

READY OR NOT?

NAVIGATING THE DFS 504 RULE

An aerial photograph of a runner in a blue and black uniform crossing a finish line on a red track. The runner is in a dynamic pose, with arms and legs spread wide. The track has white lane markings and large white numbers (8, 9, 5) visible. A blue geometric shape is in the top left corner.

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INTRODUCTION

Institutions supervised by the New York Department of Financial Services (NYDFS) face a big hurdle in April as they submit for the first time under the new DFS 504 rule to certify that their BSA/AML¹ transaction monitoring and OFAC² sanctions screening programs are up to scratch. The new rule imposes a much higher level of rigor, and the annual submission³ exposes boards of directors and senior officers to a heightened risk of personal liability, in addition to the very sizeable fines that non-compliant institutions may face.

This is a big exercise and it is critical to get it right. Keys to success include: demonstrating that the core AML transaction monitoring and sanctions screening capabilities are fit for purpose, positioning and effectively communicating the program to the regulator, and ensuring that senior management and key personnel are sufficiently well-informed and educated.

It's also important to ensure the first certification process fits well into the institution's longer-term strategic response. After months of preparation, institutions face several immediate and medium term concerns as the first filing date approaches. Three key questions that firms should be asking are:

- A. Are we well positioned to achieve compliance by April 2018?
- B. What are the key competencies we must demonstrate?
- C. How do we best position and plan for beyond the April 2018 submission?

Given the principles-based nature of the rule, there is no one-size-fits-all approach. However, there are common threads applicable across institutions. In the immediate term, banks must carefully navigate how to demonstrate compliance while acknowledging continuing enhancement efforts; this includes consideration of the full suite of activities across the BSA/AML and OFAC programs. Looking forward, banks have the opportunity to leverage tactical enhancements undertaken as part of the regulatory response to establish longer term, strategic capabilities.

¹ Bank Secrecy Act/Anti-Money Laundering

² Office of Foreign Assets Control of the Treasury Department

³ The new rule requires that financial institutions regulated by the NYDFS submit either a board resolution or senior officer compliance finding to certify compliance with the NYDFS regulation by April 15, 2018; and on an annual basis thereafter

CHARTING A COURSE TO SUCCESS

A. ARE WE WELL POSITIONED TO ACHIEVE COMPLIANCE BY APRIL 2018?

Firms should have a good view on the key changes that are absolutely required to be compliant with DFS 504 rule by April. What constitutes “good enough” for each program component will differ across institutions and depend largely on the AML compliance risk profile and risk tolerances of the institution, given the composition and complexity of its particular business.

The compliance program should be thoroughly documented including the results of a program diagnostic and a demonstration of current core AML compliance. The program diagnostic should include the review of all technical capabilities and processes to demonstrate progress achieved and indicate all substantial compliance risks are currently addressed. A demonstration of core AML compliance competencies should consider all program components and aim to highlight areas of particular strength.

For the resolution/attestation itself, institutions must simultaneously demonstrate compliance while establishing plans for continued improvement. Striking the right balance between these objectives requires careful communication and clear articulation of institution-specific issues. Planned enhancements should ideally be positioned as part of the continued evolution of an already robust program, and should be seen as the opportunity to bolster capabilities and to leverage tactical enhancements into longer term, strategic capabilities.

Demonstrability is critical. Senior management needs to be well-informed to be able to attest to the robustness of the program. This applies not only to the core AML compliance team but to critical stakeholders in risk, analytical functions and the business. Management should reflect on the technical and operational work that has been done and consider whether documentation and governance is of a sufficiently high standard to ensure that there is a realistic and consistent understanding of the current program status. It is not enough to answer only “Are you ready?” Institutions must also have compelling answers to the follow-up question of “How do you know?”

