
Anti-money laundering and countering the financing of terrorism – the Reserve Bank’s supervisory approach

Hamish Armstrong

In September 2010, a *Bulletin* article set out the Reserve Bank of New Zealand’s role and responsibilities with regard to the Anti-Money Laundering and Countering Financing of Terrorism Act 2009 (“the Act”). It briefly explained the regulatory and supervisory framework established by the Act, discussed the Reserve Bank’s risk-based approach in this context and outlined some of the major areas of work to be undertaken to develop and implement the Reserve Bank’s supervisory framework.

This article updates material that has been published since that article and provides further detail on the Reserve Bank’s proposed supervisory approach.

Introduction

Money laundering is the way criminals disguise the illegal origins of their money. Financers of terrorism use similar techniques to try and avoid detection by authorities and to protect the identity of those providing and receiving money for funding acts of terrorism. Under the Act, the Reserve Bank is one of three supervisors tasked with ensuring firms comply with new obligations designed to help deter and detect money laundering and terrorist financing.

AML/CFT Regime / Environment

During the past 18 months, the regulatory environment with respect to Anti-Money Laundering and Countering Financing of Terrorism (‘AML’) in New Zealand has developed significantly with the publication of several regulations and guidance. Many key thresholds and exemptions have now been set or clarified and, importantly, the date for full implementation of the Act has now been set as 30 June 2013.

National and Sector Risk Assessments

In March 2011, the NZ Police published a *National Risk Assessment* (‘NRA’). This contains information about money laundering and terrorist financing issues at

a national level and from a law enforcement perspective. The three AML supervisors¹ issued their Sector Risk Assessments on 29 March 2011. The Reserve Bank’s *Sector Risk Assessment* complements the information in the NRA and contains the Reserve Bank’s preliminary assessment of the level of risk of money laundering and terrorism financing across all the sub-sectors it supervises.

Regulations

On 30 June 2011, four sets of AML regulations were promulgated. These regulations are administered by the Ministry of Justice. The three AML supervisors, along with NZ Customs and the NZ Police, were consulted extensively during the policy development and drafting.

The *Anti-Money Laundering and Countering Financing of Terrorism (Definitions) Regulations 2011* specifically include certain financial advisers and trust and company service providers as reporting entities² (so that they are subject to the full range of AML requirements); exclude certain entities from the Act (such as lawyers, accountants and government departments); establish thresholds for occasional transactions³ and beneficial ownership;⁴ and provide further detail around designated business groups.⁵

¹ The Reserve Bank of New Zealand (responsible for banks, life insurers, and non-bank deposit takers), the Financial Markets Authority (responsible for issuers of securities, trustee companies, futures dealers, collective investment schemes, brokers, and financial advisers) and the Department of Internal Affairs (responsible for casinos, non-deposit-taking lenders, money changers, and all other reporting entities).

² The Act places obligations on certain financial institutions as well as casinos, collectively referred to as “reporting entities”.

³ Cash transactions outside a normal business relationship.

⁴ A beneficial owner is someone who has effective control over a customer or person on whose behalf a transaction is conducted.

⁵ Groups of related entities that can share aspects of their AML risk assessments and compliance programmes.

The *Anti-Money Laundering and Countering Financing of Terrorism (Exemptions) Regulations 2011* exempt certain transactions and services from the Act or parts of the Act on the basis of their lower money laundering and terrorist financing risk (e.g. currency exchange in hotels; closed insurance policies; loyalty card schemes; low value gift cards).

The *Anti-Money Laundering and Countering Financing of Terrorism (Requirements and Compliance) Regulations 2011* contain further detail in order to clarify the extent of certain obligations such as customer due diligence in relation to anonymous accounts; information to be collected about beneficiaries of trusts; and the content of annual reports.⁶

The *Anti-Money Laundering and Countering Financing of Terrorism (Ministerial Exemption Form) Regulations 2011* prescribe the form in which the Minister must make Ministerial exemptions

In addition, the *Anti-Money Laundering and Countering Financing of Terrorism Act Commencement Order 2011* sets the date by which the Act's requirements will come into effect as 30 June 2013. This planned delay is intended to give industry the opportunity to prepare themselves for compliance with the Act and also to allow AML supervisors time to develop their supervisory programmes.

