Circular on De-risking and Feedback from Recent AML/CFT Examinations

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Characteristics of an Effective System

► Risk assessment processes should be able to differentiate risks of Financial Institutions and DNFBPs; understand the nature and level of their money laundering and terrorist financing risks; allow AIs to develop and apply AML/CFT policies (including group-wide policies), internal controls, and programmes to adequately mitigate those risks; apply appropriate CDD measures to identify and verify the identity of their customers (including the beneficial owners) and conduct ongoing monitoring; adequately detect and report suspicious transactions; and comply with other AML/CFT requirements.

► This ultimately leads to a reduction in money laundering and terrorist financing activities within these entities.

Guiding Principles of RBA

► **Risk differentiation**
  ► Risk assessment processes should be able to differentiate risks of individual customers within a particular segment or grouping

► **Proportionality**
  ► AIs should apply proportionate risk mitigating and CDD measures based on the likely risk level of a customer

► **Not a "Zero Failure" regime**
  ► AIs are not required to implement overly stringent CDD processes with a view to eliminating, ex-ante, all risks

HKMA's circular on "De-risking and Financial Inclusion" dated 8 Sep 2016

Risk-based Approach to CDD

A risk-based approach helps the CDD process by determining the level of information required based on the results of customer risk assessment. However, it is:

► not implemented by some AIs at all, and
► no discernible difference between CDD and EDD in some cases

Q1:

Is there any requirement to have a HK business address? Does the HKMA mandate any specific type of address proof for verifying business address?

A1:

► No. Business address can be in HK or overseas and the HKMA does not mandate any specific type of address proof for verifying business address.

► AIs should not apply requirements which will form a potential barrier, such as accepting only one form of address proof, in verifying the business address.

► AIs are expected to take reasonable measures to verify the business address of a customer.

FAQs

Q2:

Does the corporate applicant need to provide a Hong Kong business registration certification (BRC) at the time of account opening?

A2:

► Depends on applicant - *a BRC may not be applicable to every customer* and some customers may therefore be unable to produce one.

► Some overseas corporations may not be required to register under the Business Registration Ordinance.

► Further information relating to business registration in Hong Kong may be obtained from IRD's website.

FAQs

Q3:

Are there any specific CDD requirements for start-ups and SMEs?

A3:

► No. HKMA requirements are generic to all corporates and comparatively high level in order to provide flexibility to AIs to apply them to different types of customers.

► AIs should ensure that design and implementation of their CDD requirements reflect both the operation and profile of these companies.

  ► MLROs play a key role

FAQs

Q4:

Do AIs need to establish source of wealth for every customer?

A4:

► No. The HKMA does not require AIs to establish source of wealth for each and every customer.

► Reference should be made to the HKMA's training materials in January 2016.

Q5:

Is it a requirement to have all directors and beneficial owners present at account opening?

A5:

▶ No. The presence of two or more, or all directors or beneficial owners at the time of account opening is not required by the HKMA.

Q6:

Are AIs required to take additional CDD measures if a company is incorporated offshore or has foreign directors or beneficial owners?

A6:

► AI's on-boarding process should recognise that offshore establishment and non-resident directors etc. are common profiles for many corporates seeking banking service in an IFC, like HK.

► Applications for account opening should not be rejected merely because the customer is incorporated offshore or the beneficial owners or directors of a corporate customer are non-residents.

► AIs should understand the rationale why a particular type of business relationship is sought, taking into account the customer's business model or mode of operation.

FAQs

Q7:

Do all documents have to be certified by a certifier, or one that is based in HK?

A7:

► No. Generally, where a customer is not physically present or unable to produce an original document, AIs may consider accepting a copy of the identification document which is certified to be a true copy by a suitable certifier.

► A list of suitable certifiers provided in the AMLO Guideline is non-exhaustive, allowing AIs to accept other independent and reliable certifiers where appropriate to do so.

► There is no requirement that a certifier must be physically present in HK.

Customer Risk Assessment

When assessing a customer's ML/TF risk, AIs should:

▶ take a holistic view of the ML/TF risk factors they have identified

▶ consider a range of risk factors, including country risk, customer risk, product / service risk and delivery / distribution channel risk

Customer Risk Assessment

When using risk scoring methodology with weighting on risk factors, AIs should ensure:

► weighting is not unduly influenced by one factor (e.g. nationality / place of incorporation)

► weighting should not lead to a situation where it is impossible to be classified as high risk

► an informed judgment about the relevance of different risk factors is made

► automatically generated risk scores could be overridden where appropriate *but rationale should be recorded properly*

► risk rating is not influenced by profit consideration

Customer Risk Assessment

When AIs utilise scoring system from an external service provider to calculate risk scores for customers, AIs should:

