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New Zealand AML/CFT compliance – A year in...

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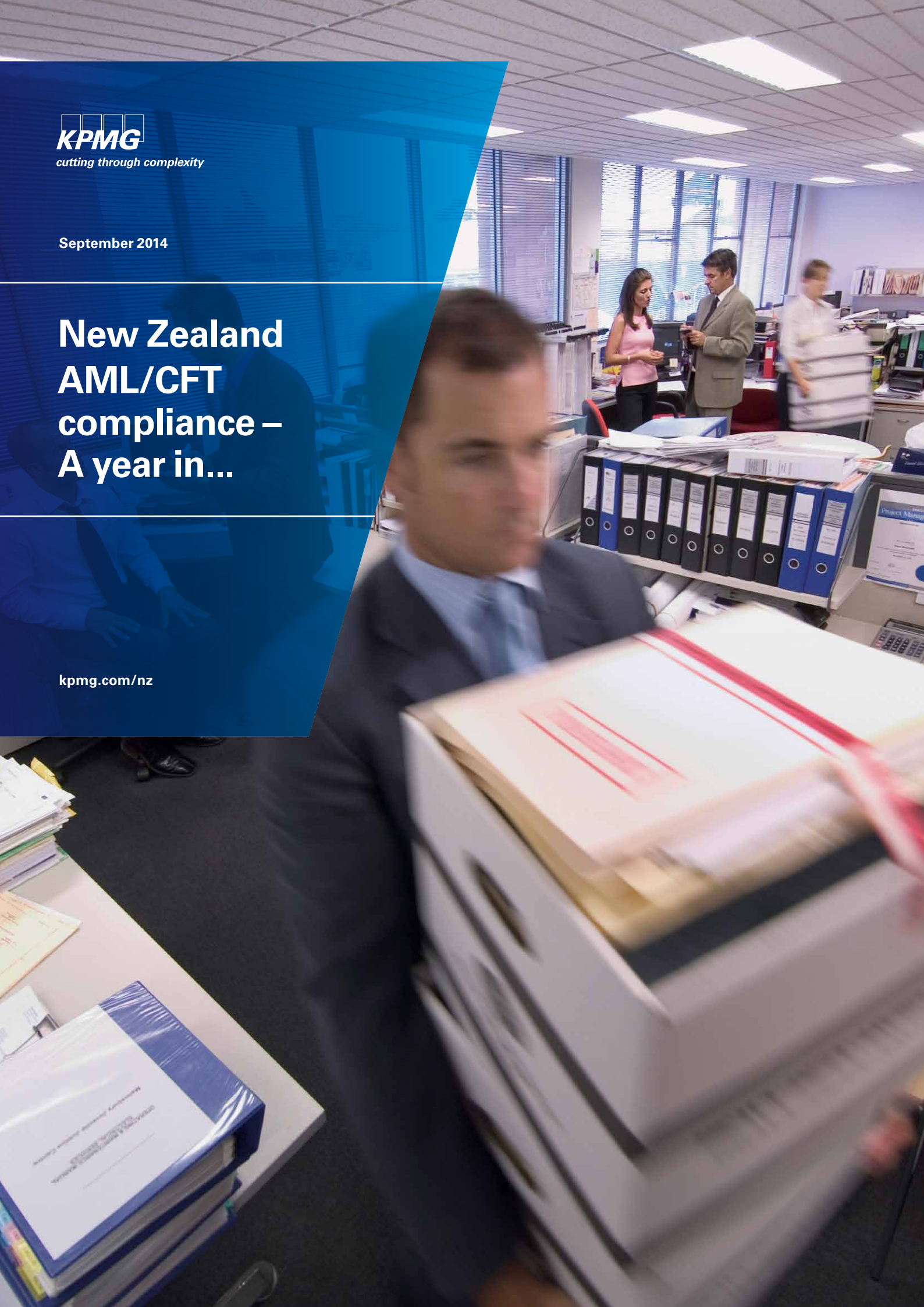

NZ AML/CFT COMPLIANCE A YEAR IN

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New Zealand's Anti-Money Laundering and Countering Financing of Terrorism (AML/CFT) regime has now been in operation since 1 July 2013. For REs, this has demanded significant management attention to ensure policies are followed. Many REs have found the journey difficult, requiring a complete overhaul of policies and procedures and significant changes in their approach to compliance.

As the anniversary passes and the annual reporting deadline approaches, REs would be well-served to learn from their own experiences and that of their peers over the last twelve months. Consideration should be given to what is on the regulatory radar both internationally and in New Zealand.

