EVALUATING DATA, ILLUMINATING RISK

BENCHMARKING FINANCIAL CRIME RISK FOR INDIVIDUAL FIRMS:

The missing piece of the anti-money laundering puzzle?

Discussion paper
01/2021

Elucidate is a Berlin-based financial crime risk quantification agency which enables financial institutions to leverage their own data to assess their financial crime risk exposure and control effectiveness.

www.elucidate.co

Editor/Contact: Max Heywood, max@elucidate.co

Many thanks to Alison Taylor, Executive Director, Ethical Systems; Richard Bistrong, CEO, Front-Line Bribery LLC; Eduard Hovsepyan, European Banking Federation; and Mateu Dohotari, World Bank for their feedback to a previous draft of this paper. Comments were made in an independent personal capacity and they do not necessarily act on behalf of and/or necessarily represent the position of their organizations.

Published April 2021

Table of contents

EXECUTIVE SUMMARY 1

INTRODUCTION 2

ELUSIVE OUTCOMES, UNINTENDED CONSEQUENCES 3

THE LONG LAST MILE: FINANCIAL CRIME RISK IS DISCONNECTED FROM BUSINESS DECISIONS 4

BENCHMARKING FINANCIAL CRIME RISK: A BRIEF INTRODUCTION 6

THE BENEFITS OF BENCHMARKING 7

CONCLUSION AND OPEN QUESTIONS 9

ENDNOTES 11

Executive Summary

The core proposition of this paper is that scoring the financial crime risk of individual firms against a standard benchmark will make anti-money laundering systems more effective, in both the private and public sectors. The essential conceptual, measurement and technological building blocks are available for a shift towards a more granular, firm-level approach to financial crime risk.

After three decades of political and policy action to tackle money laundering in the financial system, impact in terms of improved outcomes remains elusive. Despite aggregate expenditure in compliance running to hundreds of billions of USD a year, AML/CFT effectiveness in business is particularly low.

While the underlying drivers of this gap have received surprisingly little research and policy attention, our working hypothesis is that decision-makers within businesses face misaligned or competing incentive structures. For instance, financial crime risk exposure and control effectiveness do not usually factor into product pricing or personal compensation decisions.

In this context, drawing on the extensive data already available to benchmark the financial crime risk of individual financial institutions can have a transformational impact.

The Elucidate Fincrime Index (EFI), for example, draws on the over 350 data points collected by the Wolfsberg Group's Correspondent Banking Due Diligence Questionnaire (CBDDQ), and complements them with publicly available sources, a bank's own data and Elucidate's proprietary data. On a monthly basis, EFI platform users receive an automated report with their updated overall financial crime risk score, scores for each of nine risk themes, and underlying findings.

The benefits for financial institutions include continuous improvement in overall control effectiveness; more effective management of banking relationships; and greater alignment of individual incentives with financial crime risk. For public authorities, continuous benchmarking would support the ongoing monitoring of national and sector-level financial crime risk, and more effective allocation of limited supervisory resources, among others.

Additional potential applications could include input to ESG (environmental, social and governance) metrics, and the emergence of financial crime risk derivatives. Standardizing the measurement of financial crime risk also has multiple implications for research, product development and public policy which require further exploration.

We look forward to comments and suggestions to this paper and to continuing the discussion about how to most effectively tackle financial crime in practice.

Introduction

The core proposition of this paper is that scoring the financial crime risk of individual firms against a standard benchmark will make anti-money laundering systems more effective, in both the private and public sectors.

Frameworks to assess and manage risk in business have existed for decades; over a century has passed since John Moody founded the first credit rating agency.[1]

In the AML/CFT (anti-money laundering/countering the financing of terrorism) field, the global standard-setter FATF has been scoring the performance of its member countries since 2004, initially in terms of legal compliance and since 2014 also in terms of practical effectiveness in line with risk.[2]

As section 4 below illustrates, many elements of a business's exposure to financial crime risk are measurable drawing on existing data sources, as are the effectiveness of the controls a firm has in place to address that risk.

While a few years ago the technical challenges could have proven insurmountable[3], developments in large-scale data collection, storage, management and analysis, coupled with falling costs of technology have multiplied the tools available for complex organizations to assess risk on an ongoing basis.

In short, the essential conceptual, measurement and technological building blocks are available for a shift towards a more granular, firm-level approach to financial crime risk.

Benchmarking the financial crime risk of and within individual financial institutions complements existing regulatory policies and can help to bridge a range of gaps in the AML/CFT system. As section 5 details, first and foremost among the benefits of this approach would be the closer integration of financial crime risk factors into both daily and longer-term business decisions.

