HOW TO BUILD AN AML COMPLIANCE PROGRAM IN 3 SIMPLE STEPS

The 3 Step Approach to Building an Effective AML program

Creating, implementing, and maintaining and effective AML compliance program is key for organizations to prevent money laundering and to assure compliance with applicable AML regulation. Now, there is definitely no single approach that fits all organization just alike, but there are some general elements to consider. These elements are most commonly the foundational building blocks for an effective AML compliance program.

But first things first. You might wonder what an AML compliance program actually is. Basically, an AML compliance program is everything an organisation does related to money laundering prevention. This can include things such as processing policies, accounts monitoring and detection, and reporting of money laundering incidents. The aim of an AML compliance program is to expose and correctly react to the inherent and residual money laundering risk.

Usually, an AML compliance program is based upon some important factors that determine the size and scope of the program. This is important because, before creating a compliance program to battle money laundering, an organization has to analyze and draw up its potential risks and legal obligations.

1. First of all, the organizations needs to determine the risks it is exposed to.
2. Secondly, it needs to consider the applicable AML laws in their jurisdiction and fines for non-compliance
3. Lastly, it needs to have a rough idea of how possible suspicious activities could look like that indicate potential money laundering.

These are at least the very basic considerations for building an effective AML program.

3 Step Approach

If this yet sounds a little bit too overwhelming, don't worry. In the following, we will go through something which can be called a step-by-step guide to build and implement and effective AML program. It comprises of three simple steps that will guide you towards the development of an effective AML compliance program.

Step 1: The first step is to create the right organizational environment, where you should consider the corporate culture, have the senior management to support AML compliance, and make it a strategic priority.

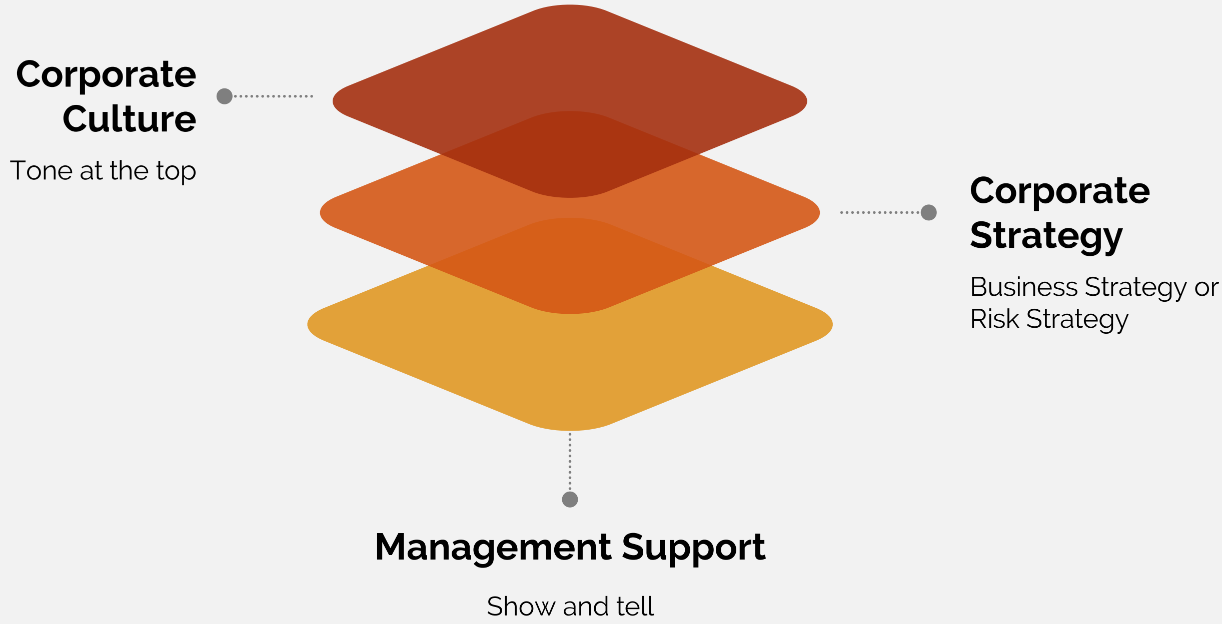
Step 3: The third step is to implement organizational measures to encounter the risks that you have identified for your organization.

Step 2: The second step is to conduct an AML risk assessment. This is done to get a holistic overview of the money laundering risks the organization is exposed to and that it can act upon.

