

Briefing note:
Identification of existing
customers by regulated firms

July 2003



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Why are we publishing this briefing note?

This note has been produced as a supplement to our (the FSA's) press release (ref. FSA/PN/0077/2003) of 22 July 2003. It provides background information and further detail on our decision not to introduce a new industry-wide requirement for all regulated firms to undertake a specific anti-money laundering 'Current Customer Review'.

Who should read this briefing note?

Senior management, Money Laundering Reporting Officers and other appropriate staff in all firms carrying out relevant regulated activities as defined in our Money Laundering Sourcebook (ML).

Trade associations and consumer organisations may also be interested in the content.

What is the 'current customer' issue?

Financial services providers are required to verify the identity of their customers under both the Money Laundering Regulations 1993 (the Regulations) and ML, which mirrors the Regulations. But some customers may not have been identified adequately or at all, either because:

- they became customers before the Regulations came into force on 1 April 1994; or
- a firm did not comply with the Regulations in the period before we were given regulatory responsibility for anti-money laundering on 1 December 2001 (N2).

We believe that the existence of customers within the financial system who have never been identified for AML purposes is a risk. This is because they may not have been subject to checks that they are who they say they are. So this is an important question for us to address in the context of our statutory objective to reduce the extent to which it is possible for a firm to be used for a purpose connected with financial crime.

Why does customer identification matter?

Initial identification is a key element of the AML regime both in the UK and internationally. It features in the First EU Money Laundering Directive, the Regulations, the Financial Action Task Force (FATF) Forty Recommendations¹, the Basel Committee on Banking Supervision's paper, *Customer Due Diligence for Banks*², our Money Laundering Sourcebook and the industry Joint Money Laundering Steering Group Guidance Notes³. It serves a number of purposes:

- deterring use of the financial system for purposes of financial crime;

¹ See www1.oecd.org/fatf.

² See www.bis.org/publ/bcbs85.htm.

³ See www.jmlsg.org.uk.

- helping firms to counter use of their products by people with false or stolen identities;
- helping firms to counter fraud;
- providing a start-point for wider Know Your Customer information and a basis for ongoing monitoring/awareness; and
- being a source of valuable intelligence to law enforcement in investigating and dealing with crime.

It is therefore important that firms have and maintain high operational standards for identifying new customers.

Law enforcement agencies have advised us that they see this identification as significant in the context of deterring, investigating and solving crime. Clearly customer identification is only one of various anti-money laundering controls used by firms. Others include having more knowledge about customers than simply identification, customer monitoring, making reports to the National Criminal Intelligence Service (NCIS), training etc.

So how have we been approaching this?

On 15 July 2002 the six largest UK retail banks (Abbey National, Barclays, HBOS, HSBC, LloydsTSB and RBS) announced that they would reconfirm the identity of their existing customers using a risk-based approach.⁴ This Current Customer Review (CCR) focuses on verification of higher-risk customers and products and the use of ‘filters’ to remove lower risk customers from the review, for example low-risk products, low value holdings, dormant accounts etc.

We welcomed this as an important initiative and evidence of the banks’ commitment to fighting money laundering and terrorist finance. In addition to the six largest retail banks, other firms have also initiated similar review exercises. The advantage to firms and customers is that customers who have passed through this process (most of them without having been contacted) will not be subject to future re-verification. Firms will also secure a measure of regulatory certainty about their existing customers.

On the same day, we indicated that we would consult on a specific rule or guidance requiring all firms subject to the requirements in ML to carry out a review of their pre-N2 existing customers. The aim was to ensure that they had been identified or that the risk of money laundering was minimal.

Since then we have been holding discussions with the industry to consider whether, and if so how, a risk-based review might be rolled out to all regulated firms. We discussed extensively the impact of possible changes in our Handbook with the main trade associations and law enforcement agencies. We considered the wider context, including relevant developments in anti-money laundering since the issue first arose, for example the KPMG review of the

⁴ For a copy of the joint press release and statement of principles see <http://www.newsroom.barclays.co.uk/news/data/734.html>.

effectiveness of the UK Suspicious Activity Reporting regime.⁵ We also carried out a preliminary, internal Cost Benefit Analysis (CBA).