In the run up to April 2018, a carefully crafted narrative and well thought-through communication strategy, informed by a good understanding of regulatory expectations and current market practice, will likely be critical in best positioning the program for success. There is a fine balance to be achieved between demonstrating progress on the one hand and proactively recognizing challenges and weaknesses on the other. *Leadership needs to ask if they are sufficiently informed and educated about the program to have confidence that the organization can demonstrate the capabilities on which they are signing off?*

B. WHAT ARE THE KEY COMPETENCIES WE MUST DEMONSTRATE?

The challenges that DFS 504 compliance poses are very much dependent on the risk profile and capabilities of each institution. In addition to facing a compressed timeline, institutions have to work with finite compliance budgets and resources to operate their on-going “business as usual” compliance program while addressing the new requirements of DFS 504.

An institution must demonstrate core competencies across all dimensions considered within the program diagnostic. For AML **transaction monitoring**, this includes considerations of where issues originate so they can be addressed at the source, starting from those posing the most severe risks to the efficacy of their programs. Similarly, for **sanctions/OFAC**, this includes consideration of where issues related to filtering and screening programs originate to prioritize those posing the most severe risks. Programs must demonstrate that an end-to-end review and testing both demonstrates reliability and does not uncover substantial weaknesses.

Some key questions related to the **transaction monitoring** program include:

1. Is the **AML risk assessment** based on a well-developed approach and methodology that takes into account the institution’s risk profile, including but not limited to customers, products, services, businesses and geographic location?
2. Does **risk identification** leverage scenario analyses and workshops to complement standard industry sources of AML risk information in order to identify the full range of AML risks and inform scenario design drivers?⁴
3. Is the **incorporation of risk assessment and risk identification** findings to transaction monitoring programs constructed on a risk-based framework and linked directly to the risk-profile of the institution?
4. Is **data collection** aligned with business-specific AML needs and based on established sources that provide correct and extensive customer, account, and transaction information to better identify and address potential BSA/AML violations and suspicious activity?
5. Is **customer and account segmentation** based on a rigorous approach to improve transaction monitoring accuracy by leveraging KYC data effectively to appropriately identify groupings of customers or accounts sharing similar profiles or behaviors?
6. Is **customer and transaction risk scoring** refreshed frequently based on behavioral/transactional information, warning triggers and inputs from the end-to-end process (e.g. feedback from AML investigator reviews)?
7. Does **transaction monitoring model development and calibration** accommodate all relevant data sources and embed risk models more cohesively into scenario design, combining quantitative and qualitative approaches to fulfill business and regulatory requirements?
8. Is there **ongoing review of scenarios** including above and below the line threshold testing and robust validation/governance to analytically verify that current transaction monitoring tools reliably identify relevant activity?

⁴ The Oliver Wyman report “Finding A Needle In A Haystack: The Case For Rethinking And Upgrading Anti-Money Laundering Transaction Monitoring” provides some further insights on ensuring a robust risk identification process to feed into transaction monitoring scenarios

9. Does **alert processing and investigative operations** have the necessary data, interfaces and tools to effectively investigate suspicious activity and minimize time spent on low-value, low risk activities?

The AML transaction monitoring program relies on having clear linkages between each stage of the process: risks identified should be clearly addressed by robust models and scenarios, these in turn should generate output that is reliably escalated and reviewed by surveillance operations, and the highest quality SARS possible should be reported in a timely manner.

Some key questions related to the **sanctions/OFAC** program include:

1. Are there **comprehensive and up-to-date lists** covering all of the relevant customer types and segments, including a robust process and governance to update lists on a regular basis and to certify that screening for relevant individuals and entities is not missed?
2. Is there reliable **identification and verification of beneficial owners** of legal entity customers to ensure the beneficial owners are included as part of the customer list to be screened?
3. Are **customer data feeds** integrated into a robust data warehouse including screening algorithms and rigorous end-to-end systems assurance and SLAs?
4. Is there sufficient **transparency and testing of matching algorithms** including regular performance monitoring and validation, and robust processes and governance?
5. Are there robust **investigation processes** that allow for limited discretion and include an SLA framework differentiated by process and business unit that supports regional business needs?
6. **Are four-eye QC checks** implemented to ensure high risk decisions are verified within the investigation process, combined with an operationally independent risk-based QA to test both decision outcomes and matching engine operations?
7. **Are there automated reports** covering end-to-end processes to demonstrate the use of KPIs in management processes, including the ability to support ad hoc requests and documented action plans if tolerances are not met?

