

Anti-money laundering current customer review cost benefit analysis

Report prepared by
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ANTI-MONEY LAUNDERING

CURRENT CUSTOMER REVIEW

COST BENEFIT ANALYSIS

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1 Executive summary

Introduction

- 1.1 This cost benefit analysis has been prepared at the request of the Financial Services Authority (“FSA”) and considers the cost/benefit implications of certain proposed changes to the FSA Handbook relating to the anti-money laundering regime.
- 1.2 The FSA is considering whether to require firms to take action through a current customer review (“CCR”) to deal with the money laundering risks arising from:
 - The absence of identification checks on customers before the Money Laundering Regulations 1993 (“the Regulations”) came into effect on 1 April 1994; and
 - Inadequate identification standards since 1 April 1994.
- 1.3 The proposed changes if implemented will bring firms up to date if they were not already with the existing “know your customer” requirements of the legislation and, in terms of the review of customers taken on before the legislation was implemented, introduce a new obligation on most firms.

Background

- 1.4 Since 1 December 2001 (“N2”), when the FSA received its new legislative powers under the Financial Services and Market Act, the FSA has had a specific remit regarding financial crime. It has developed certain rules in relation to money laundering and has been given explicit responsibility to ensure that the Regulations are enforced.
- 1.5 The FSA’s current focus on the identification of existing customers for anti-money laundering purposes follows:
 - The initiative announced on 15 July 2002 by the big six major UK retail banks (Abbey National, Barclays, HBOS, HSBC, Lloyds TSB and the Royal

Bank of Scotland Group) to re-confirm the identity of their existing customer bases; and

- The FSA investigation into the handling of accounts linked to General Sani Abacha.

The proposed options

- 1.6 The two approaches to the CCR being considered by the FSA are referred to as Option A and Option B. Both options envisage a risk based approach to the CCR and require firms to reach a position where they are reasonably satisfied that their current customers are who they say they are or that the risk of money laundering by their customers is negligible. The principal differences between the two approaches are shown in the table below.

Table 1.A	
<p>Option A</p> <p>The Handbook will include a structured process with defined outcomes. Work would need to be completed by 2005.</p> <p>Provisions in the Handbook that:</p> <ul style="list-style-type: none"> ▪ Enable firms to 'filter' out categories of customer either because adequate information should be available to them or because they present no or low risk ▪ Require firms to assess the level of money laundering risk posed by customers. ▪ Require firms to obtain identity documentation (perhaps from third parties) or review the relationship where a medium/high risk customer or where identity evidence is not available. ▪ Envisage firms ending relationships or making suspicious transaction reports as appropriate. 	<p>Option B</p> <p>The Handbook will include more discursive general guidance with discretion to firms. No completion date – an ongoing requirement for firms, although initial work may be required at the outset.</p> <p>Intention that guidance in the Handbook should:</p> <ul style="list-style-type: none"> ▪ Remind firms of the reasons for obtaining know your customer information and their legal and regulatory obligations. ▪ Encourage firms to consider the identity of existing customers and nature of transactions carried out in a risk based way and take action as appropriate.

Methodology

- 1.7 In assessing the likely costs and benefits of the CCR under each of the proposed options, we obtained feedback from relevant firms and other organisations that could be directly or indirectly affected if the proposals were implemented. We adopted a

three-stream approach focusing our efforts on the following three broad industries of the regulated community, Banking, Capital Markets, and Insurance and Investment Management. We ensured that the views of large, medium and small firms were represented.

- 1.8 We included in our analysis only those costs which would be incurred as a result of the FSA implementing either Option A or B and identified our counterfactual as where firms *are* now in terms of knowledge of their customers and compliance with the existing anti-money laundering requirements. Such an approach assumes that amongst the regulated community there is some non-compliance with the Regulations.
- 1.9 We asked firms about the likely costs and benefits of the proposed options using a carefully structured questionnaire. The cost estimates we obtained were scaled up to produce a quantitative estimate of the cost of the CCR under each of the proposed options for the entire population of regulated firms.
- 1.10 In quantifying the estimate of costs for the whole population, we sought to exclude costs incurred by those firms which have carried out or planned a CCR or similar exercise or which meet the requirements proposed by the regulatory options. As a consequence the anticipated cost of the customer reviews planned by the big six banks have been excluded from our scaling up calculations.
- 1.11 Estimating the total costs of the CCR for the population of regulated firms requires the application of professional judgement at several levels. Firstly we have applied our judgement to the responses given by individual firms to take account of the fact they may have calculated costs incorrectly. Secondly we have applied judgement in selecting, from our sample, representative cost information for different types of firm. Finally, the only tractable approach relies heavily on estimating costs per customer. Existing data on the number of customers for the various industry streams were not always available hence judgement has also been applied here and combined with data from the firms in our sample and information from the FSA on the number and types of firm.

