Financial Services

ASIA PACIFIC RISK CENTER: FINANCE AND RISK SERIES

FINANCIAL CRIME RISK MANAGEMENT IN AUSTRALIA

A RISING COST, AND URGENT IMPERATIVE

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Costs for Financial Crime are rising and financial institutions in Australia are having to bear them. At the end of 2017, one of the Big-4 banks in Australia was alleged by AUSTRAC for breaches of anti-money laundering and counter-terrorism laws. As of the first quarter of 2018, the bank has admitted culpability in half of the cases and has recently agreed to an AUD 700MN fine and settlement. The burning question for the Australian banking industry now is: how much does Financial Crime Risk Management practice need to be improved across the industry to avoid such issues in future?

BANKS HAVE FAILED TO RECOGNIZE THE LEGITIMACY OF MONEY

In Australia, the aggregate level of savings has consistently been exceeded by aggregate investment in the market[1]. This high level of investment has been historically funded by capital inflows from foreign countries. This is reflected in the form of Foreign Direct Investment by corporate and institutional investors, direct investments by foreign nationals (especially in banking, finance and real estate segments), and more recently, a marked increase in foreigners purchasing Australian government debt.

The year 2016 saw a total of AUD 64.8BN of Foreign Direct Investment [2] into the country. China alone contributed nearly 24% (AUD 15.36 BN) to the aggregate overseas direct investment. Specifically, Chinese investment in Australian real estate was valued at AUD 5.55 BN in 2016. Given that the annual gross value of sales in Australia[3] is around AUD 271.1 BN, this means that for every 100 houses, two were sold to Chinese investors. Chinese investment in Australia is also material at an economy level, with the total FDI from China being proportional to approximately 1% of total GDP. This means that the status of investments from a single country (in this case, China) can make a relatively strong impact on the local market. This underscores the need to ensure that incoming capital is robust and reliable, and above all, in all cases legitimate.

Yet, incoming cashflows are by no means all legitimate. Apart from carrying cash into a country, banks serve as the only "on and off ramp" for the payments system, and are the nexus through which all foreign money flows. Illegal money can only enter the system through the banking sector, yet banks have had a chequered history in this area of risk management. Most notably, failure to identify payments and transfers that cause a breach in sanctions, and accusations of being complicit in money laundering schemes, has been all too common. Money laundering alone has affected many banks, most spectacularly a multi-national bank which was accused of being complicit in sovereign money laundering of a staggering GBP 191.8 BN[4] (approximately AUD 350 BN) over 10 years.

Considering the extensive inflow of foreign funds, and in the context of recent matters, it is imperative for Australian banks to raise their game in active management of Financial Crime risk. This will not only help limit freedom for criminals and rogue states to operate, but also act as a simple protection against financial distress arising from rare but painful fines.

Implementing such safeguards also has a broader positive impact on the social fabric of the country. With enhanced controls and activity tracing, illegal financing of criminal activities can be expected to reduce meaningfully. This has direct downstream implications for the reduction of organized crime in the country, thereby aiding safety and security and the socio-economic welfare of the population.

1 Source: Speech by Guy Debelle, Deputy Governor, RBA on "Recent Trends in Australian Capital Flows", at the Australian Financial Review Banking and Wealth Summit, April 2017

2 Source: UNCTAD, USD19.5BN in 2015 and USD40.3BN in 2014

3 Source: Corelogic report

4 Source: https://www.int-comp.com/ict-views/posts/2016/07/22/top-5-money-laundering-cases-of-the-last-30-years/

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A FOCUS FOR GOVERNMENT

Nearly all developed economies have substantial trade in the ”black” market. This is a broad term used to refer to untaxed, cash and foremost illegal transactions, frequently associated with serious crime. Australia is no exception in this regard. Since the 1900's, the Independent Commission Against Corruption (ICAC) in Sydney has been busy chasing down wrongdoing in the political arena, famously prosecuting cases of brown-paper money bags, real estate licences and "back-scratching" deals. Australian criminal prosecutions have also included cases of terrorism funding; extremists have sought to send aid to ISIS, in cash or kind that is virtually untraceable. Various other forms of organised crime have been revealed as substantially profiting from their business. All the associated financial flows ultimately touch the banking sector, and AUSTRAC has been steadily ramping up its resources and efforts targeted at helping banks crack down on Financial Crime and its actors.