We understand Sector Supervisors are preparing reports to highlight findings from supervisory inspections and discussions. Through a watchful eye REs should be able to determine supervisors' areas of focus, expectations and problematic areas. Experience overseas shows REs are much better prepared when they embrace findings from thematic papers that enable them to benchmark existing policies and practices. We anticipate this is our supervisors' expectation in issuing them.

In the last twelve months KPMG assisted a significant number of clients by helping them to build their AML/CFT programme and risk assessment, delivering audits, and responding to supervisory findings. From this work we have seen examples of good and marginal practice, as well as identified specific areas that have proven problematic for clients. We provide our thoughts on some of these areas.

> "REs ARE MUCH BETTER PREPARED WHEN THEY EMBRACE FINDINGS FROM THEMATIC PAPERS ENABLING THEM TO BENCHMARK EXISTING POLICIES AND PRACTICES"

[1]http://www.kpmg.com/NZ/en/IssuesAndInsights/ArticlesPublications/Pages/Anti-Money-Laundering-2014.aspx

THE INTERNATIONAL VIEW

In the past year we have seen the continuation of strong regulatory enforcement, particularly related to failures around correspondent bank activity and core AML controls. A number of regulatory investigations have drawn attention to significant gaps in KYC information, including knowledge of beneficial ownership and source of funds or wealth. Regulators abroad have made clear the need to drill down to who owns and controls a client structure or arrangement, and expect entities to look through the layers where ownership is complex. Our 2014 Global Anti-Money Laundering survey identified this as a significant challenge to REs.

As regulators continue to apply a risk-based approach to their supervision, inspections globally have tended to focus on business relationships that expose the entities to a higher risk of money laundering. Reviews to determine whether entities have a robust method for determining risk and applying it to their business relationships have been popular with the risks inherent in Politically Exposed Persons (PEPs) attracting scrutiny. With the continued political instability, this is likely to remain on their radar.

This regulatory attention has resulted in financial institutions reducing their risk appetite and 'de-risking' their business with examples where banks have exited higher risk relationships such as PEPs or customers resident in 'higher risk' countries or industries. This highlights the trend for REs to factor in the incremental compliance costs of a proposed relationship or book of business to the decision of whether to on-board a customer.

Also piquing the interest of international regulators are money laundering risks related to trade finance transactions, as tighter controls in traditional channels have enabled criminals to exploit vulnerabilities in this sector. Thematic reviews and regulatory studies by organisations such as Financial Action Task Force (FATF) have pointed to the need to focus on this sector, starting with increased training and risk assessments within this line of business.

"IN THE PAST YEAR WE HAVE SEEN THE CONTINUATION OF STRONG REGULATORY ENFORCEMENT"

THE NEW ZEALAND VIEW

From our work with RE's we summarise our observations over four key areas of compliance:

Risk Assessments

We saw several good examples of risk assessments clearly demonstrating that REs had put real thought into understanding the money laundering risks in their business. This was particularly apparent where the RE provided an outline of their methodology and actions to assess the risk.

A number of clients listed scenarios that are commonly accepted to be higher risk, but did not utilise corporate data to demonstrate how this specifically applied to their business. For example, a blanket statement that politically exposed persons and customers sourced through non face-to-face channels presents little value without reference to corporate data identifying whether the risk exists within the business. Where detail is lacking, it will be difficult to understand how an assessment would actually impact the elements within the programme.

We also saw examples where risk assessments were in 'draft' form, undated, and/or lacking any sort of version control. This could easily prompt supervisors to query whether the document had completed its review process and been formally adopted. Version control helps to monitor changes and demonstrate that a RE is regularly reviewing and updating its risk assessment.

Client Due Diligence

The Client Due Diligence (CDD) requirements have become significantly more onerous and complex. At its core the obligations permit RE's to apply a risk-based approach. This necessarily requires front-line staff to apply subjective judgements to the circumstances and documentation presented by clients. Nevertheless, a number of REs appear to have copied and pasted regulations into their CDD procedural documents without providing any guidance to front line staff on how those judgements should actually be applied. In talking to operational staff at a number of RE's it was apparent that many individuals found this lack of clear direction difficult, which could result in substandard CDD being performed.

