fair RBA assessment of their clients' AML/CTF systems and controls.

5. Financial Crime Risk Framework and Adequacy of Bank's AML/CTF Systems and Controls

5.1 Factors impacting the FCC Framework

Embedding an efficient FCC framework is surrounded by number of challenges. As these challenges are even more apparent for the bigger players in the banking world, in this part I'll attempt to analyse the situation from a major global bank perspective. A simplified view would be

[58] Michael Imeson, 'De-risking in correspondent banking – time to reverse the trend' *Wolters Kluwer Insights* (22 November 2016) < https://www.wolterskluwerfs.com/article/de-risking-in-correspondent-banking-time-to-reverse-the-trend.aspx> accessed 03 July 2017.
[59] Standard Chartered, 'Standard Chartered hosts first financial crime compliance training for correspondent banks' *Press Release* (2015) < https://www.sc.com/global/av/ph-pr-financial-crime.pdf> accessed 03 July 2017.
[60] Anurag Bajaj, 'Promoting financial inclusion in correspondent banking' (Session at Standard Chartered Sibos Geneva 2016) <https://www.sc.com/en/banking-services/business-banking/transaction-banking/promoting-financial-inclusion-in-correspondent-banking.html> accessed 03 July 2017.

to group the risk drivers affecting bank's FCC framework into two groups: external and internal factors.

External factors will include the legislative complexity and regulatory landscape as illustrated through multiple regulatory regimes to which a global major bank must adhere, including the US extraterritoriality element. Therefore, a bank operating across different jurisdictions must develop a tailored approach, accounting for the local jurisdictional requirements. A good example is the UK's POCA 2002 s335-336 'consent' regime and the requirement for obtaining prior authorities' permission for proceeding with a transaction where suspicion exists and a report has been previously submitted, which concept has been recently further clarified by the National Crime Agency (NCA) by amending the terminology and replacing 'consent' with 'defence to a ML offence' or 'defence to a TF offence' in order to add clarity in respect to banks' application of the RBA.[61] However, the important moment is that not all jurisdictions recognise this concept of prior authorities' consent, for example, this is not a requirement in Australia, Japan or Netherlands.[62] Furthermore, in some jurisdictions the rules on prior consent are not explicit but this is rather a judgment call by the designated person processing the transaction who determines whether to proceed or not, which in practice would mean a position much closer to the non-requirement end of the 'pre-approval' spectrum. Republic of Ireland (ROI) Criminal Justice Act s42 illustrates this stance. Therefore, for instance, replicating the AML/CTF policies and procedures of an ROI or other jurisdiction located parent bank where the consent regime is different or non-existent into a UK located subsidiary cannot be considered as a fit for purpose model as the UK 'consent' requirements will not be addressed in such scenario. Consequently, a unique FCC framework is required for each jurisdiction where the global bank operates.

The internal factors shaping FCC framework chiefly relate to the complexity deriving from the global bank's multiple business lines which means that sector tailored processes and procedures should be developed beneath the overarching policy level in order to address each business' specifics. This is because the requirements for addressing the AML/CTF risks will vary depending on the business line unique features, for example, trade finance or treasury and investment banking AML/CTF risks do not mirror the AML/CTF risks related to corporate and business banking, or the ones in respect to mass market retail personal banking characterised with high volumes of transactions. Other internal factors include the scale of business, transaction volumes and sizes,

[61] NCA, 'Requesting a defence from the NCA under POCA and TACT' (Publication) (June 2016) 3 <http://www.nationalcrimeagency.gov.uk/publications/713-requesting-a-defence-under-poca-tact/file> accessed 08 July 2017.
[62] PWC, 'Know Your Customer: Quick Reference Guide' (Guide) (January 2016) 87, 132, 501 <https://www.pwc.com/gx/en/financial-services/publications/assets/pwc-anti-money-laundering-2016.pdf > accessed 08 July 2017.

which in turn affects bank's risk appetite thresholds and tolerance, budget and affordability for investing in technology, for example, systems for automation of customers' risk assessment, customers and payments screening model, method of transaction monitoring, and investing in human resources by hiring experts and knowledgeable staff capable of tackling the ever-changing financial crime related typologies and trends.