Step 1:

Creating the right organizational environment

The first step in building an effective AML Compliance program is to have or create the right organizational environment. This organizational environment requires three important elements, which are organizational culture, strategic priorities, and management support. Let's go through them individually.



Corporate Culture

Firstly, we should always be aware of the fact that people are at the center of it all. Nearly all cases of money laundering scandals and misconduct have one thing in common: it is usually individuals or a group of individuals who failed in their function, or at least did not act as resolutely as they should have. In most cases, the likely motivation is the sales culture of the institute on which targets and ultimately monetary compensation are based. No one is denying that an organization must make money in order to remain in the market. What is more difficult is the decision whether or not to deal with existing or potential clients with a high risk profile. The conflict of interests between economical and regulatory aspects is obvious: let's call this the organization's risk appetite.

What has this to do with corporate culture you might ask? The short answer is that behavior determines culture, and behavior can be adjusted to be in line with the company's risk appetite.

To build a sound AML compliance culture and incorporate it into the daily business, the leadership of the organization must clearly and transparently communicate corporate culture and expected behavior. This is also commonly referred to as the tone at the top. The leadership needs to deal with money laundering on a regular basis and significant cases of non-compliance in terms of money laundering violations should be brought to its attention.

Corporate Strategy

The second element is to bring AML to paper as part of the organization's business or risk strategy, because everything holds up on paper. The strategy needs to clearly articulate the strategic risk appetite of the organization as well as the corporate culture and behavior that is expected towards achieving this risk appetite. It is also important to remember that this document must be available at a place that is accessible for all people that are part of the organization.

Management Support

The third element to create the right organizational environment is management support. This is important, because the managers of the organization need to implement the tone from the top in daily business and to make sure that the tone is adhered to. Messages from the management should be unambiguous and pitched at a level understood by all – not corporate jargon that baffles and bemuses the worker bees. Most of all, management needs to practice what they preach. In terms of visibility, this means attending training with the troops and be seen to be engaged.

Step 2:

Conducting an AML risk assessment

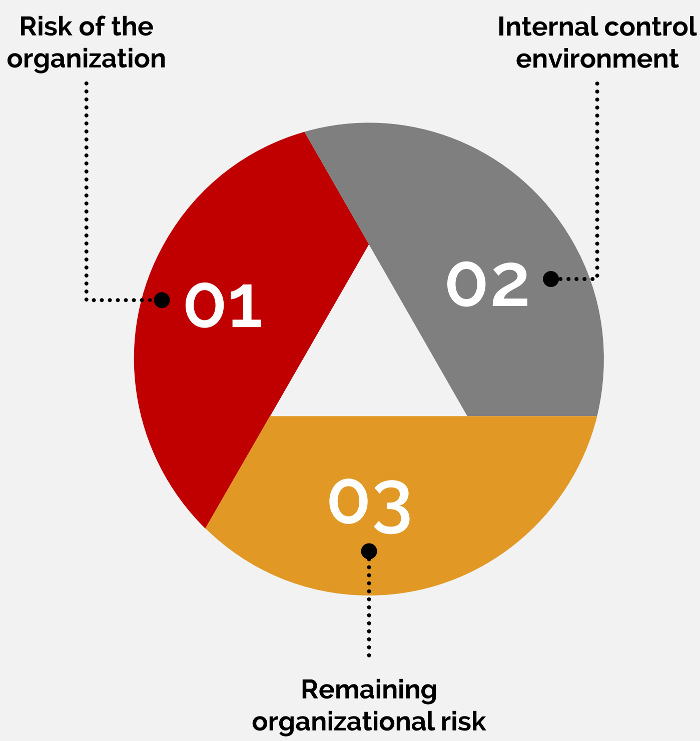
The second step in building an effective AML program is to conduct a money laundering risk assessment. This is important, because an organization have an overview of the specific AML risks it may be exposed to and it needs to be aware of potential deficiencies. But let's be more precise.

The AML risk assessment serves three objectives:

Objective 1: The first objective is very obvious; it is identifying the general and specific money laundering risks an organization is facing.

Objective 2: The second objective is determining how these risks are mitigated by the organization's AML program controls. Having said this, this would obviously require to already have some sort of AML controls in place. If your organization does not have any controls in place yet, this would basically mean that the degree of AML risk mitigation is zero and that is about time to get cracking.

Objective 3: The third objective is establishing the residual risk that remains for the organization. Now what's the residual risk? You have the AML risk, you have certain measures that mitigate that risk to some degree, and what remains after applying the measures is the residual risk.