Similarly, proper management of the REs' exception process is crucial to providing compliant CDD. REs with specific requirements for forms of acceptable documentation need to have a contingency plan for situations where a client is unable to fulfil those requirements. If a RE has policies regarding acceptable documents to prove residential address or identify beneficial ownership, for example, it may be appropriate to accept alternative forms of documentation or in limited scenarios 'defer' verification subject to the requirements in section(s) 18(3) and 24(3) and the prohibition under section 37. For several clients, it was evident that exceptions were being granted by compliance officers for business convenience rather than as exception.

"A NUMBER OF REs APPEAR TO HAVE COPIED AND PASTED REGULATIONS INTO THEIR CDD PROCEDURAL DOCUMENTS"

For deferrals, it was evident that the RE's did not have a process to follow up and ensure the 'deferred' documentation had been obtained.

CDD is a cornerstone of the AML/CFT obligations, and without appropriate control of the exception/deferral process, a RE will erode the value of its procedures and expose it to the risk of non-compliance.

The prescription provided by the Identity and Verification Code of Practice has been both a benefit and hindrance to some entities. On one side of the coin, clarity enables entities to be definitive within their procedures and assurance. A number of entities have created identity "certification certificates" to help ensure certification meets the prescribed requirements. On the other side, however, some REs have found the prescription difficult where customers are on-boarded by overseas affiliates for account opening purposes internationally. As a result, identity documentation provided to open accounts in New Zealand has often fallen short of the Code of Practice, particularly the requirement to link the certification to the named individual (i.e., presenter).

Where entities have been required to identify and sometimes verify source of wealth or funds, the clients we worked with appeared to be making their best endeavours to do so. This particular requirement demands significant judgement and has been a common factor for overseas regulatory enforcement action. From our review work and significant experience overseas, we make four observations to help entities demonstrate they have taken, 'meaningful measures' to understand their customers' source(s) of wealth or funds:

1. Entities should actively document what they understand the source(s) of wealth or funds to be and provide supporting documentary evidence as the basis for reliance. Expecting supervisors to piece together and make inferences from 'snippets' of information often buried amongst client file documentation is fraught with risk.
2. Internal file notes detailing source(s) of wealth or funds are good practice.
3. Where there are red flags and/or obvious inconsistencies between the understood wealth or funds and the client's income, the entity should apply appropriate challenge through enquiry or research.
4. Client reluctance or difficulty in obtaining required information has not been accepted as a defence.

While there is no 'right answer' for every customer circumstance, REs must ultimately be able to demonstrate how they became comfortable that the customer's that the source(s) of funds or wealth is legitimate.

Transaction Monitoring

The obligation to monitor accounts and transactions to identify unusual or suspicious activity has been approached in different ways by various REs.

"CDD IS A CORNERSTONE OF THE AML/CFT REGIME, AND WITHOUT APPROPRIATE CONTROL OF THE EXCEPTION/ DEFERRAL PROCESS, A RE WILL ERODE THE VALUE OF ITS PROCEDURES"

Some larger organisations identified the scale of the obligation early on and spent considerable time and investment sourcing and implementing electronic solutions, often via transaction monitoring (TM) solution providers. This process has resulted in some frustration, as new TM solutions are often incompatible with the old disparate and disjointed legacy systems that are found within many larger financial institutions.

Other REs with suitable IT resources decided to design and build their own TM system. While some abandoned these projects early on, choosing instead to install off-the-shelf products, others persevered and managed to create a basic and functional product that generally does not have the benefits of the commercial software, such as case management functions and full auditability. With some of these in-house systems the absence of a testing environment to review different triggers and parameters has created challenges for a number of REs with the production environment being used to alter different alert generating scenarios.

In terms of avoiding supervisory attention in this area, the rationale for disposition of alerts is key. RE's will also need to justify how their alert parameters align to their ML/TF risks and would be advised to have this documented with their alerts subject to regular review rather than trying to do it, 'on the fly' when asked during an inspection.

Assurance

Supervisors have shown particular attention to ensuring the RE has adequate and effective policies and procedures in place to monitor compliance with a firm's programme. Entities should document their approach to assurance and be able to demonstrate compliance through provision of evidence such as management reports, assurance reports, and control testing output. The focus and extent of testing should obviously be aligned to the entity's risks and proportionate to their operations – what is expected from a large bank will be quite different to that of a small financial adviser.

It is evident to us that supervisors are particularly interested in the level of awareness or engagement around AML/CFT compliance by senior management. We observed good examples where clients were able to evidence oversight through governance committee minutes. Encouraging management to 'front up' and fully engage during inspections was seen as one way to demonstrate their commitment.