Our main goal with this discussion paper is to introduce financial crime risk benchmarking as a novel yet powerful approach to the compliance and anti-financial crime community, policy-makers and institutional investors.

As a company with 30 staff, we are not impartial proponents of this concept: our core product, the Elucidate FinCrime Index (EFI), is built on the benchmarking of financial crime risk for individual firms. This is why we also welcome feedback to our own approach, in the spirit of continuous improvement.

Although currently our primary focus is on entities in the banking sector, the fundamental principles and tools of financial crime risk benchmarking can also be applied to non-bank financial institutions (NBFIs), and in fact to any business that is exposed to financial crime risk.

Before introducing the practicalities of financial crime risk benchmarking, section 2 below provides a brief recap of the systemic challenges in the global anti-money laundering system. Section 3 then looks more closely at the problem of misalignment between compliance and business systems within financial institutions. Following the overview of financial crime risk benchmarking and its benefits in sections 4 and 5, section 6 concludes and sets out areas for further exploration.

Elusive outcomes, unintended consequences

The systemic anti-money laundering weaknesses of the global financial system have been extensively analysed. After decades of political and policy action to tackle money laundering in the financial system, impact in terms of improved outcomes remains elusive.[4]

Law enforcement officials in the EU have estimated that professional money launderers have a 99 percent success rate in running criminal profits through the financial system.[5] A strikingly similar estimate for the US is that less than 1 percent of the financial proceeds of crime is recovered by authorities each year.[6]

Since 2014, the FATF has been carrying out its fourth round of in-depth country assessments, including looking at the effectiveness of AML/CFT systems. For over 100 countries assessed as of early 2021, the majority of effectiveness ratings are either “moderate” or “low”. Across the 11 outcome areas reviewed by FATF, no more than a handful of countries have achieved high levels of effectiveness, in any of the areas assessed.[7]

Referring to country-level performance in tackling dirty money, the executive secretary of FATF in May 2020 concluded that “everyone is doing badly, but some are doing less badly than others”.[8]

Among the unintended consequences of the increased pressure on banks to tackle financial crime is de-risking: international banks choosing to entirely exit relationships with jurisdictions seen as high-risk. De-risking can severely affect access to financial markets and has a wide range of societal costs such as the impact on remittances and financial inclusion.

Paradoxically, de-risking has not eliminated the risk of illicit flows, but often simply reallocated these risks to less transparent channels, be they overburdened local banks or the informal market.[9]

Despite aggregate expenditure in compliance running to hundreds of billions of USD a year[10] AML/CFT effectiveness in business is particularly low: to date FATF has yet to find a country with a high level of private sector effectiveness in preventing financial crime. FATF country reports contain multiple references to businesses having gaps in their understanding of risks and in the implementation of their AML/CFT obligations.[11]

At the same time, the question of what drives the (lack of) effective implementation of AML/CFT measures at the individual firm level has received surprisingly limited research and policy attention. As the next section outlines, available evidence suggests a fundamental misalignment between financial crime risk management and business incentives.

The long last mile: financial crime risk is disconnected from business decisions

An expression frequently heard among AML/CFT analysts is that firms view expenditure on compliance as a "cost of doing business" or as a "tick-the-box" exercise aiming to satisfy regulatory requirements, rather than being driven by the primary purpose of reducing financial crime.

The question of why this might be the case has rarely been addressed, requiring further research which is outside the scope of this paper. Our working hypothesis, however, is that decision-makers within businesses face misaligned or competing incentive structures, from the C-suite level down.

For instance, an individual employee such as a relationship manager in a bank is, on paper, expected to undergo compliance training, follow the bank's policies and make use of its reporting system. On the other hand, their personal performance and compensation package are linked to business targets, and usually assessed via a different system.

The business and compliance systems are rarely operating on an equal footing. While business targets can be set and measured using a range of indicators, until now financial crime risk has lacked reliable metrics, in particular when it comes to evaluating outcomes achieved.

On top of the well-known limitations to management in the absence of metrics ('you can't manage what you can't measure'), in contexts where multiple goals co-exist, those that are easier to assess may be given more attention by decision-makers, regardless of their relative potential impact.[12]

In addition, comprehensive exercises that can support the risk-based allocation of compliance resources, such as Enterprise-Wide Risk Assessments (EWRA) are not yet widespread or are carried out on an irregular basis. Similarly, in-depth public policy evaluations such as National Risk Assessments or FATF peer reviews are infrequent.