Codes of practice

The *Identity Verification Code of Practice* ("the Code") was issued on 1 September 2011. This was issued jointly by the three AML supervisors and applies to all reporting entities across all sectors subject to supervision. The Code provides a suggested best practice for all reporting entities conducting name and date of birth identity verification in respect of customers (that are natural persons) who have been assessed to be low to medium risk. Importantly, compliance with the Code is not compulsory. Reporting entities may opt out and develop alternative processes, so long as they can demonstrate that such processes are equally effective as those set out in the Code.

⁶ Annual Compliance Reports that reporting entities must submit to their AML supervisor.

Guidelines

The AML supervisors have issued three joint guidelines, applicable to all reporting entities across all sectors.

The *Risk Assessment Guideline* was issued on 13 June 2011. Undertaking a risk assessment is a key obligation on reporting entities and lays the foundation for all risk-based decisions and controls within its programme to address money laundering and terrorism financing risks. It involves identifying and assessing the risks their business might reasonably expect to face. This guideline was developed to assist reporting entities in this process.

The *Interpreting "Ordinary Course of Business" Guideline* was issued on 21 September 2011. This clarifies the meaning of the phrase "in the ordinary course of business" in the Act, which is an important part of assessing whether a firm is captured by the AML regime.

The *AML/CFT Programme Guideline* was issued on 13 December 2011. A reporting entity's programme will set out the internal policies, procedures and controls necessary to detect money laundering and financing of terrorism and to manage and mitigate the risk of it occurring. The programme must be based upon the entity's own risk assessment. This guideline was developed to assist reporting entities develop their AML programme.

In addition to these joint guidelines, the *Insurance Business Coverage Guideline* was published solely by the Reserve Bank for the insurance sector. This will assist businesses that provide life insurance to determine whether they have obligations under the Act, by providing our views on several potential exemptions and carve-outs established by the *Anti-Money Laundering and Countering Financing of Terrorism (Exemptions) Regulations 2011*.

Future guidance

In the lead up to 30 June 2013, we expect to issue guidelines on several more topics, including a *Designated Business Group Guideline*, which will assist reporting entities' consideration of their eligibility to form a designated business group and will set out the process by which they should notify their supervisors; a *Country Assessment*

Guideline, to assist reporting entities in assessing the adequacy of AML regimes in overseas jurisdiction; an *Audit Guideline*, setting out our expectations in relation to the review and audit of risk assessments and AML programmes; and a *Beneficial Ownership Guideline*, to assist firms in undertaking due diligence on their customers with more complex ownership structures.

Supervisory Approach

Risk-based Approach

As well as the outward facing work outlined above, we have been preparing ourselves for day to day operations post-30 June 2013, when the Reserve Bank will assume responsibility for supervising our population of reporting entities.

Given the number of reporting entities and the necessarily finite supervisory resources, we will supervise reporting entities according to the risks they present to the objectives of the Act (namely: to detect and deter money laundering and the financing of terrorism; to maintain and enhance New Zealand's international reputation; and to contribute to public confidence in the financial system).

This requires a consistent process to identify, measure and prioritise the risks posed by reporting entities to these statutory objectives, in order to inform any decisions regarding appropriate regulatory responses. For this purpose we have begun developing an entity risk assessment model ('ERA'), which assesses the business of each reporting entity against criteria or characteristics that may make that business more susceptible to being used for money laundering or financing of terrorism. This involves an assessment of their customer types, product/services, delivery channels, and the countries and institutions they deal with. These characteristics are based on international experience⁷ and information from NZ Police as set out in the first NZ National Risk Assessment. For example, a financial product that allows third party payments is considered higher risk than a pure "savings" product; a corporate customer with an opaque or complex ownership structure is considered higher risk than a natural person; and an overseas customer in a

jurisdictions with high levels of corruption is considered higher risk than a domestic customer.

We began this assessment process in 2011, using information received from a series of AML surveys. This will continue as an internal and confidential process⁸ after 30 June 2013 through AML annual reporting requirements and will drive the development of our AML supervisory approach, determining how the Reserve Bank will undertake its statutory function of monitoring reporting entities for compliance with their regulatory obligations. The nature and extent of our supervisory relationship with any individual reporting entity will depend on how much of a risk we consider it poses, as established using the entity risk model discussed above.