"SUPERVISORS HAVE SHOWN PARTICULAR ATTENTION TO ENSURING THE RE HAS ADEQUATE AND EFFECTIVE POLICIES AND PROCEDURES IN PLACE TO MONITOR COMPLIANCE WITH A FIRM'S PROGRAMME"

NEW ZEALAND SUPERVISORY APPROACH

The three supervisors have been actively engaging in desk-based reviews and onsite inspections to assess REs' compliance with the legislation. We have seen evidence of firm action for significant breaches. Where entities had self-identified, communicated and demonstrated active remediation at the time of an inspection, supervisors appear to have rightly considered this to be mitigating factor in the subsequent report.

Our overall impression of the supervisory approach so far is that they have used the first 12 months to identify and better understand their pool of REs while educating REs on expectations and consequences for future non-compliance. While supervisors may not agree, it is our opinion that there has been something of an initial grace period for some significant issues while entities shored up their processes and policies.

Both KPMG and our clients have found that all three supervisors have been available for consultation for both formal and informal guidance. They have been active in consultations with participants to assist with the development and adoption of practical processes, for example, the recent consultation on Managing Intermediaries.

One consequence of the new regime and consistent with international experience is that our big banks appear to be de-risking their books by closing or declining relationships in areas where they have traditionally welcomed business, for example remitters. This on the face of it appears to be a commercially-driven decision due to incremental compliance costs relative to the returns they generate. For these small businesses that may act as a key financial link to many families around the Pacific, closure of accounts are terminal, despite the business investing in often fully compliant AML/CFT programmes.

Another observation is that the supervisors are asserting 'sovereignty' in their reviews of businesses that are a small arm or subsidiary of a larger international business. Where international policies are adopted and AML/CFT functions outsourced, it is evident that the supervisors expect the New Zealand reporting entity to demonstrate that New Zealand obligations are met and show how local management gain comfort. Where assurance is sought from colleagues overseas REs would be well served to ensure the reviewer has a detailed knowledge of New Zealand obligations.

"WE HAVE SEEN EVIDENCE OF FIRM ACTION FOR SIGNIFICANT BREACHES"

THE YEAR AHEAD

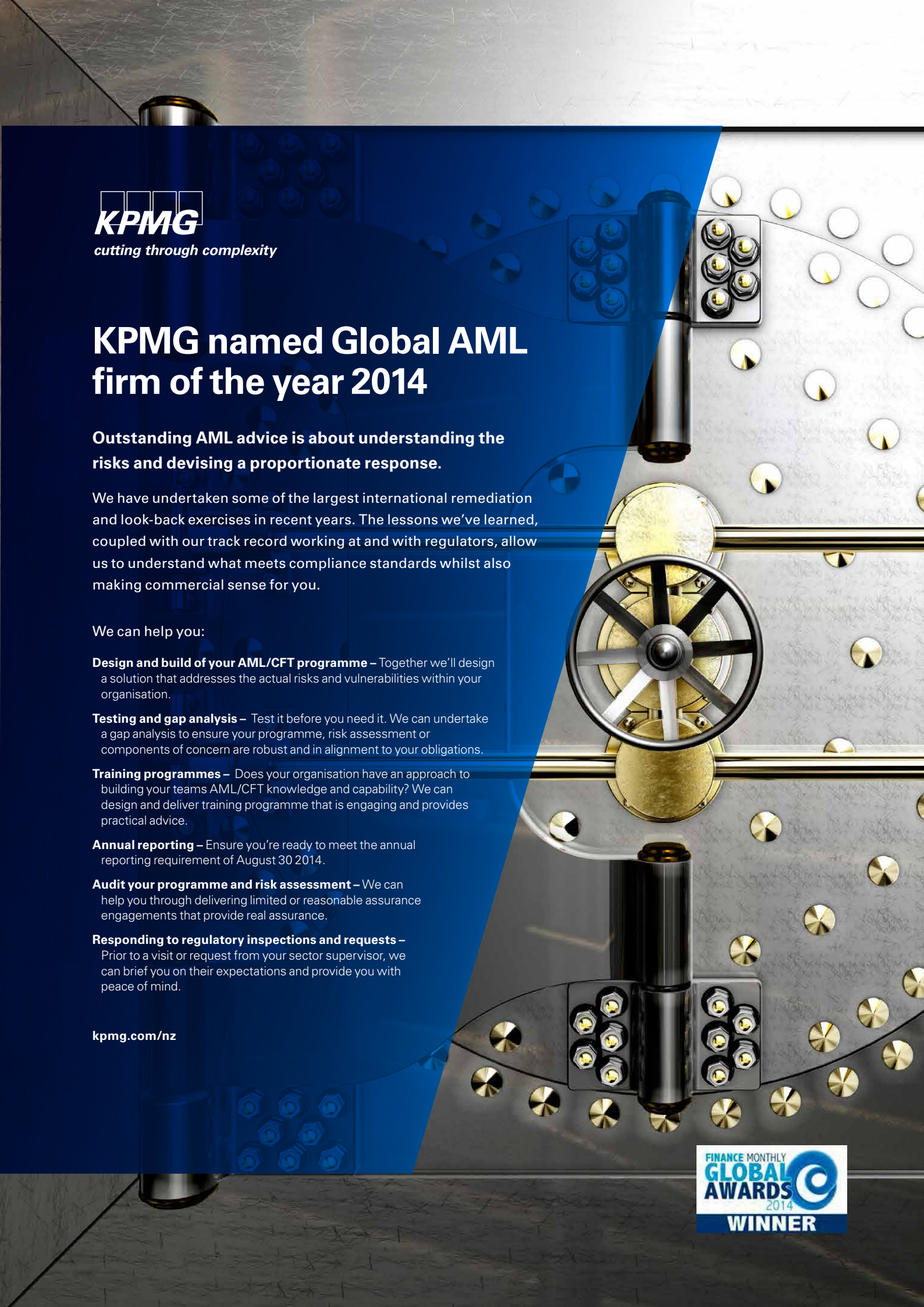
Based on our experience and communication by the supervisors we expect the next 12 months to be marked by more intrusive inspections, particularly around testing of CDD files. Where first year inspections have found significant breaches, REs would be well advised to ensure that remediation programmes have been completed or are in advanced stages. As raw annual return data and the results from audits are turned into meaningful intelligence, the supervisors are also likely to become more risk-focused in their inspection approach.

