

TITLE COMPLIANCE FUNCTION AUDIT IN COMMERCIAL BANKS

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Abstract: The goal of this paper is to investigate the mechanisms implemented by the banking system to combat money laundering and terrorism, on the background of the increase in the volume of financial transactions. Starting from the variety of mechanisms and forms of money laundering and from the increase interest of the states in combating related crimes, institutions specializing in combating this phenomenon were created at intergovernmental level. The banking system as a whole is interested in combating the phenomenon given the distortions that can be generated by a generalized context of fraud, corruption and money laundering, substantiated in damaging the credibility of the financial institutions with which it enters a business relationship, to the extent where it is impossible to determine the currency necessary based on the demand of the real economy. In this context, the investigation of the mechanisms implemented by banking institutions with the purpose of identifying and blocking suspicious transactions is of special interest.

JEL classification: M41, M42

Key words: critical; money laundering; banking system; internal audit; compliance risk management

1. INTRODUCTION: NEED, CONCEPT, ACTORS, REGULATORY FRAMEWORK

Money laundering is an activity complementary to illegal activities by which they provide the extraction and reintroduction or the resulted amounts into the circular flow. Legal provisions associate this concept with the financing of terrorism, drug, arm and human trafficking, and tax evasion, but the reality shows that it covers much more varied illegal activities such as organ trafficking, bribery, influence peddling, fraud, financing election campaigns. In the latter case, money laundering presents two values, namely the unknown source of possibly illicit funds, and the prerequisite for the future defrauding of public money, which is why the implemented AML mechanisms aim at identifying persons exposed politically, relatives and intermediaries.

Initially associated with the service sector due to the reduced possibilities to check the reality and the traceability of money, currently, money laundering can be quartered in any field that allows for the quick transiting of large amounts of money, including trading securities, real estate transactions, sports clubs, non-profit organizations, gambling, etc.

Due to the fact that there are many environments and activities to which it is associated, money laundering is hard to prove, as the persons involved might use legal,

financial and fiscal counselling services in order to dissimulate the amounts behind legal activities.

A special feature can be seen in respect of laundering money resulted from tax fraud transiting tax havens or areas that are non-cooperative in respect to money laundering which makes the identification and documentation process more difficult and longer. The same category includes defrauding public money which can involve publicly exposed persons and their intermediaries, generically referred to as PEPs, and the need to combat them led to the conclusion of intergovernmental agreements on exchanging information with the purpose of avoiding tax fraud.

Regardless of the type of illegal activity to which money laundering is associated, an important feature is the need to convey large amounts in short periods of time, in or between different tax legislations, which turns the banking system into a good transit channel. According to the records of the National Office for Prevention and Control of Money Laundering, in Romania, 84% of the money laundering operations are committed through the banking system; this information is based on the number of suspicious transaction reports sent to the Office.¹

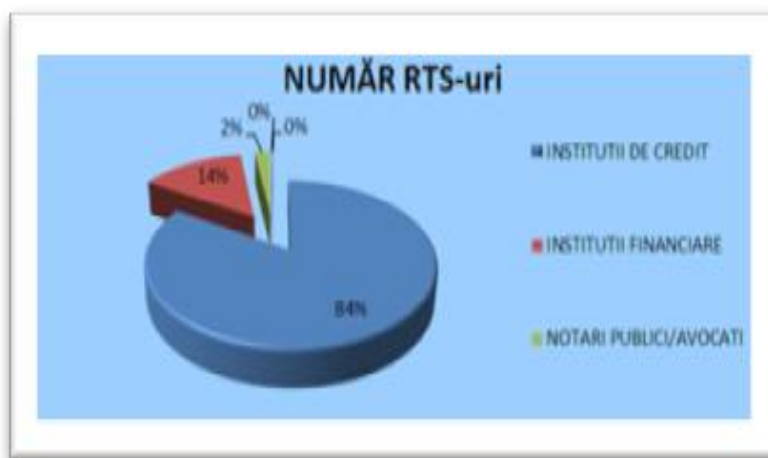


Figure no. 1 RTS distribution / category of reporting entities.