This means we will focus most of our supervisory resource and attention on identified areas of higher risk⁹ within our population of reporting entities so that those entities that are most at risk of a money laundering and/or terrorist financing ('ML/TF') event occurring within their business are subject to the most supervisory attention. It is important that these entities have appropriate AML controls, since the likelihood and/or impact of an event in these entities is greater.

This risk-based approach to supervision is consistent with the intention of the legislation and with the approach that reporting entities themselves are expected to follow when designing and implementing their anti-money laundering controls. This approach is being increasingly encouraged by FATF and was formally included in their revised recommendations earlier this year. It has already been implemented by international supervisors such as the UK's FSA and Australia's AUSTRAC and it is also the approach planned to be taken by the other domestic AML supervisors, Department of Internal Affairs and the Financial Markets Authority.

⁷ E.g. FATF, APG, UK's FSA and Australia's AUSTRAC

⁸ Entity risk assessments and individual firms' risk ratings are and will remain confidential. We may consider publishing aggregated data, once we have developed a deeper understanding of the range of risks within our population of reporting entities.

⁹ This may include specific reporting entities or clusters/groups of reporting entities, specific products, specific customer types, etc.

Supervisory responsibilities

As an AML supervisor, the Reserve Bank has a number of new statutory functions. These are set out in section 131 of the Act, and include:

- s131(a) : to monitor and assess the level of risk of money laundering and financing of terrorism across all of the reporting entities it supervises:
- s131(b) : to monitor the reporting entities it supervises for compliance with the Act and regulations and for this purpose to develop and implement a supervisory programme.

At first glance these seem to be similar concepts. In practice, however, they are quite different functions.

Monitoring and assessing the level of money laundering and financing of terrorism risk across reporting entities involves measuring and understanding the likelihood and impact of a money laundering or terrorist financing event occurring in one of these firms.

It is envisaged that the ERA process described above will continue to be our primary tool for monitoring and assessing ML/TF risk within our reporting entities. The ERA is currently an annual process of collecting and analysing information relating to the characteristics of reporting entities, their business models and practices. As we move closer to and then into business-as-usual, the ERA model will be adjusted to incorporate an assessment of the adequacy of a reporting entity's controls.

This information will be used to assess the likelihood and impact of a ML/TF event occurring in each individual reporting entity, with entities then being grouped into "clusters" of higher/medium/lower comparative risk.

As well as enabling reporting entities to be grouped into these broad categories, information collected via this process will also be useful in conducting entity-specific analysis of ML/TF risk or controls systems.

Monitoring reporting entities for compliance with the Act and regulations involves measuring and understanding the extent to which firms are fulfilling their legal obligations.

This involves assessing the extent to which a reporting entity has implemented an effective control framework as required by the Act, separate from the ERA (which focuses on the risk of an ML/TF event actually occurring).

It is with regard to this second function – monitoring

reporting entities for compliance with their legal obligations – that the Reserve Bank is expected to develop a supervisory programme.

Although the primary objective of the supervisory programme is to monitor firms' compliance, any information gathered during such supervision will also improve the Reserve Bank's understanding of the risks within the reporting entities, assisting it to fulfill its function under s131(a) of the Act.

Supervisory tools

The Act grants the Reserve Bank specific powers to carry out the functions detailed above.

Section 132 of the Act states that the Reserve Bank, as supervisor, has "all the powers necessary to carry out its functions under this Act".

In addition, the Reserve Bank has the specific power to:

- on notice, require production of, or access to, all records, documents, or information relevant to its supervision and monitoring of reporting entities for compliance with this Act (section 132(2)(a)).
- conduct on-site inspections (section 132(2)(b)).

We will also use methods of supervision not involving the formal exercise of statutory powers, including:

- reviewing annual reports;
- issuing questionnaires / conducting surveys;
- desk-based reviews of risk assessments, policies, procedures or audit reports;
- meetings with firms / presentations; and
- analysis of data from external sources.

We intend using these tools in a mixture of baseline monitoring and risk-based supervision.