In February 2003 we appointed Pricewaterhouse Coopers LLP (PwC) to carry out a further, more extensive CBA on our behalf. We are publishing this CBA in full.

What options did we consider?

The CBA considered two policy options for identification of existing customers. Both involved use of a risk-based approach and were developed in consultation with the industry:

- Option A – a structured risk-based review by all firms with a fixed completion date, similar to that being undertaken by the six largest retail banks; and
- Option B – a less prescriptive approach based on general guidance, putting greater responsibility on firms.

What were the key findings of the CBA?

PwC spoke to a sample of approximately 100 small, medium and large firms using a combination of face-to-face and telephone interviews. The firms spanned the range of sectors subject to the provisions in ML. The sectors were divided into three groups:

- *banking* (retail / commercial banks, private banks, building societies);
- *capital markets* (investment banks, derivatives brokers/dealers, institutional fund managers); and
- *insurance and investment management* (life insurance, IFAs, stockbrokers, retail fund managers).

90% of the firms interviewed thought we were right to address this issue.

PwC also considered the costs and benefits more widely, including to consumers and law enforcement agencies.

The full report is available on our website via www.fsa.gov.uk / publications.

Key findings highlighted by PwC's CBA are:

Potential costs

- Option A is estimated to be significantly more expensive than Option B. PwC suggest that the main reason for this is that Option B provides greater flexibility to tailor work to the firm in question, thus reducing the number of customers who would need to be verified.
- The potential costs are estimated at £174m for Option A and £92m for Option B. Approximately 90% of these costs would be compliance costs to firms, with the remainder being costs to customers and NCIS and other law enforcement agencies.

⁵ On 1 July 2003, the Home Office issued the findings of research they had commissioned into the effectiveness of the UK suspicious activity reporting regime. For a copy of the report entitled 'Money Laundering: Review of the Reporting System' see www.homeoffice.gov.uk.

- The costs – both absolute and relative to overall spending on anti-money laundering – would potentially be greater for the insurance and investment management sector than the other groups, largely due to the volume of customers involved.
- The estimated costs to the retail banking sector would be lower than to the other sectors (note that the work of the six largest retail banks is excluded from this estimate).
- The cost per customer to capital markets firms (£36 - £44 per customer) would be higher than for banking (£0.80 - £2 per customer) or insurance & investment management (£0.80 - £1.25), due to the greater complexity of the types of business and customers (eg overseas, corporate).
- Manual verification of customers (eg contacting by letter to ask for documentation) represents the largest proportion of costs.
- The report indicates that under Option A there could be an increase of 65% in the numbers of SARs (Suspicious Activity Reports) generated, leading to increased costs to NCIS and other law enforcement agencies.
- PwC also found that 64% of firms surveyed thought they would need to contact at least some of their customers. They estimate that the total number of customers to be re-verified could be as high as 11.2 million.

Potential benefits

- Firms were most positive about the potential benefits of *regulatory compliance*, ie that the CCR would result in better compliance with the Regulations and the Proceeds of Crime Act 2002, reduced reputational risk etc.
- Firms were less positive about the *commercial benefits* (eg increased marketing opportunities) and the *wider social benefits* (eg deterring money launderers).

What have we decided?

We have decided that **we will not be consulting on a specific requirement for all regulated firms to carry out a review of their pre-N2 existing customers** to ensure that they have been identified or that the risk of money laundering is minimal.

However this decision does not diminish the importance of customer identification in the fight against money laundering. The law enforcement agencies who are the main users of anti-money laundering efforts by the financial services industry consider that customer identification is a key control – and we agree. Firms should not be ignoring any gaps in their identification controls, whether in respect of customers taken on before the Money Laundering Regulation came into force in 1994 or otherwise.

We also remind firms – particularly senior management – that they are already required under our Handbook to establish and maintain effective systems and controls for countering the risk that they might be used to further financial crime, which includes money laundering. Firms that do not seriously address risks (including the risk that they have not confirmed the identity of existing customers) are exposing themselves to the possibility of action for breach of our rules or of the Money Laundering Regulations. In some circumstances this might involve a special review similar to that being carried out by the six largest retail banks and others.