AUSTRAC's budget has been increasing in line with the increased proliferation in Financial Crime, and state efforts to respond. In 2010, AUSTRAC's annual budget was AUD 79.9MN. The estimated actual budget for 2016-17 was upped to AUD 88.6MN by the government, with additional funds made available for recruiting appropriately skilled staff. On December 2017, the Australian Minister for Justice, the Hon. Michael Keenan announced a new funding package to inject an extra AUD 43.3MN "to allow AUSTRAC to recruit more staff to ensure our financial institutions comply with the AML/CTF law and AML/CTF Rules."[5]

This injection is a significant statement of intent by the Australian Government and AUSTRAC to Banks and other Reporting Entities to ensure they have in place appropriate responses to their AML/CTF obligations. In some quarters, this is seen as too much: there is a concern that the banking sector is being pushed by AUSTRAC to do the work of state criminal agencies and to bear the cost. However, before we conclude this might be a case of 'oversteer' by Government, it is vital to note that the additional infusion of resources is expected to bring AUSTRAC's resources in line, rather than ahead of, international peer agencies.

50%

INCREASE IN AUSTRAC'S ANNUAL BUDGET TO COMBAT MONEY LAUNDERING

Even before the latest increase in resourcing, AUSTRAC has been far from idle. The increased incidence of Financial Crime has also witnessed increased efforts by AUSTRAC to prevent those activities, and punish wrongdoing. As one measure of this, fines imposed by AUSTRAC have increased as more criminal activity has been discovered. In 2015, AUSTRAC fined a large US-based remittances business on the back of concerning findings from a scheduled compliance assessment as part of regular engagement with AUSTRAC. The organization was ultimately fined twice in the same year, with penalties nearing AUD 500,000. At the beginning of 2017, another firm – in this case an Australian wagering company – was fined almost AUD 50MN for breaches of anti-money laundering and counter-terrorism financing laws. And famously, the banking case towards the end of 2017 saw AUSTRAC bringing allegations against that had a theoretical maximum fine of a trillion dollars and is likely to end with billions in fines. Taken together, these represent a monumental shift in the order of action taken by AUSTRAC, where the agency has moved towards showing much greater appetite to hold institutions directly accountable for their role in managing Financial Crime.

THE IMPERATIVE FOR REGULATED FINANCIAL INSTITUTIONS

AUSTRAC and other regulators will not simply pay more attention and call to account using their powers to fine, but also expect much more of the banks in terms of monitoring, controls and reporting. Banks and reporting entities will have to move closer to international norms in terms of investment in preventing Financial Crime. In terms of cost, we expect most banks will need to

5 Source: https://www.linkedin.com/pulse/austrac-given-50-budget-increase-ensure-amlctf-compliance-neil-jeans/

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62%

PERCENTAGE OF AUSTRALIAN FINANCIAL FIRMS HAD NOT MADE CHANGES TO MEET THE RECOMMENDATIONS BY THE FATF

at least double their annual spend on Financial Crime risk management in business-as-usual state. Additionally, many banks which are coming from a lower base will need to significantly upscale their Financial Crime control environment to meet international norms. Estimates for large-scale Financial Crime control transformation programs range from AUD 70MN to AUD 150MN annually (average spending by industry leaders and large banks, excluding remediation cost) of which 10-20% will continue to accrue annually in business-as-usual state.

At the lower end of the spectrum are typically domestic banks, with a limited international footprint. Such banks are characterized by:

- Less stringent local regulations and/or low regulatory intervention
- Institutions with historically higher levels of investment in Financial Crime control
- Greater use of internal resources, only leveraging external advisors in key SME roles

At the higher end of the spectrum are large global universal banks, with the following characteristics:

- Significant regulatory intervention/findings
- Historical underinvestment in Financial Crime control programmes
- Higher global minimum standards, e.g. global application of US standards
- High dependency on external advisors, e.g. advisory, legal and specialist SMEs

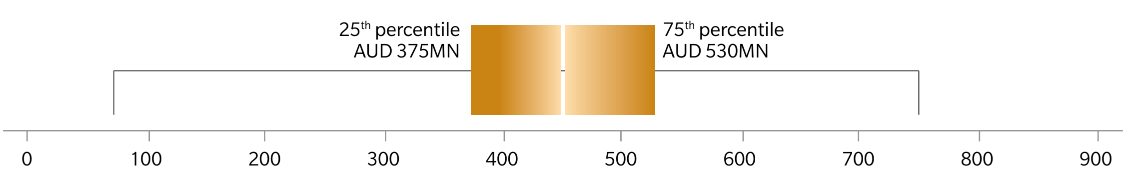
Australian banks will need to increase investment, aligning themselves to where they need to be in future, which almost without exception is ahead of where they map at present. This is not a simple case of Australian banks reacting to changes in the domestic regulatory landscape. Their investment in risk and compliance management has been on the uptick since 2013, but is still lower than spending in the rest of the world, in particular Europe and North America. There is genuine work to be done.

