Enhanced Customer Due Diligence

ADVISORY / FINANCIAL SERVICES

AUDIT ▪ TAX ▪ ADVISORY

Prof. Dr. Peter A.M. Diekman RA
Aruba, 16 November 2010

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Banking requirements

- **Main requirements are laid down in:**
  - The 40+9 FATF Recommendations (1990/2002)
  - Customer Due Diligence for Banks – BCBS, October 2001
  - 3rd EU Directive on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing of 26 October 2005
  - The 1992 Annunzio – Wylie Anti Money Laundering Act
  - The 2001 US PATRIOT Act – more in particular Title III "International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001"

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Basel Committee on Banking Supervision

- Main document is “*Customer Due Diligence for Banks – BCBS, October 2001*”

- Basic principles:

A. Thorough client identification and on-boarding process
B. Transactions monitoring and transaction filtering
C. Ongoing KYC updates
D. Robust risk management

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Basic Principles - Thorough client identification and on-boarding process

- Applies to all kind of clients
- Basis for Knowing the Customer
- Dynamic in nature and must therefore continue after on-boarding process
- Different requirements for different purposes...

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Identification requirements

Natural Persons

•legal name and any other names used (such as maiden name);

•correct permanent address (the full address should be obtained; a Post Office box number is not sufficient);

•telephone number, fax number, and e-mail address;

•date and place of birth;

•nationality;

•occupation, public position held and/or name of employer;

•an official personal identification number or other unique identifier contained in an unexpired official document (e.g. passport, identification card, residence permit, social security records, driving licence) that bears a photograph of the customer;

•type of account and nature of the banking relationship;

•signature.

Corporate Entities

•name of institution;

•principal place of institution's business operations;

•mailing address of institution;

•contact telephone and fax numbers;

•some form of official identification number, if available (e.g. tax identification number);

•the original or certified copy of the Certificate of Incorporation and Memorandum and Articles of Association;

•the resolution of the Board of Directors to open an account and identification of those who have authority to operate the account;

•nature and purpose of business and its legitimacy.

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Basic Principles - Thorough client identification and on-boarding process

Client due diligence means taking into account all those factors that the bank needs to determine whether a client is and remains acceptable to the bank. The assessment must be risk-based and sufficiently extensive for the bank to be able to form a reasonable belief and to be confident that it:

- Knows its client;
- Has insight into the nature and background of the client and their (commercial) activities;
- Is aware of the existence and identity of beneficial owners and beneficiaries (if any);
- Has no reason to believe that the client's funds and assets have an illegitimate source;
- Has insight in the client's needs for products and services;
- Knows which risks it runs in order to manage those risks appropriately.

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Basic Principles - Thorough client identification and on-boarding process

Minimum procedures with regard to Client Due Diligence:

- Internal client on-boarding written procedures
- No account opening prior to completion of CDD
- Clearly described deviation and emergency procedures
- Each account (clients) must have a relationship owner – avoid “orphan” accounts
- Regular training and education of staff (particularly client-facing staff)
- Clear and well defined definitions of high, medium and low risk
- Clear escalation procedures to higher levels of management
- Written instructions for enhanced client due diligence procedures
- Clear instructions regarding the responsibilities of client-facing staff and the compliance function
- Procedures for knowing the customer of the bank’s customers (second ring of customers)

- Procedures for CDD in connection with correspondent banking

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Basic Principles - Thorough client identification and on-boarding process

Minimum procedures with regard to Client Due Diligence:

- Enhanced due diligence regarding high risk clients

  - Enhanced due diligence must be imposed on a risk sensitive basis
  - Increased number of board members must be identified and screened
  - Identification of Ultimate Beneficiary Owner (UBO) and other main shareholders
  - In-depth understanding of the client's business
  - Understanding of the prospective use and purpose of the account
  - Ultimate decision making on account opening and on-boarding of the client to be made by senior management

  - Enhanced due diligence by default when politically exposed persons (PEPs) are involved as owners of board members

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Basic Principles - Transactions monitoring and transaction filtering