What are the reasons for our decision?

The issue is whether we can introduce a general requirement that applies to all the 10,000 or so firms we regulate.

A number of factors were relevant to our decision *not* to impose a general requirement. For example we already have **existing requirements** in our Handbook that oblige firms to maintain adequate systems and controls to counter money laundering.⁶ Initially we thought that the risks might be sufficiently great to mean that supplementary rules or guidance would be required. However we have now concluded that this would be disproportionate. The existing requirements offer flexibility, and it is important that firms consider the current customer question in the most appropriate way, given the nature of their business and the money laundering risks they face. Adopting a cross-industry approach, even on a risk-focused basis, is not the best solution.

The CBA also indicates that a significant proportion of firms interviewed (33% for Option A and 46% for Option B) consider that they **would not need to take any further action** if a specific current customer review requirement was introduced. This might be because they have already undertaken review work, because they have good systems and controls in place or because they maintain close ongoing relationships with their customers.⁷

Given the overall findings of the CBA we **cannot be sufficiently confident that the incremental benefits would outweigh the costs**, and that therefore a CCR would be proportionate.

Two other relevant factors were the **impact on consumers** and the **suspicious activity reporting (SAR)** regime. We wanted to avoid a disproportionate number of demands on consumers to verify their identity (in many cases, multiple requests from different firms). We also do not want to add significantly to the number of SARs at a time when the system for receiving and processing them is under pressure and subject to review (as shown in the KPMG report⁸ published in July 2003). And we did not want to contribute to defensive reporting, a risk highlighted by the PwC report.⁹

We also took account of the fact that existing customer identification is **only one of a number of areas in which firms are spending money on anti-money laundering controls**. Others include identification of new customers, monitoring, record-keeping, training, implementation of the requirements of the Proceeds of Crime Act 2002 etc. It is important for firms to make their own judgements about which parts of their anti-money laundering arrangements require attention.

⁶ Senior Management Arrangements, Systems and Controls 3.2.6R which requires a firm “to establish and maintain effective systems and controls for (...) countering the risk that the firm might be used to further financial crime”.

⁷ See CBA, p39.

⁸ See KPMG report into effectiveness of the UK suspicious activity reporting regime. For a copy of the report entitled ‘Money Laundering: Review of the Reporting System’ see www.homeoffice.gov.uk.

⁹ See CBA, p 61-62.

What standards apply to regulated firms?

We expect firms to have adequate AML systems and controls in place, covering identification (including identification of existing customers) but also the other key controls eg training, making SARs etc. In particular, senior management must consider the existing obligation under rule 3.2.6R of the Senior Management Arrangements, Systems and Controls module of our Handbook. This requires a firm “to establish and maintain effective systems and controls for (...) countering the risk that the firm might be used to further financial crime.” Financial crime includes money laundering.

The requirements in SYSC 3.2.6R are high level, covering overall AML systems and controls. As such, they cover customers who may have become customers before April 1994.

So what does this mean for firms?

Whether firms will consider that they need to take steps to identify existing customers (including pre-1994) will depend on the individual circumstances of the firm. We know that a number have already considered and dealt with this issue. For others it may not be relevant, for example where the firm only started doing business after April 1994 and has had a good standard of compliance. But we are taking this opportunity to remind firms of their high-level requirements and to consider what this means in the context of their current customer base.

When carrying out risk assessment and mitigation we would expect firms – as part of their overall approach to AML – to have considered the risk posed by existing customers who have not been identified. We also expect them (if appropriate) to take steps or put controls in place to mitigate this risk. We encourage senior management and MLROs to consider these questions and take any appropriate steps:

- Have you had good AML controls since 1994?
- Is the existing customers question relevant? (for example do you have pre-1994 customers?)
- If so, has the question been acknowledged and discussed as part of an overall AML risk assessment?
- How great is the money laundering risk posed by your existing stock of customers?
- Have senior management agreed procedures / changes / company policy on the identification of existing customers?
- Have you already taken steps to address the question eg full or risk-based review?
- Do you feel that your current standard of compliance (or standards since 1994) with the ML Regulations poses legal risk?
- Do you feel that your current standard of compliance (or standards since 2001) with the ML Sourcebook poses regulatory risk?
- Are you exposed to reputational risk?
- Have records been kept of any risk assessments, review work, senior management decision-making etc?