1.12 In summary while we have taken care to ensure that our estimates are fair they are subject to a certain degree of uncertainty principally because the CCR is a difficult exercise for firms to cost (and something that we cannot easily “audit”) and as outlined above we have had to make numerous assumptions in the scaling up process.

Findings on costs

1.13 Our estimate of the total cost of the CCR under Option A and Option B is summarised below:

	Option A	Option B
	£'m	£'m
Compliance cost to firms	152.3	85.7
Cost to customers	20.8	6.3
Cost to NCIS/law enforcement	0.9	0.3
Total	<u>174.0</u>	<u>92.3</u>

1.14 As the above table shows the compliance cost to firms estimated at £152.3m under Option A and £85.7m under Option B represents the majority of the estimated total cost of implementing the CCR. As a comparison, our estimate of the likely cost for the big six banks to complete their separately agreed customer reviews has been quantified at £118m.

1.15 The CCR under Option A is likely to prove more expensive for all parties affected by the proposals, the regulated firms, customers, the National Criminal Intelligence Service (“NCIS”) and law enforcement.

1.16 Option A is a prescriptive approach that does not take into account firms’ individual circumstances and as such is likely to result in more customers requiring detailed manual verification and more suspicious transaction reports when compared to the CCR under Option B. The latter provides firms with the opportunity to adopt an approach which is more appropriate to the customer profile and the range of products

and services offered by the firm. Consequently under Option B the “residual” population of customers requiring detailed manual verification is likely to be far smaller, which reduces the cost for firms to complete a CCR, leads to reduced imposed costs on customers and is likely to result in fewer suspicious transaction reports.

- 1.17 Our findings have shown that there are significant variations in the estimated compliance cost to firms and the cost per customer across the different industry streams:

Compliance cost and cost per customer by industry	Option A		Option B	
	£'m	Cost per customer	£'m	Cost per customer
Banking	41	£2.03	16	£0.78
Capital Markets	29	£43.57	19	£36.18
Insurance & Investment Management	82	£1.25	51	£0.81
Total	<u>152</u>		<u>86</u>	

- 1.18 One common factor however across all industry streams and the different sizes of firms was that the detailed manual verification of customers was likely to represent the largest proportion of the cost to firms to complete the CCR.
- 1.19 Our estimate for the Banking stream represents a relatively low proportion of the total compliance cost principally because the cost associated with the big six banks completing their voluntary customer review exercise falls outside the scope of this cost benefit analysis. The Banking stream includes those firms with predominantly UK based personal customers, such as building societies, which are likely to incur a lower cost per customer (because they are able to make more use of credit reference agencies and the FSA draft filters) but also includes a number of international banks which have a significant number of overseas non-personal customers and are likely to face a far higher cost per customer.
- 1.20 The Capital Markets stream is likely to incur the lowest aggregate compliance cost primarily because there are a large number of Capital Markets firms that have

already conducted customer review exercises and who consider themselves already compliant with the proposed options. Such firms are unlikely to incur a significant incremental cost to complete the CCR or prove compliance. The average cost per customer for this industry stream is likely to be high, because many of the customers of the Capital Markets firms are corporations, trusts, hedge funds and other entities based in overseas locations which are unlikely to be filtered out and which generally take more time to manually verify.

1.21 Insurance & Investment Management firms are anticipated to incur the highest aggregate costs to complete the exercise due to the larger customer bases of firms in this industry. Our estimate of the average cost per customer in this industry stream is relatively low as a large number of the FSA draft filters can be applied, and the high number of UK domiciled personal customers can be more easily verified by credit reference agencies. Both would lead to a significant reduction in the number of customers requiring detailed manual verification.

1.22 Our findings have also identified a number of other factors which are likely to affect to some extent the costs to complete a CCR. These include:

- Existing level of compliance with the Regulations;
- Whether a verification exercise has already been completed;
- Quality of customer data and how records are stored;
- Availability of resources to carry out the CCR; and
- Significant levels of old (Pre 1994) customers.

Findings on benefits

1.23 Generally the view of most firms in our sample was that any benefits arising out of the CCR were likely to be modest and those firms facing the greatest cost implications from the CCR were the most critical of the likely benefits. Notwithstanding this 90% of the firms in our sample thought that the identification of pre N2 customers was an issue which needed to be addressed by the FSA. Many

did not however consider the CCR with its retrospective approach to be the best solution.