Source: The National Office For Prevention And Control Of Money Laundering, Annual Report 2015

The association of the money laundering activity with high-risk criminal activities led to its inclusion into the category of criminal activities with negative effects at the highest level. Thus the Financial Action Task Force (FATF) 2014 – 2015 annual report identifies a direct link between terrorism increase at international level and

¹ The situation is according to the statistical records of the number of suspicious transaction reports (STR) submitted to National Office for Prevention and Control of Money Laundering (ONPCSB) according to the 2015 annual activity report (graphic, page 9). The reality may be different, in fact, as entities in other areas may face unidentified and unreported suspicious transactions, because they have no specialised structures implemented or no specialised staff. Starting from this hypothesis we can deem that the information is positive, meaning that the banking system has implemented adequate tools for the identification and reporting of transactions suspected of money laundering/terrorism financing.

obtaining finance by terrorist organizations, setting as an absolute priority the implementation by all member states of the legal framework and mechanisms for the criminalization of terrorism financing and the implementation of the established financial penalties.

The International Monetary Fund, through its assessments made in connection to ML/FT concluded that the money laundering and terrorism financing activity undermines the integrity and stability of the financial sector, discourages foreign investments and disturbs capital flows, having negative consequences on the financial stability and macroeconomic performance of countries; moreover, on the background of increasingly interconnected world economies, the negative effects can be conveyed to the financial stability of other countries.²

The answer of the society was the development of an international framework for combating money laundering and terrorism financing known as AML / CFT under which international institutions and national states cooperate to implement adequate measures. The international institutions contributing to the development of the framework for combating money laundering and the financing of terrorism are: the United Nations Organization that adopts international penalising regimes at AML/CFT level; Financial Action Task Force on Money Laundering (FATF – GAFI) the main actor in the elaboration of recommendations concerning money laundering and terrorism; Egmont Group that supports the establishment and provides the support for Financial Intelligence Units (FIU); the European Council.³

For the implementation of the legal framework, inter-institutional agreements were concluded between The National Office for Prevention and Control of Money Laundering (ONPCSB) and institutions managing information or that are involved in drafting and applying laws on money laundering: the National Office of Trade Register, the Ministry of Public Finance through the National Agency for Fiscal Administration, the Financial Supervisory Authority, the Agency for the Administration of Pension Funds, the Ministry of Justice, the Ministry of Interior, the Prosecutor’s Office attached to the High Court of Cassation and Justice, Romanian Intelligence Service, the Foreign Intelligence Service as well as authorities with financial control and prudential supervision competences: the Romanian Court of Accounts, NBR Supervision Department, the Committee for Granting Licenses and Authorising Gambling within the Ministry of Finance, the National Securities Commission, the Insurance Supervision Commission, etc., ONPCSB having a central role in managing the process.

In compliance with Law no. 656/2002 as amended, reporting obligations were established in relation to information on the money laundering activity for a wide category of professional activities: financial auditors (CAFR), credit institutions (ARB), lawyers (INPPA, UNBR), administrators of private pension funds, casinos (ONJN), tax consultants, financial service investment companies, insurance/reinsurance companies, notaries public (UNNPR, INR), non-bank financial institutions (ALB), chartered accountants and certified accountants (CECCAR), payment service providers, foreign exchange offices, real estate agencies, associations and foundations; the reporting of AML/CFT information is not subject to professional secrecy.

² According to workpaper “The IMF and the Fight Against Money Laundering and the Financing of Terrorism”.

³ Summary, according with Training manual on combating money laundering and terrorist financing: Annexes 1-3 (pages 102-103,107).

In relation to the banking system, regulators have the responsibility to periodically update the main regulations and good practice books and to review limits and significance thresholds related to transactions, so that their activity may remain compliant with the objectives associated to AML/CFT, and commercial banks are responsible for the implementation of adequate mechanisms for the compliance with the regulatory framework in the operational activity.

2. INDEPENDENT CONTROL FUNCTIONS IN COMMERCIAL BANKS

The purpose of any entity is profit, and setting ambitious objectives in relation to the turnover, client portfolio, products, etc. can encourage the staff interested in getting bonuses to display fraudulent behaviour or to turn a blind eye to operations suspected of money laundering, and for this reason, the elements defining the “fraud triangle” are valid both in the case of fraud and in the case of ML/FT.⁴

Moreover, familiarity risks may appear between employees and customers due to long business relationships with the customer, or own interest threats resulted from the involvement of the employees or of members of their families in the customer’s activity, the forms of persuading them to get joined interests can be varied, aiming at persons who can be involved in the leadership or to equity participants, granting loans or commercial incentives, or other advantages. The favouring factors and the aforementioned risks require the implementation of a structure meant to efficiently identify and monitor risk. The efficiency of the identification and monitoring process depends on the independence of the structure in charge with achieving the commercial objectives.