- A Thomson Reuters survey[6] last year found that 62% of Australian financial firms had not made changes to meet the recommendations by the Financial Action Task Force (FATF), a global group of government anti-money-laundering agencies.

The overall context of an imperative to stay on the front foot against Financial Crime is unlikely to change in the near term. Looking overseas, the US saw a shocking 20x increase in Suspicious Activity Reports (SARs) in just 3 years (between 2012-2015) while growth in transactions increased moderately by approximately 3% between 2013 and 2015 (see Exhibit 2).

While SAR filings have also been increasing in other major financial centres around the world with annual growth rates of 11% between 2012 and 2016 [7] those rates have been far lower than

Exhibit 1: Large scale financial crime control transformation programs, typical spend (AUD MN; *excluding remediation* cost, total spend over 3-5 years)



6 Source: Thomson Reuters, "Cost of Compliance 2017 Report", 2017
7 Source: Royal United Services Institute, "The Role of Financial Information-Sharing Partnerships in the Disruption of Crime", October 2017

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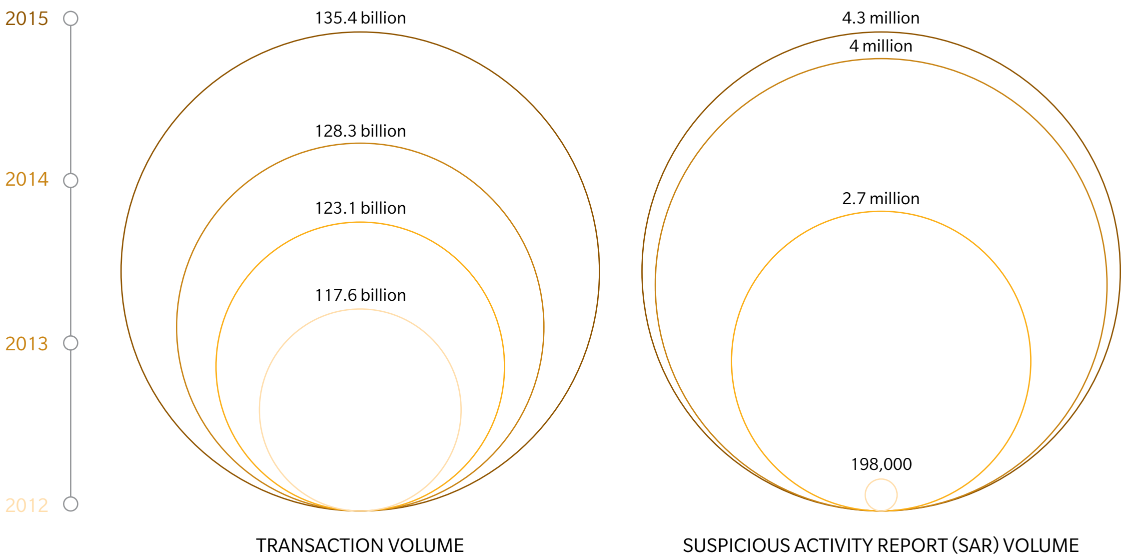
Exhibit 2: Recent trends in transaction volumes and suspicious activity report filings in the USA



Sources: BIS Committee on Payments and Market Infrastructure. Statistics on payment, clearing and settlement systems in the CPMI countries. Figures for 2015. December 2016; FinCEN SAR Stats. Technical Bulletin. March 2017; Data includes reports for money laundering, fraud, mortgage fraud, casinos, identification documentation, insurance, secruities/futures/options, structuring, terrorist financing, and other suspicious activities.

the ones experienced in the US market while increases in transaction volumes have been similar across the major financial centres such as Singapore, Hong Kong or Australia[8]. The differences observed in SAR filings growth rates can generally be attributed to three factors:

1. Either there is indeed more suspicious activity in the US market compared to other financial centres, or
2. Regulators in other jurisdictions are less stringent on reporting activities, or
3. The US regulator is much more sensitive with what constitutes suspicious activity and the reporting requirements it imposes on the entities operating within their jurisdiction.

In any case, the numbers show that even in sophisticated markets, financial-crime operations are not yet fully effective – especially given that regulators have observed that only 10-20% of reported SAR filings actually add value to active law-enforcement investigations[9]. We therefore expect that regulators in many affected markets will keep raising demands on their reporting entities and that the pressure and need to raise awareness and investment will not go away.