- 1.24 Based on our discussions with firms, trade associations, NCIS and law enforcement we consider that the potential benefits arising from the CCR can be broadly categorised into three areas: (i) improvements in the level of regulatory compliance (for example with the Regulations and the Proceeds of Crime Act), (ii) commercial benefits such as improved customer databases and (iii) an increase in the prevention or reduction of financial crime, providing benefits to both firms and to society. Of the three broad categories, the firms in our sample were most positive about the potential benefits to regulatory compliance.
- 1.25 64% of the firms in our sample thought that the Option A approach to the CCR would increase the level of compliance with the Regulations and the Proceeds of Crime Act. They also acknowledged that the CCR was a lower cost alternative when compared to some of the “know your customer” remediation exercises that have recently been undertaken by some firms.
- 1.26 Just over half of the firms in our sample thought that the CCR would lead to an improvement in customer databases and related records and around a quarter of firms thought that it would lead to reduced marketing costs or improved marketing effectiveness.
- 1.27 Firms were generally not persuaded of the crime prevention benefits of the CCR, with less than half of the firms in our sample agreeing that it would deter money launderers. The view of a number of firms was that transaction monitoring would be a more effective deterrent.

Wider market impacts

- 1.28 With regard to the wider market impacts of Options A and B we concluded that the costs involved were not of a nature that was likely to affect the quantity, quality or variety of transactions in the market. Primarily this is because neither option affects

the cost or profitability of doing business with new customers, as these are covered by the post N2 anti-money laundering requirements.

- 1.29 We do not expect Options A or B to dull firms' competitive incentives. With regard to existing clients, more than 90% of firms said that they were unlikely to narrow the range of products or services they offer as a result of the proposed CCR under either option. To the extent that there would be an impact, the number of customers affected was likely to be small and firms indicated the effect would be slightly less under Option B than A.
- 1.30 We also considered the issue of whether third party providers of electronic verification services would be able to cope with the demand created by the proposed CCR. A major credit reference agency indicated that they would be able to meet the likely increase in demand and stated that the risk that they would not be able to was less under Option B, which has no deadline for completion of the CCR.

2 Introduction to the cost benefit analysis

Objectives of study

- 2.1 This report has been prepared in response to the request by the FSA for an independent cost benefit analysis (“CBA”) of certain proposed changes to the FSA Handbook relating to the anti-money laundering regime. The FSA wishes to take the CBA into account in deciding whether and how to require firms to take action through a current customer review (“CCR”) to deal with the money laundering risks arising from:
- The absence of identification checks before legal obligations were introduced in 1994 (via the Money Laundering Regulations 1993 (“the Regulations”)); and
 - Inadequate identification standards since 1994.
- 2.2 In essence there are two strands to the FSA proposals for the CCR, (i) the review of those customers taken on before the existing legislation was implemented (a new obligation on firms) and (ii) the review of customers taken on after the legislation came into effect, (thereby bringing firms up to date with the “know your customer” or “KYC” requirements of the Regulations).
- 2.3 The FSA’s proposals represent an extension to the current anti-money laundering requirements for most firms and as a consequence are likely to be heavily scrutinised by those firms that will be affected. We have been asked to identify and quantify where possible the incremental costs and assess the incremental benefits arising from the two policy options under consideration and to take into account the costs and benefits for regulated firms, consumers and society including the immediate “beneficiary” of anti-money laundering policies, namely law enforcement.

- 2.4 Essentially the two options which are summarised in Section 3 below and described further in Appendix I require relevant firms¹ to reach a position where they are reasonably satisfied that their current customers are who they say they are or that the risk of money laundering by their customers is negligible.
- 2.5 As a matter of general policy, the FSA will subject policy alterations to CBA in order to accomplish its stated objective of cost-effective regulation and to fulfil its requirements under the Financial Services and Markets Act (“FSMA”). The FSMA requires the FSA to include CBA in certain of its publications and have regard to the principle of proportionality between burdens or restrictions imposed by its rules and the benefits those rules create.
- 2.6 As far as possible and where appropriate this report adheres to the principles, tools and techniques set out in the guide “Practical Cost-Benefit Analysis for Financial Regulators” prepared in the FSA Central policy directorate. It also gives due regard to the FSA Occasional Paper “Cost-benefit Analysis in Financial Regulation”.
- 2.7 In summary the FSA standard approach to CBA suggests considering policy options on the basis of six market impacts. These impacts are (i) the direct costs to the FSA itself, (ii) the compliance costs to industry, customers and others² (iii) the quantity of transactions completed in the market, (iv) the quality of transactions completed in the market, (v) the variety of transactions completed in the market and (vi) the efficiency of competition in the markets affected. Aside from the direct costs to the FSA (which are being considered by the FSA), we address each of the above impacts in this report.
- 2.8 Finally we have also considered the specific requirements and suggestions detailed in the FSA Request for Proposal dated 14 February 2003.