3 Steps to perform an AML Risk Assessment

So how do you perform an AML risk assessment. There are numerous ways of how to do this, which differs across organizations and across industries. However, there is a conventional logic behind them and we will look at a general approach that can be used to conduct a money laundering risk assessment. As a general rule, the money laundering risk assessment should cover the entirety of the organization's business, but it may be conducted in parts, or as part of a rolling cycle with a particular focus.

Now the AML risk assessment is performed in 3 phase. Phase 1 is to determine the inherent risk, phase 2 is assessing the internal measures, and phase 3 is to derive the residual risk.

Step 1: Identifying the inherent risk

Let's explore about determining the inherent risk.

The inherent Risk represents the exposure to money laundering risk in the absence of any control environment being applied.

In order to identify the inherent risk, assessments across numerous risk categories are commonly undertaken, depending on the organization. Common categories include Clients, Products and services offered, Distribution channels, Geographies of doing business in, and something that is usually called other qualitative risk factors

Let's spend a word or two on these exemplary risk factors that might be assessed.

Clients

Let's start with Clients: For the purposes of assessing the inherent money laundering risk of a business division, unit or business line, the client base and business relationship should be assessed. A number of Client types, industries, activities, professions and businesses, alongside other factors can increase or decrease money laundering risks. The following categories can be used to stratify the client base and to identify aspects of client risk: client type, ownership, industry, activity, profession and business.

Products and Services

Next up are Products and services: The volume of product types offered by the business and associated KPIs should be determined or estimated. The product types should then be assigned a risk category. For example, low money laundering risk, moderate money laundering risk, or high money laundering risk. This data can then be utilized to determine what percentage of each product type are rated according to the risk classification. You might for example see that 25% of your products have a moderate money laundering risk.

Delivery Channels

Then we have channels: Some delivery channels can increase money laundering risk because they increase the risk that the identity and activities of the clients can be disguised. Consequently, it should be assessed whether, and to what extent, the method of account origination or account servicing could increase the inherent money laundering risk.

Geographies

Next up are geographies: Identifying geographic locations that may pose a higher risk is a core component of any inherent risk assessment. Doing business in certain geographic locations can be associated with a higher risk of money laundering. For the geographic risk evaluation, you can use lists from the FATF or other organizations.

Additional Risk Factors

Last but not least, additional risk factors can have an impact on operational risks and contribute to an increasing or decreasing likelihood of breakdowns in key AML controls. Qualitative risk factors directly or indirectly affect inherent risk factors. For example, significant strategy and operational changes, or opening in a new location may affect the inherent risk.

Step 2: Evaluating the internal measures

Let's move on to phase 2 of the money laundering risk assessment. Once the inherent risks have been identified and assessed, internal controls must be evaluated to determine how effectively they offset the overall risks. Controls are programs, policies or activities put in place by the organization to protect against the materialization of a money laundering risk. These controls are also used to maintain compliance with applicable AML regulation. AML controls are usually assessed across different control categories. Typical categories may include Corporate Governance, Policies and Procedures, Monitoring and Controls, Employee Training, as well as Detection and SAR filing. Each of these areas is assessed for overall design and operating effectiveness.

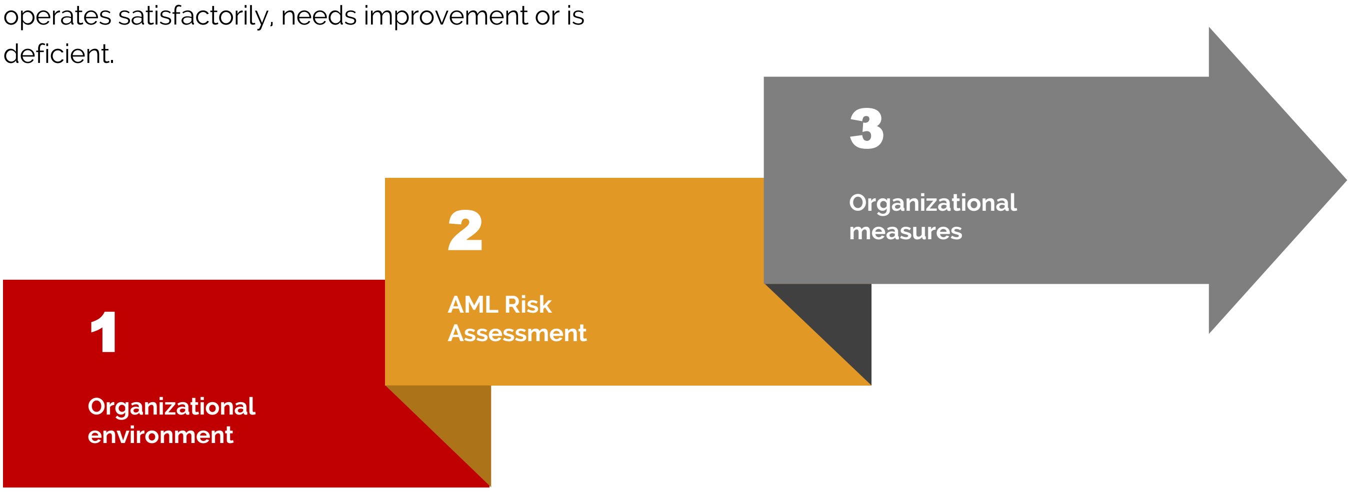
There may be both a positive or negative indicator of control execution and these should be clearly documented in order to assess the operating effectiveness of each control.