5.2 Robust AML/CTF Framework based on two pillars: Governance and AML/CTF Systems and Controls

Both the international and the UK national standards entail inclusion of AML/CTF risks management within banks' overall risk management framework. International bodies such as the FATF underlines the importance of efficient AML/CTF risks management in the FATF Recommendations and also its subsequent publications 'Guidance for a Risk-based Approach: The Banking Sector' and 'Transparency and Beneficial Ownership', while the BCBS has published practical guidelines for sound AML/CTF risks management. In the UK, the FCA calls for AML/CTF risks management in a thoughtful and considered way through establishing and maintenance of adequate AML/CTF systems and procedures which should be proportionate to the risks identified as per FCA Financial Crime Guide Part 1 and Part 2, also covering the ML topic at higher level in its FCA Handbook.

The FCC framework should address the areas of AML/CTF, Sanctions, Fraud, Anti-Bribery and Corruption, Information/ Data Security and Cyber Crime risks, detailing the all the core end-to-end processes which must be documented. Regulators' expectations are that the bank will regularly assess AML/CTF risks in order to gain solid understanding of these risks, which will in turn allow the bank to successfully manage and mitigate the same. In order to meet the legislative requirements and regulators' expectations, bank's board must to have a clear statement of risk appetite in place. The risk appetite should determine the maximum acceptable unavoidable amount of risk, which should be then regularly reviewed, taking into account the external factors such as legislative and regulatory changes, and the findings from the regular and ad-hoc risk assessments.

A robust AML/CTF framework for a bank or any financial institution will be founded on two pillars: first, an effective and implementable governance strategy, and second, adequate AML/CTF systems and controls based on RBA. Both pillars are equally important. The latter is analogous to FATF's recommendation for national AML/CTF framework which should also be based on RBA and here an accurate risk assessment is crucial for allowing efficient allocation of resources for combating ML and TF, while the former is key for developing strong risk culture in the bank, which is paramount for supporting efficient functioning of the AML/CTF systems and controls.

5.2.1 Governance

5.2.1.1 Governance Strategy and Organisational Structure

Sound governance would mean implementing and maintenance of a solid organisational structure with clearly defined roles and responsibilities, including clear communications channels and proper reporting lines to permit for accurate Management Information (MI) flow and availability of the same to the management and relevant committees in a timely manner, in order to allow for prompt actions to be taken as appropriate. The organisation must include the role of Nominated Officer or MLRO as the person responsible for managing of all AML related matters, while the recent legalisation changes also impose the requirement for appointing of a board member as the person responsible for compliance with the MLR 2017.

5.2.1.2 Senior Management Involvement

The senior management is responsible for developing a strong risk culture within the bank by sending a clear message that taking excessive AML/CTF risks is outside the bank's risk appetite. Senior management should continuously work on embedding values that place AML/CTF responsibilities ownership with each employee individually, rather than encouraging false impressions that these sit solely with the bank's AML/CTF specialised function which is a fairly regular misconception in many financial institutions. In addition, the senior management must ensure that adequate level of staff and sufficient expertise exist within the AML/CTF function in order to allow them to advise, guide, and support strong AML/CTF culture within the organisation.

5.2.1.3 MLRO

The MLRO is the focal point for all AML issues within the bank and as such, is expected to take pro- active role in the continuous improvement of the AML/CTF systems and controls rather than being traditionally seen as an individual with the specific responsibility for receiving, evaluating and if necessary, externalising the SARs. Furthermore, the MLRO should be able to demonstrate expertise in their day-to-day AML/CTF compliance duties, including ability to communicate AML/CTF related matter at all levels within the bank and the MLRO is also expected to take on a range of other duties including evaluation of new products and services by determining the AML/CTF risk levels related to those, preparing relevant intelligence including monitoring reports and MI reports to the board and senior management. Therefore, the MLRO must possess sufficient seniority, credibility and independence, in order to influence the senior management in a way of keeping the AML/CTF topic high on board's agenda at all times.

In addition, a proactive MLRO will build professional relationships with various regulators and would advise the business units of proposed or pending regulatory changes, also coordinating and ensuring that bank policies and procedures are current and up to date. The MLRO is further responsible for monitoring the compliance administrative matters and will coordinate the AML/CTF training in the bank. The MLRO role has been assigned with strict FCA obligations under the approved persons regime[63] while now the personal accountability is added under the Senior Managers Regime – SMR17.[64] Failure to comply could lead to significant negative consequences including two years imprisonment or financial penalty.