In future, we anticipate supervisors will be more 'forensic' in their assessment by probing how policies and procedures have been effectively operationalised. REs should not take comfort from desktop policy reviews, but instead 'look under the bonnet' and see how the program is working in practice.

"WE EXPECT THE NEXT 12 MONTHS TO BE MARKED BY MORE INTRUSIVE INSPECTIONS"

About the Author

Gareth Pindred has an LLB and is a chartered accountant. Gareth spent seven years in the New Zealand Police before joining KPMG London in 2005 where he helped reporting entities comply with their AML/CFT obligations. He has particular specialisation in delivering remediation engagements having led client due diligence projects in the United Kingdom and offshore jurisdictions. Gareth joined the New Zealand firm in 2013 where he has leveraged his remediation experience to help clients bring a focused, proportionate approach to compliance.



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KPMG named Global AML firm of the year 2014

Outstanding AML advice is about understanding the risks and devising a proportionate response.

We have undertaken some of the largest international remediation and look-back exercises in recent years. The lessons we've learned, coupled with our track record working at and with regulators, allow us to understand what meets compliance standards whilst also making commercial sense for you.

We can help you:

Design and build of your AML/CFT programme – Together we'll design a solution that addresses the actual risks and vulnerabilities within your organisation.

Testing and gap analysis – Test it before you need it. We can undertake a gap analysis to ensure your programme, risk assessment or components of concern are robust and in alignment to your obligations.

Training programmes – Does your organisation have an approach to building your teams AML/CFT knowledge and capability? We can design and deliver training programme that is engaging and provides practical advice.

Annual reporting – Ensure you're ready to meet the annual reporting requirement of August 30 2014.

Audit your programme and risk assessment – We can help you through delivering limited or reasonable assurance engagements that provide real assurance.

Responding to regulatory inspections and requests – Prior to a visit or request from your sector supervisor, we can brief you on their expectations and provide you with peace of mind.

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FINANCE MONTHLY GLOBAL AWARDS 2014 WINNER

Any questions? If you have any questions on NZ AML/CFT Compliance, our team would be happy to help.

Please feel free to contact:

Stephen Bell
Lead Partner Forensics, Advisory
T: +64 (09) 367 5834
E: stephencbell@kpmg.co.nz

Gareth Pindred
Associate Director, Advisory
T: +64 (09) 363 3633
E: garethpindred@kpmg.co.nz

Michal Amzallag
Associate Director, Advisory
T: +64 (09) 363 3218
E: mamzallag@kpmg.co.nz

kpmg.com/nz