Minimum procedures with regard to transaction monitoring and filtering:

- Define client profiles for each client account
- Client profiling must be audited for accuracy and appropriateness
- Have software in place enabling the monitoring of all transactions on all accounts
- Clear follow up and escalation procedures on hits
- Procedures ensuring confidentiality of reporting of unusual transactions to FIU
- Management information (MI) on monitoring hits
  - MI on (false) positive hits
  - MI on follow up actions
  - MI on consequences for client risk categorisation
- Clear procedures for exiting clients whose profile or transactions give rise to suspicion of money laundering or terrorist financing

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Basic Principles - Transactions monitoring and transaction filtering

Minimum procedures with regard to transaction monitoring and filtering:

- Screening of all payment transactions against latest and most accurate screening lists issued by Central Banks and Government
- Audit of accuracy of screening lists
- Strict written procedures for filter hits ensuring freezing of money and reporting to FIU
- Regular management information (MI) about hits
  - MI on number of hits divided into positive and false positive hits
  - MI on escalation and decision making
  - MI on consequences of client risk categorisation
- Clear procedures for exiting clients whose profile or transactions give rise to suspicion of money laundering or terrorist financing

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Basic Principles – Ongoing KYC process

Minimum procedures with regard to ongoing KYC process:

- A diligent process in place to ensure regular update of the KYC with deadlines regarding the re-assessment of clients
- Clear deadlines for re-assessing the clients’ risk profile
- A system in place ensuring diligent monitoring of the clients’ reputation and activities
- Regular meetings with clients to update the client information

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Basic Principles – Robust risk management

Minimum procedures with regard to robust risk management:

- Primary focus on:
  - Reputation risk
  - Operational risk
  - Legal risk and
  - Concentration risk
- Effective KYC procedures form a pivotal part of risk management
- Internal audit must independently evaluate the quality of risk management

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Correspondent Banking

Issues regarding Client Due Diligence

- **Ultimate beneficiary and/or originator of the transaction is (are) unknown**
- **Reliance must be placed on due diligence conducted by other banks**
- **How does the bank protect its own integrity in regards of money laundering and terrorist financing?**

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Correspondent Banking

- **Correspondent and respondent banking is**

  - Entering and maintaining a relationship with other banks
  - Entering into a relationship with other banks is not very different from engaging with a new client
  - A critical review is warranted with regard to
    - The other bank's reputation
    - The law and regulations in the country of domicile
    - The latest FATF country review for the country of domicile
    - Other sources of information about the bank and the country of domicile

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Correspondent Banking

Reliance to be placed on other banks

- **Since the bank cannot perform its own client due diligence it must rely on the due diligence performed by the correspondent bank**
  - Monitoring of correspondent bank's ongoing reputation
  - Monitoring of transactions initiated by correspondent bank
  - Perform filtering of each transaction against latest filter lists issued by Central Banks
  - Regularly review the relationship with correspondent banks and determine if the relationship can be pursued

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Correspondent Banking

Protecting integrity

- Do not maintain correspondent / respondent banking relationships with banks whose reputation is at stake

- Remain critical with regard to countries of domicile
  - Critical FATF reviews
  - Bad press
  - Change of political situation
  - Known reputation for illicit business

This may result is closing the correspondent banking relationship

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Monitoring and filtering

Important features of monitoring and filtering

- **Client profiling**
- **Transactions monitoring**
- **Transactions filtering**
- **Reporting of unusual transactions**

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Monitoring and filtering

Client profiling

- Normal client behaviour
- Highly predictable
- Changing behaviour over time
- Setting appropriate parameters

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Monitoring and filtering

Monitoring

- **Outlier detection**
- **Message screening**
- **Sequence analysis**
- **Analysing links between clients**

This may result in filing an unusual or suspicious transaction report with the FIU

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Monitoring and filtering

Filtering

- **Application of the latest filters**
- **Certain transactions are prohibited as a result of international law and regulations**
- **Freezing of amounts**

This may result in filing an unusual or suspicious transaction report with the FIU

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