► understand the system logic and how factors are combined to generate overall risk scores

► ensure the system can cater for their business operations and risk profiles

► be able to demonstrate that scoring reflects their understanding of the risks

Example – *requires enhancement*

Bank A assessed risk at customer level using a scoring system purchased from an external service provider:

- The system used a range of risk factors with weighting to calculate the final risk scores and risk ratings of customers
- Excessive weighting was given to a single risk factor – assets under management (AUM)
- The system only considered a customer's nationality / place of incorporation to assign risk scores for country risk
- The system only offered a few options in the list of businesses to calculate scores on customer risk

Resource Adequacy often Drives Effectiveness of Implementation

► Known weaknesses should be clearly articulated

► Is more always better?

   ► More does not always mean more effective

► Effectiveness is about risk mitigation

   ► Adequately and appropriately prioritised allocation of resources against key risks

   ► Based on identification, assessment and understanding of risks

   ► Should be at the heart of board's actions and thinking

      ► not "what does HKMA expect?"

► See also "Putting risk-based in AML – The Road Ahead" dated 25 Sep 2015 on http://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/aml-cft/HKIB_Speech.pdf

"more" and "effectiveness"

► The HKMA recognises that
  ► reforms that would increase costs and a need for resources would NOT automatically increase effectiveness; and
  ► an increase in resources is NOT always possible

► Experienced MLROs / Compliance Officers have an important role to play in "adding value" but we do not always see:
  ► a proactive role
  ► the ability to apply resources and effort in the right spots
  ► must be prepared to demonstrate these qualities – should not spend whole time fire-fighting

Example

Bank B's transaction screening system was ineffective:
- Inadequate coverage of designated parties database
- Lack of validation of system before implementation
- Ineffective matching algorithm (e.g. no fuzzy logic)
- Inappropriate threshold setting without assessment record (e.g. exceptionally high matching threshold of 99%)
- Inappropriate filtering rules
- System did not support the screening of Chinese commercial codes but no manual processes to address this shortcoming

Example

Branch C's transaction monitoring system was ineffective:

- Adoption of the system from Head Office without validation before local implementation
- No adequate review of thresholds and parameters
  - Must take into account different local characteristics of business lines and customer types
- Adoption of inappropriate score deduction function in alerts generation
- Rely on Head Office to perform periodic review of the system (without considering the local context)

Adverse Information Handling

► Use of negative or adverse news as a source of financial intelligence aids customer screening and risk assessment purposes

► Increasingly useful / important part of AML Model / means to identify higher risk activities or relationships

► Can be applied before a relationship is established and periodically, on a risk-based approach, over the course of the relationship

► Robust policies, procedures and oversight are essential

Example

Bank D utilised an online screening tool to identify adverse information associated with the Bank's customers but:

- Coverage lacking in some areas: cost consideration
- Lack of policies and procedures overseeing adverse information and handling adverse information alerts (e.g. review scope and completion timeframe)
- Insufficient documentation of justification in alert closure
- Lack of quality assurance check / compliance review on alert handling