For the appropriate management of their risks, banks have implemented a set of good practice principles known as corporate governance - they have developed organisational structures, they have drafted policies, internal rules and procedures meant to ensure the implementation of an environment appropriate for internal control. Moreover, legal provisions require commercial banks to implement some control functions on risk management, compliance control and internal audit within their organizational structure.

All the bank structures have responsibilities related to the identification and reporting of the compliance risk to the compliance function that provides the compliance risk management at centralised level.

According to the regulatory framework⁵ commercial banks must implement a compliance policy, applied permanently and at central level through the compliance function. At the same time, the legal requirements on the compliance risk management require that the structure that manages the process should be independent and should have direct access to the management body.

For the fulfilment of its tasks, the compliance function has access to, and checks all the activities, products and services in terms of compliance with the regulatory framework. Any inconsistency is duly reported to the executive management so that the latter may take steps to mitigate the risk. The compliance function also advises the management bodies on the compliance or acts and processes with the legal framework and the standards it must meet. This aspect is very important, because the

⁴ The fraud triangle, presented in the specialized literature as being developed by Dr. Donald R. Cressey. Comprises three factors: pressure, opportunity and rationalization.

⁵ NBR Regulation no. 5/2013, cap. 4.3, “*The Compliance Function*”.

provision of inadequate consultancy services will be directly reflected in the quality of the decisions made by the management body.

The compliance function ensures the compliance with the regulatory framework and the reporting requirements, the current activity of the bank, the staff's compliance with the business conduct and the conduct in the relationships with the clients, the elimination of conflicts of interests and non-compliant practices.

The compliance function has an important role in the development and implementation of the products and services provided to the clients, as inadequate products, presented in an inappropriate manner, in the absence of transparency, have hidden costs, and in general, the non-compliance with the good practices can lead to lawsuits with clients or customer protection.

Thus, we can conclude that the emergence of any forms of litigation related to the process and services sold to clients, the selling practices or the contractual conditions represent to some extent the failure or weakness of the compliance function in its activity of developing and implementing products or in relation with the selling process. Collective processes are a confirmation of unhealthy practices in the activity performed and constitute an indicator and a factor for the assessment of the quality of the compliance function.

The compliance function ensures the monitoring of the clients' behaviour, for the identification of the suspicious money transactions, the activity being organized within a separate structure.

The legal framework for combating money laundering and the financing of terrorism must be translated into own regulations within the institution, including the monitoring of the activity of non-resident politically exposed persons.

In addition to the information provided by the authorities and the bodies specialising in AML/CFT, banks also develop and manage own databases with non-grata persons, with negative reputation, with whom they do not intend to carry out any business. These databases include historical information on clients' inappropriate behaviour, fraud or attempted fraud, deceit, the negative mass-media information being managed by the antifraud departments.

The compliance function carries out controls at the level of all structures based on an annual and multiannual activity programme. The results of its verifications performed together with the recommendations proposed for the risk alleviation are submitted for approval to the management body and the steps taken are monitored within the structure.

In order to fulfil its objective, the legal framework provides that the compliance function must be independent and must have sufficient competence area. In order to be effective, the compliance structure must have a proactive behaviour, making sure that the policies and procedures are observed by ad-hoc tests and controls; a behaviour reactive to isolated or particular incidents is not recommendable.⁶

The compliance risk management is carried out continuously through the staff in the operational structures and the support activities. The compliance function monitors the observance of the legal framework by all employees and especially by those in contact with clients. The compliance function assesses the impact of all

⁶ Sound Practices paper – private banking, prepared by the Federal Reserve bank of new York, July 1997; section 1301.0, III. Risk management practices and Monitoring systems, Compliance.

changes occurred in the organizational structure, the products and services provided, the assessment being carried out both before and after the implementation of changes, and the extent of the assessment is proportional to the changes made.

Separately from of the compliance activity, the internal audit function is also implemented within banking institutions, which can also be outsource in compliance with the regulatory framework, but must remain independent.

An independent and skilled internal audit structure is crucial for the provision of an efficient governance process⁷.

The internal audit assesses risks after the implementation of the controls planned by the management. The internal audit provides, through successive tests performed on the implemented controls, the continuous improvement of such controls. The internal audit structure assesses the compliance of the activity with the internal regulations, and carries out tests on the integrity of the financial and operational information, and the asset protection, etc.

The audit promotes the ethical conduct within the entity and the performance management, the communication of information concerning risk, and the control horizontally and vertically, and provides the streamlining of the communication among the management, the board, and the external auditor, the relationship with the surveillance and control authorities being the attribute of the compliance function.