Let us make an example: For Training, there will be a number of elements required to be present within an effective training framework. As such, the control assessment will focus on each of these elements, such as whether staff training needs have been assessed, whether specialist training is provided for key roles, or whether training is being completed on time. These elements require the organization to assess whether each element operates satisfactorily, needs improvement or is deficient.

The results for each control category are associated with a score, which reflects the relative strength of that control. Each category can then be assigned a weighting based on the importance that the institution places on that control. What comes out at the bottom will be used in Phase 3.

Step 3: Determining the residual risk

Okay, so once both the inherent risk and the effectiveness of the internal control environment have been considered, the residual risk can be determined. Residual risk is the risk that remains after controls are applied to the inherent risk. It is determined by balancing the level of inherent risk with the overall strength of the risk management controls. The residual risk rating is used to indicate whether the money laundering risks within the organization are being adequately managed.
It is general practice to apply a 3 tier rating scale, to evaluate the Residual Risk on a scale of High, Moderate and Low. Any rating scale could also be used, for example a 5 point scale of Low, Low to Moderate, Moderate, Moderate to High, and High. But a 3-tier rating scale is really the most common.



Using the AML Risk Assessment Results

Now that you have performed an AML risk assessment and have the results, what do you do with them? They can be used in an organization in many different ways. Here are the top 5:

1. First of all, they can be used to identify gaps or opportunities for improvement in AML policies, procedures and processes.
2. Second, they can be used to develop risk mitigation strategies including applicable internal controls and therefore lower the residual risk exposure.
3. Third, they can be used to make informed decisions about risk appetite and implementation of control efforts, the allocation of resources, and technology spend.
4. Next, they can be used to ensure senior management are made aware of the key risks, control gaps and remediation efforts.
5. And last, they can be used to ensure regulators are made aware of the key risks, control gaps and remediation efforts across the organization.

Step 3:

Implement organizational measures

Now the third and last step to build an effective AML compliance program is to implement organizational measures. And hereby, we make use of the results of step 2. We use the results of the money laundering risk assessment to identify gaps or opportunities for building and improving organizational measures.

In practice, it is very much an iterative process. If your organization is just starting out with building an initial AML program, or has had one in place for many years there are four basic pillars that should be considered. These are internal policies, procedures, and controls; a designated compliance function; an independent audit function; and ongoing employee training program;

We will explore about each of these pillars a little bit more detailed, so that you have the basic knowledge to design an effective AML compliance program.

Pillar 1: Policies, Procedures, and Controls

Let's start with internal policies, procedures, and controls. The establishment and development of an organization's policies, procedures and controls are really the foundation to a successful AML program. Together, these three parts define and support the entire AML program, and at the same time, act as a blueprint that outlines how an organization is fulfilling its regulatory requirements.

All three parts should be designed to mitigate the identified AML risks and should take into account the applicable AML laws and regulations that the organization must comply with.

Policies

First of all, an overall AML policy should be formalized in a written document and validated by the organization's leadership. The policy should contain a chapter dedicated to money laundering risk management. This chapter should outline three points: The maximum money laundering risk tolerance; the guidelines to be followed when defining the money laundering risk management procedures; and the internal counter measures and controls.

Procedures

Secondly, the internal procedures should be in line with the AML policy. It is recommendable that the procedures cover basically all the essential money laundering procedures.