AI recognised the importance of adverse information and established this in its AML/CFT system, <u>but effectiveness could be further enhanced</u>
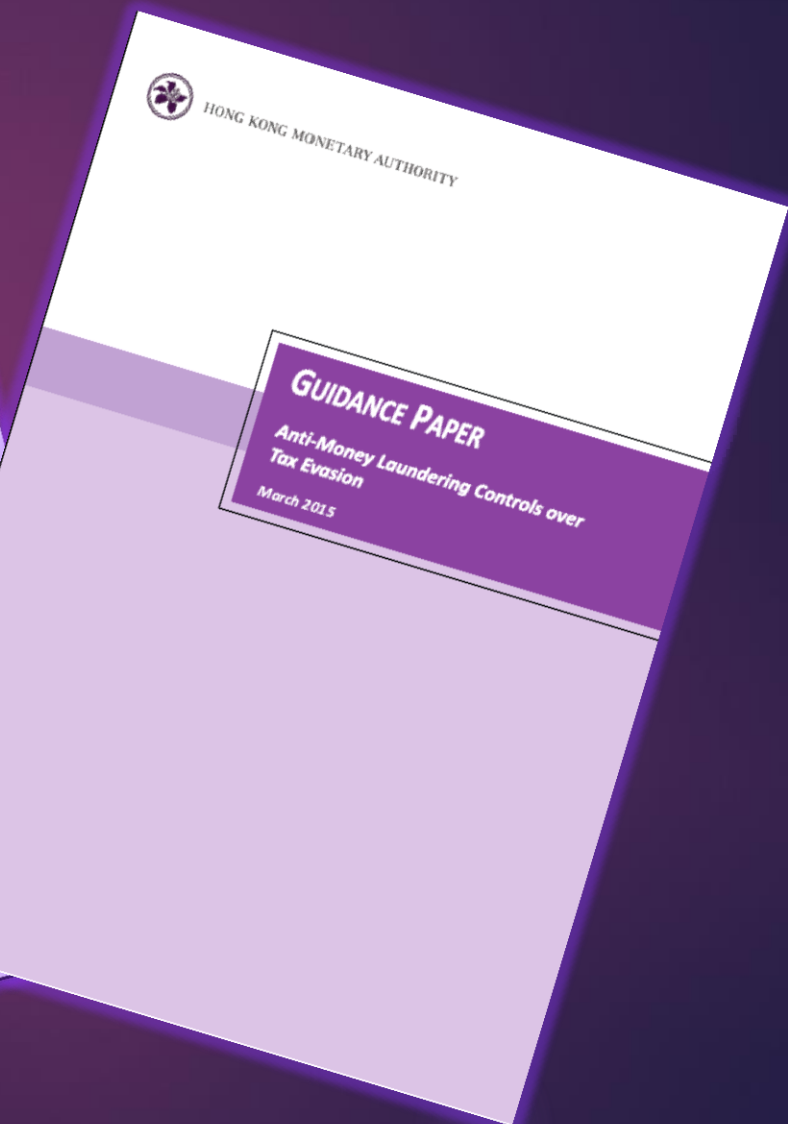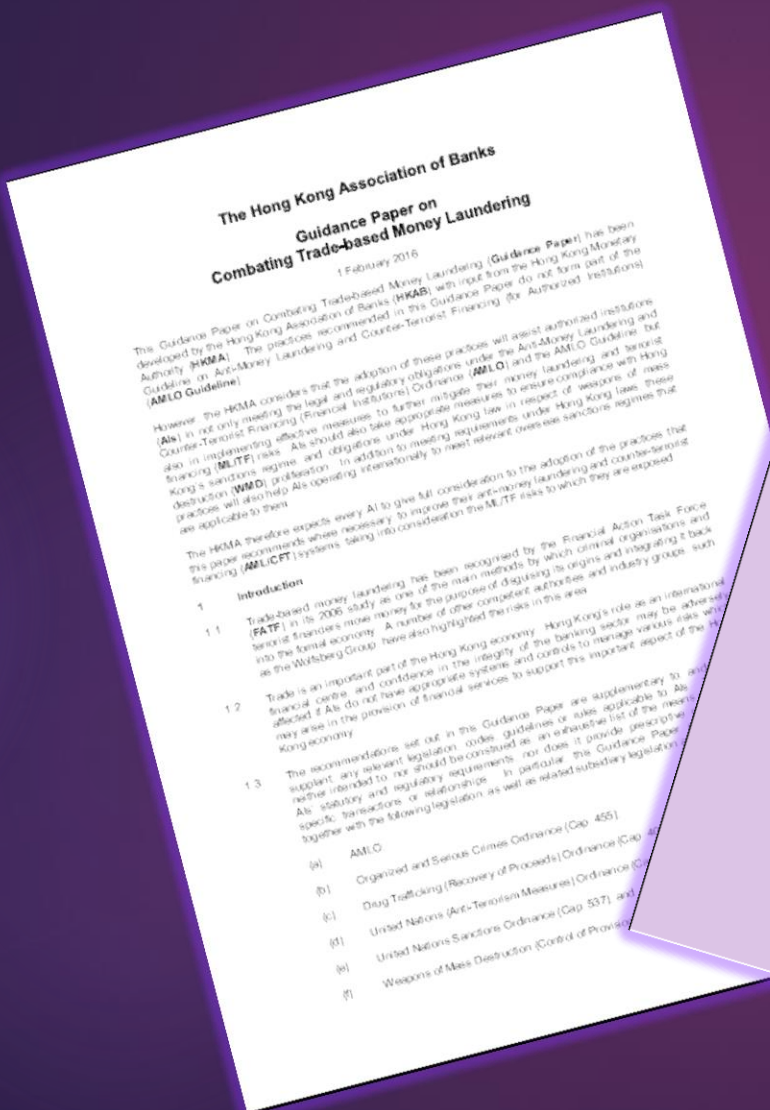
Internal Audit

► Effectiveness of Internal Audit Reviews

► Frequency & scope of reviews must address Bank's risks

► Findings of recent IA and compliance reviews on AML controls often do not drive change

> ► Quality issues or information not discussed at sufficiently senior level

► Inconsistency in implementation of remedial measures

► **Conclusion**: not all AIs' approach of reviewing effectiveness of AML systems is comprehensive

Q & A