5.2.1.4 Three Lines of Defence

The three lines of defence model is perhaps the default choice for most banks. In this AML/CTF risk management model the front-line employees who own and directly manage the day-to-day ML and TF risks are considered to be the first line of ML and TF prevention barrier, while the second line are the departments that provide advice, oversight and where necessary a challenge to the first line. The third line is internal audit, an independent function responsible for monitoring the effectiveness of policies, procedures, systems and controls as per the FCA's guide. The Internal Audit function provides assurance that ML and TF risks are adequately managed by both the first and second line, while also ensuring that the second's line advice, guide and oversight is fit for purpose. A good practice may also include appointing external auditors, for example, in situations where specialised expertise is required. In many countries the external auditors play important role in evaluating banks' internal controls and procedures ensuring that they are compliant with

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[63] FCA, 'Requirements of approved persons', *News Stories* (02 November 2016) <https://www.fca.org.uk/firms/approved-persons/requirements > accessed 14 July 2017.
[64] FCA, 'CP15/22 Strengthening accountability in banking: Final rules (including feedback on CP14/31 and CP15/5) and consultation on extending the Certification Regime to wholesale market activities' (Consultation Paper CP15/22) (July 2015) 12-27 < https://www.fca.org.uk/publication/consultation/cp15-22.pdf> accessed 15 July 2017.
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AML/CTF regulations and supervisory practice but nevertheless, it is still bank's responsibility to ensure that audit scope is adequate to address the bank's risks and that the auditors possess the requisite expertise and experience. As per BCBS guidance, the bank should also ensure that it exercises appropriate oversight of such engagements.

5.2.2 AML/CTF Systems and Controls

Adequate AML/CTF systems and controls should have the capability for addressing the AML/CTF risks efficiently and through the whole the end-to-end customer life cycle, from on-boarding until the end of the business relationship.

5.2.2.1 Policies and Procedures

The bank should have in place robust AML/CTF policies and procedures, prepared in accordance with the RBA and effectiveness should be reviewed at least annually and ad-hoc in line with the changing environment, for example, as soon as material changes that may affect the policies and procedures have occurred. The policies and procedures must be easily accessible for bank staff and senior management must ensure that these are understood by all employees.

5.2.2.2 Risk Assessment

In order to understand AML/CTF exposure, the bank should carry out comprehensive and regular risk assessments of its businesses, which evaluation must include several factors such as its products and services, customer types, transactions channels, on-boarding channels and geographies to cover for both: its customers' domicile and transacting jurisdictions. This business wide risk assessment will help senior management to understand the inherent and residual risks related to different segments, which should in turn allow them to take appropriate actions by applying RBA and proportionate usage of bank's resources. In addition, the findings will also serve as a barometer of the policies and procedures robustness and efficacy. In line with FATF standards, bank's risk assessment need not be complex, but should be commensurate with the nature and size of bank's business.

5.2.2.3 CDD

The bank must to identify and where appropriate to verify their customers, also applying the necessary level of due diligence. Based on perceived AML/CTF risks calculated by taking into account various factors such as product, industry, geographies, transactions volumes, etc., the customer will usually fall under low, medium or high risk category which then determines the level of scrutiny at on-boarding and during the customer's life cycle. For example, for low and medium risk classified customers, the bank will apply standard CDD which would usually include understanding the nature of the intended business relationship and establishing the origin of customer's sources of funds and wealth, while for high risk classified customers EDD is appropriate which in practice means extra scrutiny, for example, in addition to establishing the sources of funds and wealth, a concrete evidence to prove the legitimacy of both will also be required. The high risk classified customers are the subject to closer on-going monitoring and more frequent periodic reviews, for instance, the bank may decide for annual reviews for this category and setting 3 and 5 years review cycles for medium and low risk classified customers respectively. Where applicable, usually for business customers or trust structures, the bank must also identify and where necessary verify the ultimate beneficial owners by applying RBA, hence a pragmatic approach would be for the bank to define certain thresholds of ownership or voting rights that will trigger identification and verification. PEPs are special category of high risk classified customers which are individuals entrusted with prominent public functions, thus being perceived to pose increased ML risks due the potential higher risk for abuse of their positions in respect of corruption or bribery. For each customer, the bank must also understand the nature and purpose of the relationship and expected accounts operations which will allow for correct customer risk assessment at on-boarding and adequate periodic and ad-hoc reviews during the course of the business relationship, including more accurate calibration of the transactions monitoring systems.