The most critical aspects for sanctions/OFAC are: to ensure that comprehensive lists are in place commensurate with the business and risk profile of the institution; to maintain sufficient data quality, integrity and completeness; and to ensure matching algorithms are sufficiently robust and well-explained.

It is unlikely that many programs will meet all of these criteria at the outset and indeed it is recognized that the adoption of a risk based approach will require evolution through time. *Leadership needs to ask if the core capabilities are "good enough" and how the organization should position around known challenges and weaknesses?*

C. HOW DO WE BEST POSITION AND PLAN FOR BEYOND THE APRIL 2018 SUBMISSION?

As institutions start to put the finishing touches on a Board Resolution or Compliance Finding, it is important to include a well-developed DFS 504 compliance plan beyond the 2018 submission date. Often, response programs will have been executed as one-off exercises, rather than developed as a part of robust, repeatable processes. It is important that the capabilities developed are leveraged as part of an ongoing improvement plan to ensure the institution remains up-to-date.

Establishing a robust target operating model helps in setting the direction of the overall program and in prioritizing initiatives to improve efficiency and effectiveness. The target operating model should build on existing capabilities and areas of core strength. A detailed action plan, including deadlines and key milestones, should address gaps between the current state and the future state. Additionally, the target state should include periodic testing and validation of data/systems and new compliance initiatives, as well as an ongoing assessment of program capabilities.

Business-as-usual considerations should include:

1. **Periodic reviews of transaction monitoring and filtering programs** to reflect changes to the institution's risk profile based on results from the BSA/AML & OFAC risk assessments and applicable rules and regulations, and to determine whether the systems continue to be suitable for the institution or require material improvement to update or redesign.
2. Sufficient **program oversight by the Board of Directors and Senior Management** through MIS reporting and periodic briefings by senior compliance personnel. Compliance officers should be prepared to rationalize additional funding and investments in people, systems and technology as part of the compliance budget planning process for ongoing compliance of DFS 504.
3. **Data reconciliation** between source data and transaction monitoring and filtering programs to ensure data accuracy, integrity and quality across systems. Designation of a dedicated person or group to develop and execute a periodic data testing plan and gap assessment is recommended. Gaps identified through the data testing plan should be remediated in a timely matter.
4. **Training and education** of all relevant stakeholders is critical to ensure the long term success of the compliance program. Specialized training to members of the Financial Intelligence Unit (FIU) on updated transaction monitoring and OFAC policies and procedures ought to take place with sufficient regularity and intensity, and aim to create a culture of compliance and awareness, ensuring that all changes are cascaded throughout the organization.

It is essential that the requirements of DFS 504 become embedded in business as usual to avoid the necessity for time consuming and costly sprints directly before the annual submission and retro-fitting of short term tactical solutions without proper strategic coordination and governance. *Leadership needs to ask if they are dedicating the proper attention and the right resources to ensure the organization is well positioned to build a solid DFS 504 compliance framework beyond the first submission?*

MOVING FORWARD

The stakes have never been higher for institutions to submit to the Superintendent a well thought-out and well developed Board Resolution or Senior Officer Compliance Finding that reflects the requirements of DFS 504. Institutions should be mindful that the submission represents a point in time progress report of efforts made to date. Successful firms will stay focused on the tone from the top by advocating the right compliance culture, dedicating the appropriate funding and resources and executing an ongoing assessment program. *Leadership needs to ask if the organization is ready to support a successful long-term compliance program capable of dealing with the latest evolving threats in line with regulatory expectations – and if not – what is the plan?*

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