Baseline monitoring

All reporting entities will be required to submit an annual AML report with basic information about their operations, risk assessments and compliance programmes. This will also include an element of self-certification of compliance with their legal obligations. These annual reports will be reviewed and any apparent areas of increased risk will be escalated for more in-depth supervisory follow up.

Risk-based monitoring:

In addition to this baseline, off-site monitoring, we propose to focus both off-site and on-site supervisory efforts on identified risk clusters. The ERA will identify clusters of firms (e.g. high, medium and low risk) and this will be used to determine a schedule of on-site inspections, with larger, more complex and riskier entities being inspected more regularly.

In addition to assessing firms' compliance with their legal obligations, this will enable us to validate and update each entity's risk rating, by incorporating a formal assessment of the quality of their control systems.

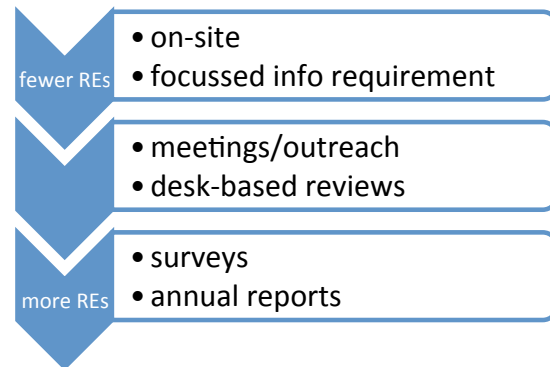
The depth and breadth of these inspections will be largely determined by the nature of the entity being inspected. For instance, an inspection of a small credit union could cover most, if not all, aspects of AML compliance in one day or less. However, a three or four day inspection of a large bank might necessarily be limited to specific aspects of its AML/CFT programme.

In addition to the on-site supervisory activities described above, we will also undertake off-site risk-based supervision. We anticipate that information and intelligence from law enforcement, the Financial Intelligence Unit and National and Sector Risk Assessments may identify further clusters of higher risk products, business lines, countries or customer types. Similarly, areas of potentially higher risk may also be identified by our base-line monitoring or on-site inspections.

In this context, a wider range of supervisory tools, including information requirements, surveys and desk-based reviews of annual compliance reports, audit reports, risk assessment or policies/procedures, will be applied in a graduated/escalated manner, determined firstly by the number of reporting entities within which the risk has been identified and which will be targeted by the tool.

For instance, if an increased risk or issue is identified in a single reporting entity (e.g. if specific intelligence from law enforcement concerning a particular registered bank), it will be more likely to be subject to an information requirement or on-site visit. If an increased risk is identified in relation to an entire sub-sector (e.g. if a National Risk Assessment suggests that credit unions are being exposed to a higher risk) or a particular customer type

(e.g. if criminals controlling bullion dealers are identified as more likely to be laundering criminal funds) then we are more likely to use a thematic survey or questionnaire to a large number of reporting entities in order to monitor and assess the level of compliance in relation to that specific risk.



The results of these supervisory activities will be examined as they become available. This may require us to reassess the risk profile of the entity or group of entities involved, require entities to take remedial action or may lead to a consideration of enforcement action.

We also plan to increase our knowledge and understanding of our firms' business and ML/TF risk by undertaking thematic work. This might include requests for, and subsequent desk-based review of, information relating to particular business lines or products/services (e.g. reviewing banks' policies and procedures concerning correspondent banking); particular subsectors (e.g. reviewing the risk assessments from all building societies); or particular customer types (e.g. reviewing all firms' approaches to dealing with customers who are trusts, or Politically Exposed Persons¹⁰).

Conclusion

The Anti-Money Laundering and Countering Financing of Terrorism Act 2009 places new obligations on financial firms and on the Reserve Bank as AML supervisor.

The Reserve Bank is committed to a risk-based regime that allows firms the flexibility to deal with risks in a

¹⁰ Persons who hold prominent public functions in an overseas country and their families.

proportionate and effective manner and means that we will use the full range of supervisory tools at our disposal more effectively, paying greater attention to higher risk reporting entities than lower risk ones.

The new regulatory regime, and the responsibilities it places on firms, should reduce the potential for money

laundering and the financing of terrorist activities to occur in New Zealand.

All publications referred to above can be found on the Reserve Bank website – www.rbnz.govt.nz/amlcft