5.2.2.4 Customer Screening Systems

The PEP customers as a special high risk category are subject to EDD and more frequent regular reviews but the in practice the identification of this type of customer can be problematic. Therefore, the banks often opt for a robust third party vendor screening systems of the type of Thomson Reuters World Check[65] or Lexis Nexis Bridger Solution.[66] The senior management must ensure

[65]Thomson Reuters World-Check, 'Find Hidden Risk' (Brochure) (2015) <https://www.thomsonreuters.com/content/dam/openweb/documents/pdf/governance-risk-compliance/fact-sheet/world-check-risk-screening-fact-sheet.pdf > accessed 14 July 2017.

[66] LexisNexis, 'Lexis Nexis Bridger Insight' (Brochure) <http://www.nexis.co.uk/downloads/bridger_insight_brochure.pdf > accessed 14 July 2017.

that effective and up-to-date screening systems are in place, as although itself not a legal requirement, the screening of customers' names will identify potential PEPs and customers subject to different sanctions regimes such us UK/EU, USA's Office of Foreign Assets Control (OFAC) and UN. The screening should be carried out at the on-boarding and then on regular basis vis-à-vis the existing customer database as soon as the vendor's PEPs lists or the external sanctions lists feeding into the screening systems are updated. For a global major bank this usually means overnight screening. From a practical point of view it is important to highlight that the screening can produce a number of 'false positives' alerts which may wrongly indicate potential PEP or sanctions listed customer, for example, due to names similarity. The bank should have enough staff to manually check the created alerts in order filter out the genuine alerts and action accordingly. This of course creates additional costs but the hefty fines for having the screening wrong, more often than not, justify the money spent on screening systems.

5.2.2.5 Transactions Monitoring

While the method for on-going monitoring is not prescribed by the UK regulator which implies that banks can opt for manual or automated monitoring, a major global bank would be expected to implement and maintain a combination of both, in order to determine whether the transactions carried out are consistent with bank's knowledge of the customer, for example, based on CDD collected at the point of on-boarding. According to EY's recent research, the most widely used automated transactions monitoring systems in the UK are those provided by the vendors NICE Actimize and Oracle.[67] However, the bank is expected to apply RBA in respect of on-going monitoring, for example, while automated monitoring based on pre-defined thresholds and historic patterns could suffice for low and medium risk classified customers (if generated alerts are further investigated), the high risk category will warrant extra manual scrutiny. In both scenarios where suspicious arise, these must be reported to the authorities' by submitting a SAR and bank should also review the relationship with that particular customer which may ultimately lead to termination of the connection.

5.2.2.6 MI Reporting

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[67] EY, 'AML Transaction Monitoring: A Survey of UK Financial Institutions' (Publication) (September 2014) <http://www.ey.com/Publication/vwLUAssets/AML_Transaction_Monitoring_A_Survey_of_UK_Financia.4/$FILE/1488612_AML_Transaction_Monitoring_A_Survey_of_UK_Financia.4%20(EMAIL).pdf> accessed 15 July 2017.

The accurate MI should provide senior management with enough meaningful information in order to allow them good understanding of the AML/CTF risks to which the bank is exposed, thus placing them in a position to act fast at first signs of threat by taking the appropriate mitigation or remediation actions. The MI should be provided regularly and ad-hoc as the risk dictates and needs to include overview of AML/CTF risks and emerging trends, legal and regulatory developments, and assessment of the existing systems and controls effectiveness. Furthermore, the MI should offer snapshot of customer database, for example, figures for the low, medium and high risk classified customers, ideally with separate data for PEPs, number of exited customers, volumes in respect of PEP and sanctions customer screening matches and alerts created by the automated transactions monitoring, number of SARs disclosed to authorities, etc. On annual basis, the MLRO report which should include all the reliant MI and assessment of the adequacy and effectiveness of bank's AML/CTF policies, procedures, systems and controls must be also produced.