This is where the introduction of standard financial crime risk metrics can directly contribute to achieving outcomes, both by allowing the continuous improvement of compliance systems themselves, and by supporting the integration of effectiveness outcomes into policy and organizational performance metrics.

The need for stronger outcome-based incentives is not only seen in specific cases where business functions have directly pressured compliance functions to ignore red flags and onboard high-risk clients.[13]

In 2019 and 2020 the UK's Solicitors Regulation Authority (SRA) visited 74 law firms to assess their readiness to tackle financial crime. After completing its review, two thirds of the firms were requested to make improvements. Among the SRA's findings were that in 21% of cases the source of funds had not been checked adequately or at all.

As noted in the previous section, this finding, in itself, is not unusual. What makes the SRA report specifically worth mentioning is that it touches on a key underlying reason for the gap between policy and practice at law firms: 'often…the fee earners were not following procedures'.[14]

A 2020 survey of C-suite management and senior compliance officers again supports the view that anti-money laundering concerns take a backseat to business decisions. Remarkably, out of the 600 interviewees, 24,9% admitted that they choose to incur the risk of anti-money laundering fines and violations when doing business 'all the time', while another 35,6% admitted to doing so 'regularly'. Just 14,9% responded that they did not incur the risk of an anti-money laundering violation when doing business 'and are right not to'.[15]

Until this misalignment is addressed, the impact of strengthened regulatory policies on business practice is likely to be low, including that of measures intended to change incentives. For example, introducing executive liability for anti-money laundering controls may have limited effectiveness in the absence of systems specifically designed to align behaviours throughout organizations.

This dynamic can fundamentally change where standardized metrics of financial crime risk are present. The next section introduces the Elucidate FinCrime Index (EFI) as an illustration of how financial crime risk can be scored against a standard benchmark on a regular basis. Section 5 then provides an overview of the benefits of this approach.

Benchmarking financial crime risk: a brief introduction

As mentioned in section 1 above, a large number of factors related to financial crime risk are quantifiable drawing on existing data sources. This section draws on the Elucidate FinCrime Index (EFI) - the regulated financial crime risk benchmark to date - to illustrate how data can be leveraged to generate standardised financial crime risk scores.[16]

The starting point for the EFI is the Correspondent Banking Due Diligence Questionnaire (CBDDQ), developed by the Wolfsberg group of banks[17], together with a set of open source data points. The Wolfsberg questionnaire collects over 350 data points for each financial institution across a range of areas including its product and channels, bribery and anti-corruption policies, customer due diligence policies, and audit process, among others.

The EFI complements the data collected via the CBDDQ and publicly available sources with a bank's own data and Elucidate's proprietary data. It then runs over 1200 discreet, automated tests against this dataset to generate an overall EFI score, as well as scoring each bank across nine standard risk themes as outlined below:

1. Organisational reputation
2. Culture and employee conduct
3. Bribery and corruption
4. Geographic footprint
5. Sanctions
6. Customer Portfolio
7. Products and Channels
8. Transactional activity
9. Governance framework

Examples of tests run by the EFI under the nine themes include:

- Transactional activity: Do >98% of outgoing payments include account name, address and number?
- Customer portfolio: Does the private banking portfolio consist of >25% of total clients, with >25% offshore/non-resident portfolio?
- Governance framework: What is the frequency of AML/CFT & Sanctions functions reporting to the Board (or equivalent senior management committee): monthly, quarterly, half-yearly, yearly?

On a monthly basis, EFI platform users receive an automated report with their updated overall score, scores for each of the nine themes, and underlying findings. Drawing on these findings, the EFI platform allows users to define and track remedial actions. They also have options to share EFI information on their own bank with selected external counterparties in a secure environment, ranging from a summary of overall scores to detailed reports.

Model controls established for the EFI include a formal Model Governance and Control Framework and an external Model Oversight Committee. Further details are captured in the EFI White Paper and Technical Paper which are available for download on our website.[18]

The first cohort of banks using the EFI platform is already yielding insights as to the applications of financial crime risk scoring in practice. These have been complemented through bilateral exchanges with regulators, industry bodies, compliance practitioners and AML/CFT experts to identify additional potential applications, as outlined immediately below.

The benefits of benchmarking

What changes in practice when financial crime risk can be benchmarked? This section provides a snapshot of the benefits and expected benefits for both the private and public sectors, as well as exploring two longer-term applications. During 2021, Elucidate will publish a series of (anonymised) case studies capturing lessons learned for a number of these benefit areas.