The top 5 areas that you will see covered in the organizations' procedures are

1. How to conduct the Money laundering risk assessment
2. Customer and transaction due diligence measures
3. Analysis of atypical customer behavior and reporting requirements
4. Embargoes, sanctions, and trade
5. Internal whistleblowing

Controls

Lastly, organizations should implement an internal control system to monitor compliance with AML procedures. This internal control system should be proportionate to the nature and extent of the organization's activities. This system, which may take multiple forms, should also be adapted to the risk classification established by the organization. The internal control system should cover all activities that could potentially expose the organization to money laundering risks and should apply to the entire AML system. It should contain at least the following three elements:

- Checks relating to the activities of the operational services and departments
- Checks relating to the activities of the compliance or AML function
- And Checks relating to third-party business introducers or subcontractors

Pillar 2: Compliance AML Function

This actually brings us right to the second pillar of an effective AML program, which is the compliance or AML function.

AML programs should appoint a designated principal compliance function including a mainly responsible compliance officer. This compliance officer must be responsible for overseeing the general implementation of AML policy within their organization.

AML Compliance Officers should have sufficient experience and authority within their organization to ensure they can perform their duties effectively. Those duties include communicating with authorities and auditors, briefing senior management, and making AML policy recommendations based on audits and reports. It goes without saying that AML compliance officers should be experts in the legislative requirements of their local environment.

Pillar 3: Independent Audit

Now the third pillar of an effective AML program is somewhat related to this: An independent audit function. An effective AML compliance program should build in a schedule of independent testing and auditing. Independent testing should be mandated to take place every 12-18 months, although organizations working in particularly high-risk areas might consider a more frequent schedule than that. The audit function can either be internally or externally, but whatever is chosen to test AML compliance, it must be qualified to conduct a risk-based audit that is appropriate to the organization.

Excursus: The 3 Lines of Defense
Before we move on to the last pillar, this is actually a good time to briefly explore about the three lines of defense. The three lines of defense is a concept used in the wider field of corporate governance, compliance and risk management. So in order for an organization to design an efficient risk management system, the processes used to control the company risks should be interconnected in a holistic system. This three lines of defense model does exactly that; it integrates the main roles and responsibilities of the internal control system of the company in a consistent system. Because money laundering is a risk, the three lines of defense concept is also commonly applied here.

The 1st Line of Defense
In the first line of defense the operative management is confronted with risks in daily business operations which have to be controlled. This line is responsible for the identification and assessment of these risks as early as possible and the setting up of effective control measures to prevent the risks from occurring.

The 2nd Line of Defense
The second line of defense is a function which primarily monitors the control activities of the first line of defense. In most organizations, this is the Compliance unit and this is also where the AML function should be.

The 3rd Line of Defense
The third line of defense is the function that is carrying out internal audits. They ensure the reduction of risk based on the highest level of independence and objectivity within the company.

Pillar 4: Employee Training Program

The fourth pillar to consider for an effective AML compliance program is employee training. While every employee within an organization should have a working knowledge of AML procedure, specific employees will bear greater responsibility for the implementation of its AML compliance program. It may be appropriate for an organization to implement a base level of training for all employees, and add further, targeted training to those with more AML-specific responsibilities. Therefore, in a manner similar to creating an audit and testing schedule, an AML compliance program should ensure that those employees receive regular training, and know how to perform assigned duties.

Checklist: Building an effective AML Compliance Program

- **Establish** a strong tone at the top and commitment to compliance
- **Appoint** a compliance officer to ensure that you have adequate resources
- **Prepare** risk assessments for customers, products and services
- **Develop** policies and procedures that outline roles and responsibilities
- **Conduct** training and communicate frequently about risks
- **Establish** regulatory change management program to track new regulations (coordinate with industry groups such as DATA and Bitcoin Foundation)
- **Audit** programs at least annually (further testing may be needed)
- **Create** procedures for exceptions and escalating risk incidents
- **Develop** relationships with regulators, prepare for examinations.
- **Provide** ongoing reports to management, boards, and investors.

Example: Designing an AML Risk Assessment Matrix

Impact

Likelihood

	Negligible	Minor	Moderate	Significant	Severe
Very Likely	Low Med	Medium	Med Hi	High	High
Likely	Low	Low Med	Medium	Med Hi	High
Possible	Low	Low Med	Medium	Med Hi	Med Hi
Unlikely	Low	Low Med	Low Med	Medium	Med Hi
Very Unlikely	Low	Low	Low Med	Medium	Medium