The internal audit structure brings added value if it is independent and objective; under such circumstances, it can provide reasonable assurance to the management bodies in relation to the control framework, risk management and the governance of the institution; by a systematic and disciplined approach, it can improve the activities of the organization, contributing to the achievement of the set objectives, by assessing and improving risk management, control and governance processes.⁸

The internal audit comprises in its scope of action all the activities, processes, internal structures and outsourced activities. The compliance functions and the risk management require special attention due to the central role within the internal control system and the management of the institution's risks.

In relation to the ML/FT risk, the internal audit provides an integrated approach for the assessment of the process of identifying and reporting suspicious activities, including in its scope of action both the activity of the commercial structures, the decision making and monitoring bodies as well as the structure that coordinates the process of identifying and reporting suspicious transactions.

The "tone of the top" concept is perfectly valid both for an appropriate audit as well as a compliance activity: the approach must be supported by the executive management, otherwise the commercial structures interested in reaching their target and getting their bonuses may have an inappropriate behaviour in their relationship with the clients, or will not be interested in identifying and reporting transactions suspected of money laundering/financing of terrorism, which activities can otherwise generate high profits⁹.

⁷ Corporate governance principles for banks, principle 10: audit intern, www.bis.org.

⁸ Features highlighted following the reinterpretation of the Definition of the internal audit activity provided by the Institute of Internal Auditors.

⁹ I started from the assumption that the money laundering activity focuses the conveyance of large amounts of money regardless of the type of product and associated cost, as long as it provides the extraction of the gain from the crime.

The personnel involved in the AML/CFT activity should be independent and objective: they should not have business relationships and should not be involved in the assessed entities. A written statement concerning the potential conflicts of interests is a useful tool for the avoidance of a conflict of interests¹⁰.

The structure in charge with the identification and monitoring of the conflict of interests must provide the assessment of the AML/CFT structure, while also carrying out a self-assessment, which constitutes an important assessment topic in the audit activity.

The general framework and the good practices are crucial in the activity performed and are supported proactively by the bank management, who is interested in maintaining an adequate climate meant to prevent fraud, eliminate the conflict of interests, implementing the measures required for the compliance with the legal framework.

3. THE AUDIT OF THE COMPLIANCE FUNCTION IN TERMS OF AML – CFT

The association of the image with money laundering poses a problem of trust from business partners, and losing a good reputation in the market has immediate effects; for example, including a bank on the Worldcheck list can be followed by ending the correspondent relationship by partner banks (no actual examples were identified in the mass-media in this respect), fines from the supervision authorities and penalising the guilty personnel.

In order to make sure that the ML/FT risk is appropriately hedged, the audit structure should cover, through its audit missions, the processes performed by the compliance structure, as well as the activity of the operational and support structures¹¹, starting with the Compliance Plan and ending by effectively implementing the plan and the recommendations.

Thus, the audit of the compliance function includes the Client Acceptance Policy, the AML/CFT policies, the human resources policy, the risk and lending policies, analysing processes both at the compliance level, as well as at the level of the operational units and support functions.

The compliance plan must provide the identification of the list of specific activities and the determination of those who could be part of the money laundering circuit (cash transactions, deposits, internal/external money transfers, lending, credit and debit cards, operations performed with securities in client's accounts), and following the assessment, a AML/CFT risk level is determined for each activity.

Special attention is paid to outsourced activities (card processing, selling credit products or credit cards via brokers, processing payment operations) for which the provider must ensure an ML/FT risk level similar to that ensured by the bank before the outsourcing.

¹⁰ The need to meet the objectivity and independence conditions, the criteria considered for the ascertainment of the conflict of interests and the solution identified for the alleviation of the risk are taken over by assimilation from the Code of Ethics of the Chamber of Financial Auditors; commercial banks, through their own code of ethics, can set different criteria for the personnel of the compliance function.

¹¹ The verification of the activities of the operational structures in terms of AML/CFT will probably be assessed in distinctive commitments by that of the compliance structure.

The ML/FT risk assessment should cover the entire product and service portfolio, in such a way as each proposal for the introduction/change of a product/service should be the object of the assessment.

In the client account opening process, information is collected about the client, the source of funds, the real beneficiary, the operational staff must collect sufficient information in order to determine the risk level; the information must be complete, and the persons without a criminal record or with outstanding probity should not be an exception. No anonymous accounts are opened in the absence of documents. Special attention must be paid to invoice accounts, in which several depositors, clients or non-clients, deposit amounts of money, so as to identify depositors, the real beneficiary of the amounts and the nature of the business relationship.