5.2.2.7 Record Keeping

The bank must keep the evidence of customers' identity for five years from the point of ending the business relationship, while in respect to completed transactions again five years from the date of carrying out the transaction. All records must be easy accessible and retrievable. Also, the bank faces fines for breach of MLR2017 if unable to access the CDD and other related records when they have relied on a third party. However, it is worth mentioning that the ultimate responsibility for CDD lays with the bank itself and the conditions for reliance on third parties are extremely prescriptive and only applicable to institutions who are the subject to MLR2017 or equivalent regime.

5.2.2.8 Bank Staff, Training, Knowledge, Skills and Retention

The training of staff is paramount for both developing strong AML/CTF risk culture in the bank and for effective application of AML/CTF policies and procedures by all bank's employees. The senior management must ensure that high quality training is delivered to staff and that periodic refreshers are successfully completed by all employees. Furthermore, the content should be tailored to address the specific issues faced by employees based on their role in the bank, for example, the focus regarding front-line staff should be on identifying ML and TF risks in first place by using real life examples, while second line of defence will benefit from prompt updates on the legislation and regulatory developments.

Developing staff and their expertise regarding AML/CTF matters is crucial, this in particular for the specialised AML/CTF function employees who are expected to build strong knowledge and skills on the subject matter, in order to serve as trusted advisors on all AML/CTF issues within the bank, guiding and advising at all levels ranging from front-line colleagues to bank's senior management. Fairly often unjustifiably overlooked, the retention of AML/CTF specialists which can be achieved thorough adequate remuneration strategy, striking the right work/ life balance and providing conditions for continuous development, should be senior management's imperative if the intention is to build a solid and long-lasting AML/CTF framework.

5.3 Common weaknesses of AML/CTF systems and controls, areas for improvement

The senior management, MLRO and specialised AML/CTF functions must to closely follow the legislation and regulatory developments, keeping abreast of changes and learning from others' rather than from own mistakes. For example, FCA guides and its thematic reviews[68] are very useful source for comparison of bank's position vis-à-vis peers and for identification of its own AML/CTF framework gaps and weaknesses.

The common problems faced by banks in respect to combating ML/ TF and demonstrating compliance to the regulator chiefly revolve around the lack of resources assigned for AML/CTF compliance and in relation to MLRO's insufficient influence over senior management. In smaller banks, MLRO's duties can be merged into another role and the danger here is that such an employee may struggle to find enough time for focusing on AML/CTF related matters. The lack of senior management engagement, absence of proactive risk management and oversight is a proven recipe for compliance debacle, therefore this must be fully understood by the board of directors and shareholders, if bank's long term benefits are on their agenda.

Furthermore, the bank must ensure for correct risk classification of its customers but lack of investing in automated risk assessment and screening/ monitoring systems can often backfire, this in particularly for a bank with large customer databases, as this may result with failure to apply EDD where appropriate, for example, for high risk classified customers. On the other hand, the

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[68] FCA, 'Anti-Money Laundering and Anti-Bribery and Corruption Systems and Controls: Asset Management and Platform Firms' (Thematic Review TR13/9) (October 2013) <https://www.fca.org.uk/publication/thematic-reviews/tr13-09.pdf> accessed 15 July 2017.

flip side is that the excessive reliance on software technology can also result in failure for adequately assessing the AML/CTF risks, hence striking the right balance between automated and manual controls here is crucial factor.

Another potential area where gaps can relatively easily occur is the bank-wide risk assessments exercise. In this respect, it is fundamental that these risk assessments are carried out regularly and in line with legislative and regulatory developments, rather than being a tick box annual exercise. In addition, it is an imperative that methodology is comprehensive, well defined, accurate but also understandable to employees who will carry out this task, in order to remove any ambiguity and lower the subjectivity levels regarding the inherent and residual risk scoring. Otherwise, the results will fail to reflect the true conditions either by creating false impression that risks are under control, or at other end of the spectrum, by erroneously exaggerating the risks in other areas. This will ultimately result in inadequate allocation of AML/CTF resources leading to potentially catastrophic consequences.

Dealing with third parties such as agents or business introducers is another sensitive area which is often not given the deserved attention. From AML/CTF perspective, third parties should be treated in same way as any other bank's customer, hence they should be the subject to CDD and where appropriate EDD, on-going monitoring and periodic/ad-hoc reviews.