SIX THINGS TO DO NOW

Many firms that find themselves early in the journey of investing in Financial Crime Risk Management may struggle to know where to start and how to get a grip on the issues and their priority. The first step is getting a handle on the issues and establishing a good relationship with the regulator. AUSTRAC and other supervising bodies appreciate the complexities with which reporting entities are dealing. They are aware that controls sometimes represent a trade-off with customer experience; that systems may themselves prevent the creation of perfect controls environments; and that cultures and behaviours are slow to change. Nevertheless, their expectations have moved; we suggest an action plan targeting six areas for gains:

COMMUNICATION

Senior leadership need to cascade communication of the importance of Financial Crime controls. Cultural gaps will begin with expectations from leadership; Board and Executive Committees need to be well-versed in specific examples of failures of Financial-Crime controls and their implications.

8 Source: Bank for International Settlements, Statistics on payment, clearing and settlement systems

9 Source: Royal United Services Institute, "The Role of Financial Information-Sharing Partnerships in the Disruption of Crime", October 2017

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These can then be used to educate their leadership teams in the importance of world-class risk management in this area.

CULTURE

Uncertainty about the purpose of a transaction and identity of a customer must be unacceptable in the culture of the organization. This will be critical not just for management of Financial Crime, but also for good conduct and to satisfy community

MANAGING FINANCIAL CRIME

COMMUNICATION

- Top-down communication on importance of controls
- Active involvement from senior officials in educating the organization

CULTURE

- Risk awareness should be embedded in the culture of the bank
- Bankers are expected to be well-versed with details of each transaction

COMPLIANCE

- Compliance and reporting should be at expected levels
- Staff at all levels should be aware of relevant requirements

COVERAGE

- All customer segments, product classes, geographies etc. should be included for monitoring

COMPUTATION

- Banks should effectively leverage analytics and robotic process automation to monitor transactions and identify likely criminal activity
- Results in highest gains without excessive manpower deployment

COOPERATION

- Cooperation between banks on "best practices" in risk management
- Sharing critical information such as KYC utilities

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expectations. The playing field of expertise in finance is not level between provider and customer; bankers will be expected to have a solid grasp of transaction logic. Unusual requests should be met with questions, not executed regardless. This can be turned into a competitive advantage if done well and seamlessly.

COMPLIANCE

All staff need to understand the organization's obligations for clear and transparent reporting to regulatory and supervisory bodies. Staff should be aware of their role within that overall obligation. Compliance must be a 'gate' for performance measurement and a basic requirement at all levels

COVERAGE

Technical aspects of managing Financial Crime are equally important – all transactions need to be screened, and all customers need to go through Know Your Customer (KYC) procedures to the desired quality. Risk assessments need to be thorough and scenarios tested need to be comprehensive to cover all products and segments. All geographies, branches and subsidiaries need to meet minimum standards, which are well-articulated and understood.

COMPUTATION

While Financial Crime is a major issue for all banks, armies of people conducting transaction checks and monitoring is not the answer. The most advanced institutions are finding radical increases in productivity from analytics.

To this end, Citigroup president and chief executive of the bank's institutional clients group Jamie Forese, believes that the bank could replace up to half of its 20,000 technology and operations staff with machines over the next five years[10]. According to Mr Forese, operational positions at the bank were "most fertile for machine processing." It is an increasingly common

~40%

AVERAGE INCREASE IN COMPLIANCE EXPENDITURE AT THE TOP-4 AUSTRALIAN BANKS (2013-17)

sentiment. Transaction monitoring is moving from merely screening to use of advanced analytics and machine learning. This, by prioritizing the files for manual review, skews focus of expensive expert time to cases where it is most needed. Large complex organizations such as HSBC[11] have realized double digit gains in productivity, and helped set the goal-post for the industry.

COOPERATION

There are areas where cooperation in the industry is possible and to everyone's benefit, such as in the creation of utilities for processes that meet KYC requirements. Well-targeted cooperation makes regulators more (rather than less) comfortable, customers more satisfied (assuming privacy can be handled appropriately), and banks more efficient (where incentives are aligned).

The cost of poor Financial Crime Risk Management falls heavily on society as a whole – but especially heavily on the pockets of shareholders in firms judged to have materially missed expected standards. The response needs to be broad and deep, raising seniority of issue ownership, capabilities, and engagement at all levels of the industry. Leaders have already made substantive moves; where is your firm?

10 Source: Financial Times, "Citi issues stark warning on automation of bank jobs", June 2018
11 Source: AYASDI, "Anti-Money Laundering and AI at HSBC", June 2017

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