For financial institutions

Continuous improvement in overall control effectiveness: At the strategic level, scoring of financial crime risk allows the leadership of an institution to identify areas within control systems that require particular attention, and to track the evolution of risk exposure and control effectiveness over time. The availability of regular risk metrics enables a move away from periodic reviews towards constant monitoring of product, channels and customers, which some sources have called "perpetual KYC" (Know Your Customer).[19]

Ongoing monitoring of financial crime control effectiveness can additionally support banks in meeting evolving regulatory expectations, including the increasing integration between AML/CFT and prudential supervision frameworks.[20]

Manage banking relationships more effectively: Being able to measure financial crime exposure and control effectiveness contributes to a more nuanced and transparent approach to managing banking relationships.

Rather than using de-risking as a blunt, often subjective tool to manage cross-border risks, scoring the parties to a relationship against a common financial crime risk benchmark opens a range of possibilities. These can include differentiated risk-based pricing for correspondent banking services; establishing mutual agreements on tolerance thresholds; discussing necessary remedial actions, and the setting and tracking of progress targets within pre-agreed timeframes.

Align individuals' incentives with financial crime risk: Scoring of the overall financial crime risk and the risk for different areas within a bank can enable a closer integration between compliance and performance management systems.

For instance, a relationship manager's variable compensation could be adjusted according to their portfolio's contribution to the organisation's overall financial crime risk score over a given period of time. Personal performance indicators could be linked both to risk exposure, such as the percentage of non-resident or high-risk clients onboarded, and to control effectiveness, such as the extent to which due diligence and record-keeping obligations have been followed.

For public authorities

Ongoing monitoring of national and sector-level financial crime risk: Regular reporting of risk levels for individual banks against a standard benchmark can support the assessment of overall risk at the national level, giving public authorities, industry bodies and individual banks a common baseline and framework to evaluate progress and gaps in policy and practice.

In addition to facilitating the process of information gathering and analysis required for periodic exercises such as National Risk Assessments, ongoing monitoring of risk levels would contribute to sector-wide target-setting and tracking of progress against particular areas of concern where coordinated action is required.

More effective allocation of limited supervisory resources: Benchmarked scores for the financial institutions under oversight can complement the data already collected by authorities to provide a basis for their strategic planning and budgeting.

These could range from greater automation of the planning of on-site and off-site inspection following a risk-based approach, to identifying sector-wide risk factors and areas of concern requiring closer attention, as well as defining triggers for ad-hoc inspections. Our company is already engaging with supervisory authorities to incorporate features that meet their needs to the EFI platform.

Evidence progress as regards effectiveness: Supranational reviews such as those carried out by FATF and its associated regional bodies can require significant amounts of data collection and analysis on the part of public authorities. Similar to the process for National Risk Assessments, the preparation for these reviews can be facilitated by the ongoing data collection and analysis underpinning financial crime risk scores.

In between in-depth reviews such as FATF's Mutual Evaluation Reports (MERs), which can be up to 10 years apart, national authorities can lack objective indicators of progress. When responding to a major event that affects the reputation of the jurisdiction as a whole, for example, financial crime risk scores can evidence areas of improvement, as well as authorities' understanding of outstanding gaps.

Additional applications

Input to ESG metrics: Environmental, Social and Governance (ESG) factors are increasingly influencing decisions by institutional investors, a trend that over time will likely also spread to corporate and retail clients of financial institutions. Within the EU, the introduction of legislation establishing mandatory corporate due diligence for environmental, human rights and governance impacts is expected, possibly as early as 2021.[21]

Considering the societal impact of financial crime, objectively evidencing effective controls in this area will be a critical input when measuring a firm's ESG performance.

Financial Crime Risk derivatives: Once financial crime risk can be measured, it is straightforward to envision financial instruments that reallocate that risk. A financial crime risk swap, for example, would trigger a payout from the originating institution to a counterparty in case of a financial crime event.

Conclusion and open questions

In coming years the pressure on the financial sector to improve its AML/CFT outcomes will only grow, driven by a combination of empowered global and regional standard-setters; continued demands to protect public resources in a post-pandemic setting; and increasingly data-savvy investigative journalists, among others.

The currently available pieces of the AML/CFT puzzle are steadily being put into place: progress is being made across multiple areas including beneficial ownership, investment in enforcement, and enhanced data and intelligence sharing.

At the same time, given the low baseline in terms of outcomes described in section 2 above, relying only on existing tools means their implementation will have to improve by several orders of magnitude to meaningfully impact effectiveness.