Training which is one of the crucial elements for implementing and maintaining strong AML/CTF culture can be often neglected through complacency and falling into the trap of adopting annual tick box exercise with staff completing generic AML/CTF on-line modules, which content is rarely reviewed to reflect external and internal changes. Using real-life examples that have occurred within the bank will make a quality connection between the theory and practice but unfortunately this is not always the case. Tailored training sessions covering specific fields and issues are frequently pushed to the bottom of the priorities agenda, which is a paradox by itself, considering that this way bank's staff will lack the required knowledge and skills for adequate management of the AML/CTF risks. This approach can be costly from legal, regulatory and reputational risk perspective.

Therefore, considering the mix of increased focus from the regulator, frequent legislation changes and heftiness of AML related fines, an AML/CTF risk aware senior management is crucial for bank's long term success. The combination of heavy penalties and reputational risk linked damages can relatively easily bring even a major global financial player to their knees. The senior management is the key driving force behind the efficient and successful ML/TF combating strategy. In theory, a robust but at same time flexible AML/CTF framework and efficient

AML/CTF systems and controls, should have the ability to precisely target the ML/TF practices, which *inter alia* also has the potential for minimising the de-risking practices.

6. Reaching the Optimal Level of AMLR: Balancing Conflicting Objective and Policies

The absence of adequate AMLR would mean increased national and global ML/TF as this creates a situation where criminals are encouraged to increase their activities in anticipation that possibilities for being detected and punished are rather slim in such constellations. The ML causes social harm because it facilitates crime and enables criminals to enjoy criminal revenues[69] and in some scenarios, if allowed, criminals can virtually take over the legitimate government through increased corruption.[70]

There are no doubts that regulator's goal is to minimise the ML which justifies opting for maximum AMLR considering that this is sending a strong message that carrying out crime is not worthwhile, thus creating ultimately a better society with reduced ML. The society will also benefit from lowered corruption levels and retained strong financial position, instead of allowing criminals to gain economic power. The government will indirectly save on spending public funds on law enforcement and health care which will certainly occur if criminals find the expanding of their operations relatively easy. Therefore, this implies that governments are incentivised to opt for maximum AMLR.

However, the AMLR incentives applicable to the government are not linking directly to the banking sector considering, for example, that reduced ML does not appear to be correlated to banks' increased profits. In fact, stringent AMLR means increased spending on AML compliance by banks, which costs rise proportionally to the severity of regulator's fines imposed for inadequate AML systems and controls. Of course, as the money is a scarce resource, in order to fund their AML compliance, banks will remain inclined to pass these costs to the end customer, for example, through higher borrowing rates and lower savings rates. Furthermore, the combination of significant AML costs and related hefty fines sometimes forces banks to withdraw their high cost maintenance perceived services from certain customer categories or from some jurisdictions in order to save on AML compliance expenditures.

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[69] Takats (n 6) p7.

[70] John McDowell, 'The Consequences of Money Laundering and Financial Crime' (2001) 6(2) 8 An Electronic Journal of the US Department of State <https://www.hsdl.org/?view&did=3549> accessed 11 August 2017.

Therefore, while in theory the maximum AMLR should produce the intended outcome with reduced ML and better society, by pushing banks over the cliff, this approach in practice creates a situation where banks deny whole society segments from banking services, which then means that the maximal AMLR inadvertently produces counter effective results.

A reasonable approach for creating conditions in which the optimal AMLR will be achieved, is thorough striking the best possible balance between the conflicting AMLR objectives and desired outcomes. This means that the regulator should not observe the AMLR effects in isolation, for example, by simply comparing the ML levels before and after increased AMLR but side effects on society and its individual members must also be taken into consideration. Concentrating the attention on particular system deficiencies tends to nourish the belief that any measure which removes deficiencies is necessarily desirable, diverting the focus from the possibility that some changes may well produce more harm than the original deficiency.[71]

Theoretically, there can be two AMLR extremes: first, a situation of non-existent AMLR and second, maximum AMLR. In the first scenario, the AML compliance costs are either nil, or minimal where banks have decided to implement certain level of AML controls, for example, for ethical reasons such as corporate social responsibility or similar. This position allows for increased criminal activity within given society and the ML levels pushing towards maximum.