The bank must identify the groups of clients linked and affiliated with the purpose of identifying a high ML/FT risk for a client and to assess/reassess the risk level for the entire group and the adequate monitoring of the transactions made.

Throughout the business relationship, clients must be subject to the monitoring for the ML/FT risk so that each client should benefit from products adequate to the risk level allocated to them and to ensure the compliance with the legal limits required for cash transactions and foreign currency transfers. Special attention is paid to atypical operations – opening followed by a transfer of high amounts followed by closing the account for whose detection the implementation of IT programs is useful.

The bank defines competence levels for opening and continuing the business relationship with its clients and the products offered to them depending on the associated risk level, and the non-standard products that are granted to atypical clients must be subject to the approval of an adequate competence level and be the object of regular monitoring/review in order to maintain the ML/FT risk at a level similar to clients opened according to the standard procedure.

The compliance structure must collect and maintain updated lists of undesirable or unacceptable persons, based on the information provided by the criminal investigation bodies, national international bodies competent in AML/CFT.

Good practice books should allow the operational personnel to identify transactions suspected of money laundering and actions needed for the reporting of suspicious transactions and the enforcement of decisions to block funds. The communication process must be rapid and documented, and it is mandatory to keep the confidentiality of the transactions reported to the ONPCSB Office. The AML/CFT process in general and the reports submitted to the Office must be correctly and completely documented, in such a way as this logical approach should lead to the same conclusion underlying the reporting.

The AML/CFT procedures performed must cover a wide framework including transactions carried out through an account of the entities within the group of the credit institution and should cover the risk of the avoidance of controls by the management of their own institution. For this purpose, it is crucial to ensure the independence of the structure and the compliance with the ethical integrity, objectivity professional competence and confidentiality requirements by the personnel. Any problem of doubt identified in relation to the personnel's independence must be discussed with the top management and the board with the purpose of taking adequate steps for the tackling the issue.

The application of policies and procedures used to know clients must cover both the operations carried out in own client accounts, the operations carried out by

non-clients (cash office, foreign exchange office, foreign exchange transfers) and also occasional transactions (selling guarantees within the enforcement procedure, selling bad loan packages, selling packages of receivables, concluding rental contracts, equity investments, etc.), in such a way as to collect enough information on the transaction, the method of setting the price, the identification of the business partner, the real beneficiary and the source of funds. The criteria used to know clients must also be applied for third parties that provide services to the bank (bailiffs, notaries public, valuers, etc.).

For the appropriate management of the ML/FT risk, the human resources policy must provide for the implementation of a set of internal procedures meant to ensure an adequate behaviour in the relationship with clients and the elimination of the conflict of interest.

The lending policy must provide for the appropriate identification of the counterparty for all products (loans granted, guaranties received, guaranties issued, comfort letters, etc.), and to provide for the compliance with the purpose of the products granted in such a way as not to finance activities internationally recognized with a high risk of money laundering and financing of terrorism.

The ML/FT risk policy must provide for the protection of clients' personal data, because the access to these data would allow for opening and operating fictitious accounts or for accessing other categories of banking or non-banking products on clients' behalf and used in the money laundering circuit or for financing of terrorism. Moreover, the bank has real obligations related to the protection of personal data, and data losing can be penalised by suspending the data processing right.¹² This category includes the need to get relevant information concerning the persons who have access to the IT resources of the bank.

Following the verifications performed, the compliance function proposes measures for the correction of each deficiency which they monitor in an adequate manner, and where the case may be, it also proposes the review of the internal regulations.

4. CONCLUSIONS

The money laundering activity is associated with high-risk crimes, which is why international bodies and national authorities issued ample regulations on combating the ML/FT phenomenon which banks, as participants to the international transfer of money amounts must implement in an adequate manner. Regulatory bodies enrich the regulatory framework and continuously review the activities and the required limits, and national institutions supervise its implementation. Commercial banks implement adequate structures and identification processes, report transactions suspected of ML/FT and block funds. The internal audit structure is not directly involved in the ML/FT risk management, but through regular assessments they perform at the compliance function level, operational units and support functions ensure the improvement of the control framework and the increase in the efficiency of the tools and measures ordered by the management for the elimination of the risk of money laundering and financing of terrorism.

¹² Art. 21, letter d) of Law no. 677/2001 on the protection of individuals with regards to the processing of personal data and the free circulation of such data.

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