There is also no guarantee that a complete picture will emerge even if all of the puzzle pieces currently available are in place. A recent survey of compliance professionals found that a majority were sceptical that full compliance with AML regulations by financial institutions would adequately shield the financial sector from illicit funds.[22]

Among the main missing pieces until now has been the measurement of financial crime risk at the individual firm level. This paper has outlined how existing data sources can be analysed to generate benchmarked financial crime risk scores, and some of the benefits of this approach. Based on our experience with financial institutions and regulators to date, we are convinced that if implemented at scale this approach could be truly transformative.

Much remains to be understood and developed, however. At a research level, greater understanding of the incentives and constraints faced by individual decision-makers within financial institutions is needed. From a product development perspective, the multiple potential applications of scoring financial crime risk include the development of new HR performance management systems for businesses.

Regulatory questions include the extent to which existing frameworks, such as those applied to credit risk ratings, can be relevant to financial crime risk benchmarks, and the policy and legal implications of drawing on financial crime risk scores for official supervisory processes.

We look forward to comments and suggestions to this paper and to continuing the discussion about how to most effectively tackle financial crime in practice.

ENDNOTES

1 https://about.moodys.io/history

2 Leonardo Borlini, U4 Anti-Corruption Resource Center, "The Financial Action Task Force: An Introduction", 2015, https://www.cmi.no/publications/file/5524-the-financial-action-task-force-an-introduction.pdf

3 See for example https://www2.deloitte.com/content/dam/Deloitte/lu/Documents/risk/financial-crime-compliance_BHI.pdf

4 Ronald F. Pol, "Anti-money laundering: The world's least effective policy experiment? Together, we can fix it ", Policy Design and Practice, Volume 3, 2020 – Issue 1. https://www.tandfonline.com/doi/full/10.1080/25741292.2020.1725366

5 https://www.politico.eu/article/europe-money-laundering-is-losing-the-fight-against-dirty-money-europol-crime-rob-wainwright/

6 John A. Cassara, "Statement to the Cullen Commission of Inquiry into Money Laundering in British Columbia", https://cullencommission.ca/data/exhibits/341%20-%20002%20J.%20Cassara%20-%20Final%20Statement%20to%20the%20Cullen%20Commission.pdf

7 FATF Consolidated assessment ratings at https://www.fatf-gafi.org/publications/mutualevaluations/documents/assessment-ratings.html

8 https://www.icij.org/investigations/panama-papers/everyone-is-doing-badly-anti-money-laundering-czar-warns/

9 https://www.worldbank.org/en/topic/financialsector/brief/de-risking-in-the-financial-sector

10 https://www.gcffc.org/wp-content/uploads/2021/02/GCFFC-Financial-Crime-Information-Wall-2021.pdf

11 See https://www.fatf-gafi.org/publications/mutualevaluations/?hf=10&b=0&s=desc(fatf_releasedate)

12 Lisa D. Ordoñez et al, "Goals Gone Wild: The Systematic Side Effects of Over-Prescribing Goal Setting", Harvard Business School Working Paper 09-083, 2009. https://www.hbs.edu/ris/Publication%20Files/09-083.pdf

13 See for example https://www.justice.gov/criminal-fraud/file/1329926/download

14 https://www.sra.org.uk/globalassets/documents/sra/research/anti-money-laundering-aml-visits-2019-2020.pdf?version=4ada2c

15 https://complyadvantage.com/resource-hub/type/reports/the-state-of-financial-crime-2021/?utm_source=twitter.com&utm_medium=social&utm_campaign=2021report

16 Elucidate has been registered by the Federal Financial Supervisory Authority (BaFin) as a Benchmark Administrator in the European Security and Markets Authority (ESMA) Registry under Article 34 of the EU Benchmarking Regulation (BMR) 2016/1011

17 https://www.wolfsberg-principles.com/wolfsbergcb

18 https://elucidate.co/elucidate-fincrime-index

19 https://www.nasdaq.com/articles/8-ways-kyc-compliance-will-evolve-in-the-next-5-years-2020-11-03

20 https://www.eba.europa.eu/eba-sets-out-how-prudential-supervisors-should-take-money-laundering-and-terrorist-financing-risks

21 https://www.globalwitness.org/en/press-releases/important-step-towards-greater-corporate-accountability-european-commission-commits-new-eu-rules-regulate-supply-chains/

22 https://www.acams.org/en/media/document/acams-compliance-effectiveness-and-risks-survey