During the development of our policy we have discussed with trade bodies how a risk-based approach to identification of existing customers might work on a generic basis for different sectors. For example use of a structured approach, risk categorisation and appropriate ‘filters’ for each sector to ensure that lower risk customers are not targeted. Whilst it is clearly important for firms to consider their own situation, it may also be useful for trade bodies to build on this dialogue and provide good practice generic guidelines for their sector.

If there are no specific regulatory requirements, why are we supporting the work of the six largest retail banks and others?

We continue to believe that the existence of customers within the financial system who have never been identified for AML purposes is a risk. So we fully support those firms who are proactively taking steps to mitigate this risk, for example the programmes initiated by the largest banks in the UK and some others. Other firms may also consider that a review is appropriate given the relative risks, costs and benefits of their own situation. But we encourage firms to ensure that any such action is risk-based, with the emphasis on reviewing higher-risk customers and products, to help minimise unnecessary costs or customer impact.

Are firms able to access the electoral register?

Some firms that have decided to review their current customers have indicated that they wish to access the full electoral register via a licensed Credit Reference Agency as part of their review work. If a firm wishes to use this route they should contact their supervisor to discuss whether they need to apply for variation of their Part IV permission under Section 44(1) of FSMA, to have adequate legal cover.

What are the implications for our supervision and enforcement?

The existing legal and regulatory requirements remain unchanged. So, where we identify problems or non-compliance in the course of supervision we will consider using appropriate tools, including supervisory tools, enforcement action or prosecution for breaches of the Regulations from April 1994 onwards. If we consider this is justified by the risk, we may also require particular firms to carry out a review of existing customer identification.

In deciding whether to take prosecution or enforcement action we always take into account steps taken by a firm to deal with an issue.

What does this mean for consumers?

We hope that one result of the decision not to introduce a specific regulatory CCR requirement on all firms will be reduced impact on consumers. In particular, it should reduce the volume of requests for customers to provide evidence of identity. Where firms are carrying out proactive review work, this has been designed to be risk-based, avoiding excessive impact on customers.

However, some customers will inevitably be approached. So it is important that they are made aware of why firms ask for evidence of identity, and the role this control plays in the fight against crime and terrorism. We have recently co-operated with the industry, Her Majesty’s Treasury and the National Criminal Intelligence Service to launch information

materials that firms can use to help explain to their customers why anti-money laundering identification controls are important. We encourage firms to use these materials.¹⁰

What is the current state of anti-money laundering in the UK?

In the last three years there have been significant developments in the fight against money laundering the UK. Some of these are no doubt a result of the events of 11 September 2001 and others a response to our new regulatory role. But some are simply due to an increased awareness amongst firms that they are running risks if they do not take anti-money laundering seriously.

Some notable events include the establishment of the Money Laundering Advisory Committee, completion of the IMF Financial Sector Assessment Programme for the UK and publication of the KPMG report into the effectiveness of the suspicious activity reporting regime. In an international context, the UK has input to the new Financial Action Task Force Forty Recommendations. On the part of the industry, substantial resources have been devoted to improving standards and investing in new technologies, for example:

- proactive CCR work;
- customer monitoring systems;
- anti-terrorist finance work;
- implementing the requirements of the Proceeds of Crime Act 2002; and
- a major review of the industry-owned Joint Money Laundering Steering Group Guidance Notes is also underway.

In the context of our own work, as well as our usual supervision of firms' anti-money laundering systems and controls, we are doing theme work. This includes our policy on identification of existing customers and the wider 'Know Your Customer' data collection and customer monitoring, on which we are due to publish a Discussion Paper shortly. Our overall aim is to work towards a stronger and more risk-based approach to anti-money laundering.

¹⁰ For details of how to obtain copies of the leaflets and posters see www.fsa.gov.uk / Industry help / Money laundering and terrorist finance / Know your customer awareness campaign.