The other extreme, which is the maximum AMLR, will impact banks through increased AML compliance costs considering that AML controls strength in such scenario are expected to be proportional to the AMLR intensity. This situation would imply diminishing criminal activities and ML levels tending towards minimum. However, when arriving to the optimal AMLR point, the three undesired outcomes that emerge under maximum AMLR situation should be taken into consideration: (1) AML compliance costs are passed from banks to the end customer via increased banking fees, (2) certain customer categories and jurisdictions/ regions are denied banking services which in addition to direct impact on the local population and the questionable ethical aspect, also triggers the third outcome, (3) the increased ML levels resulting from the shift towards unregulated underground banking systems by the customer segments denied official banking.

While there are no straightforward criteria according to which the optimal level of regulation could accurately be measured[72] and quantification of both the benefits and costs is rather challenging, in assessing the net AMLR burden, it is necessary to compare the incremental costs incurred less the marginal benefits realised as a result of the AMLR.[73] Hypothetically, the regulator should keep

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[71] Ronald Coase, 'The Problem of Social Cost' (1960) 3 Journal of Law and Economics 42-43.
[72] Bagheri and Nakajima (n 15) p11.
[73] Vivien Goldwasser, 'Current Issues in the Internationalisation of Securities Markets' (1998) 16 Company &

increasing the AMLR pushing towards maximum AMLR but they must stop at the point where the total AMLR costs, both the tangible AML costs created by the AMLR burden which is then transferred onto consumers via increased banking fees and the intangible social costs such as ones associated with prevention from banking, equalise the total benefits achieved, for example, decreased ML levels, stronger economy etc. This is the point where the optimal AMLR is reached.

Analogous to the economic law of supply and demand, the optimal AMLR point will fall at the point where the AMLR benefits curve intersects the AMLR costs curve, in which equilibrium the extent of achieved AMLR benefits is exactly the same as the AMLR costs, both tangible and intangible, as illustrated in the Table 1 below. The area in the graph south of the optimal AMLR point will mean inefficiency and unnecessary high ML levels prompting the regulator to keep increasing the AMLR until the optimal point, while the all positions north of the optional point mean existence of AMLR burden and undesired outcomes such as de-risking and its consequences. Therefore, the actual graph reflecting on the real terms ML levels will look like the one in Table 2 as despite the theoretically lowered ML levels at higher AMLR intensity, in reality, the de-risking triggered shift towards unregulated banking will in fact ultimately result in increased ML.

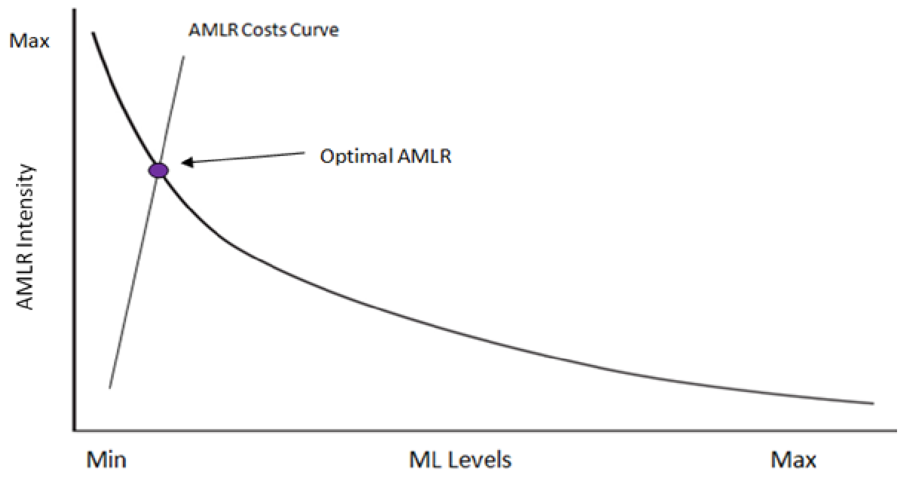

Table 1.

Securities Law Journal.

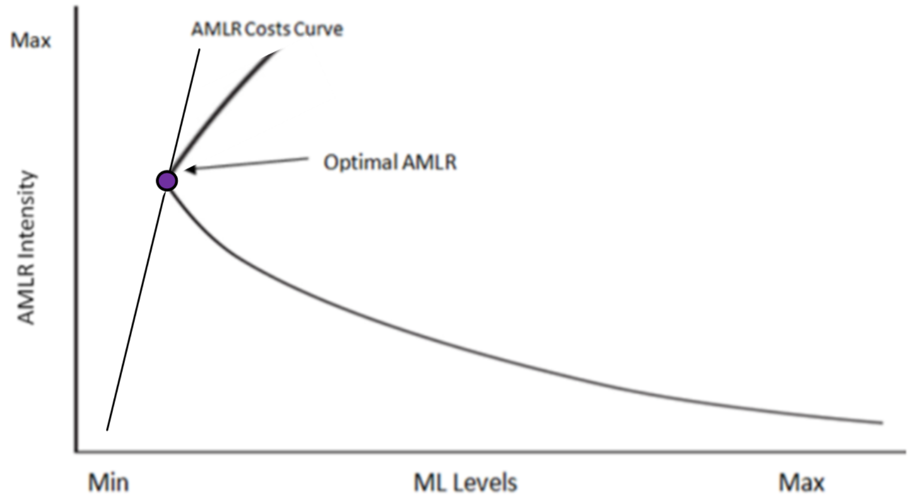

Table 2.

Similarly to the other developed economies, the current UK AMLR does not appear to be at its optimal AMLR point. In order to overcome this situation, it crucial to have closer cooperation and open discussions between the regulator and regulated sectors, in order for both parties to gain better understanding of each other's objectives. For example, banking sector should remain open-minded to the idea that tangible costs which sometimes may seem unjustified from economic aspect will produce results on long term, for instance, better society with lowered ML and more economic power for the law abiding citizens, which in turn should create potential for banks to benefit themselves from increased business activities. At same time, the regulator should look into the bigger picture in respect of the more stringent AMLR creating objectives vs. outcomes conflict and being counter effective if the net AMLR burden in reality forces banks towards de-risking, which then adversely affects society through exclusion of some customer categories from the official banking. This will also push affected parties towards the underground banking, therefore ultimately resulting in increased potential for ML, which then defeats the original purpose of the AMLR.

Understanding each other's objectives, including the potential side effects, supported with cost-benefit analysis carried out by both the regulator and banks (albeit the costs and benefits quantification challenges) will create positive conditions for the optimal AMLR to emerge. In their cost-benefit analysis, the regulator has to take into account the secondary effects of the AMLR intensity adjustments, before any changes take place, also including the parameters for imposing penalties and the severity of fines imposed for AML non-compliance. The banking sector should abandon any blanket approach practices and must to reject any short-termism but should instead take into consideration the long term effects, such as increased future business profits, before making any decision for AML compliance costs reduction.[74]

[74] Wilkins (n 45).

7. Conclusion

The complex constellation of AML/CTF legislation and regulation creates challenging conditions for the financial institutions, often forcing them to opt for unpopular practices which in turn have significant negative impact on certain customer categories, populations and jurisdictions or whole regions. The de-risking practice is one of the collateral damages resulting from the increased regulatory focus on certain areas.

While de-risking can occur for various reasons, it is evident that excessive regulatory pressure coupled with the high compliance costs is nourishing this practice. Whole regions in different parts of the world are sometimes denied banking services, which indirectly creates conditions for increased rather than reduced global ML. This is because the affected parties will almost certainly shift towards unregulated, underground money transferring systems. Furthermore, the ultimate outcome also means that large populations in certain jurisdictions, who are dependent on funds sent from abroad, will end up struggling for satisfying their basic living needs such as food and medicines, which brings the social aspects into the de-risking equation.

The paradox of the regulators condemning banks for their withdrawal from certain customer categories, including sometimes whole business sectors and entire regions, while imposing in parallel hefty fines for inadequate AML/CTF systems and controls even where no ML or TF have occurred, must be addressed through close engagement of both parties. The optimal AMLR should reconcile the total social benefits achieved, such as lowered global ML, with the restrictions faced by large populations in some regions or certain customer segments whose rights must not be adversely affected by excessive AMLR.

The only reasonable way forward is for constructive on-going discussions to take place between the regulators and banking sector, for example, by forming commissions or a body entailing both parties that will steer the cooperation until mutually acceptable solution is reached. Otherwise, if not tackled as a matter of urgency, considering the significant transactional shift from the official banking sector towards the unregulated money transfer systems, in addition to the other direct and secondary adverse effects, the de-risking problem has all the attributes for generating systemic risk.

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