¹ Defined in ML 1.1.2R of the Money Laundering Sourcebook, essentially any firm that undertakes a relevant regulated activity.

² In the current case the costs to “others” specifically relate to the costs to NCIS and law enforcement.

Structure of the report

2.9 The remainder of our report is structured as follows:

- Section 3 gives an overview of the anti-money laundering regime and recent developments that have preceded the FSA's focus on the identification of pre 1 December 2001 ("N2") customers (including pre 1994 customers) of relevant firms;
- Section 4 explains in detail our methodology for assessing compliance costs and benefits;
- Section 5 sets out our estimates of compliance costs and related findings;
- Section 6 discusses the views of firms and trade associations on the potential benefits of the CCR;
- Section 7 details our findings on other market impacts.

2.10 In Appendix I we attach the FSA's descriptions of the proposed options and in Appendix II we set out the stages to consider in carrying out a CCR. In Appendix III we include our findings on the costs and benefits identified by the six major UK retail banks that have already committed to a CCR.

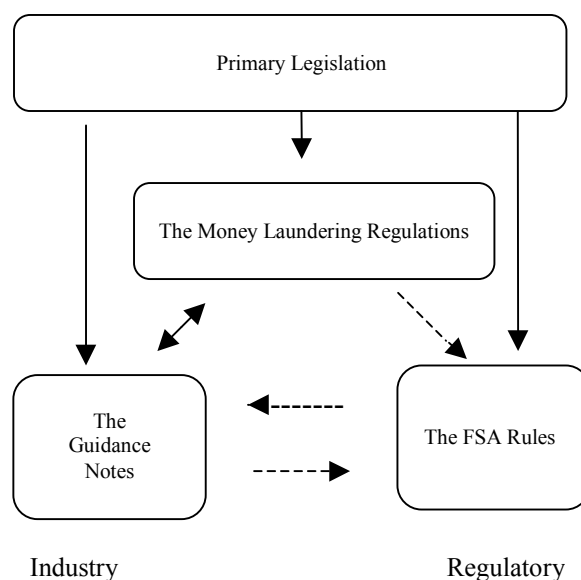
3 The anti-money laundering regime and recent developments

Introduction

3.1 This section gives an overview of the anti-money laundering regime in the UK and discusses some of the recent developments that have preceded the FSA's focus on the identification of pre N2 customers of relevant firms. The two main options for reform currently being considered by the FSA are summarised below at 3.17 to 3.23.

The UK legislative and regulatory framework for combating money laundering

3.2 In the UK there are principally four sources of authority with regard to money laundering, the primary legislation, the Money Laundering Regulations (Statutory Instruments), the FSA Rules and the Joint Money Laundering Steering Group ("JMLSG") Guidance Notes (industry guidance). The relationship³ between these four sources of authority can be summarised as follows:



3.3 The first legislation concerning money laundering was introduced in the late 1980s. Initially the legislation covered only the proceeds of drug trafficking and terrorism

³ A hard line arrow represents a formal relationship. A dotted line represents an informal relationship.

but it criminalised actual assistance in money laundering and failure to report to the criminal authorities any knowledge or suspicion acquired in the course of business.

- 3.4 In 1993, the legislation was extended to cover the proceeds of all serious crime. At the same time the Government, through the Regulations, introduced the first requirement for financial services businesses to maintain specific systems and controls to combat money laundering. The Regulations reflected the requirements of the first European Union Money Laundering Directive and came into effect on 1 April 1994. Since that date all regulated firms carrying out ‘relevant financial business’⁴ have been required to take reasonable steps to obtain evidence of the identity of new customers – referred to as “know your customer” or KYC. Prior to that date, there was no requirement for the financial sector to verify the identity of customers for anti-money laundering purposes.
- 3.5 Since 1 December 2001 when the FSA received its new legislative powers under FSMA with a statutory objective to reduce financial crime, relevant firms have also been subject under the FSA Rules to a general requirement to establish and maintain effective systems and controls for countering the risk that the firm might be used to further financial crime (SYSC 3.2.6R). The FSA was also given explicit power to develop specific rules in relation to money laundering and whilst the general approach mirrored the systems and controls requirements of the Regulations, the FSA also introduced a number of new obligations on relevant financial firms, including the requirements (i) to produce an annual report on anti-money laundering compliance; and (ii) to make use of national and international pronouncements on money laundering.
- 3.6 In complying with both the Regulations and the FSA Rules, firms are also encouraged to use the JMLSG Guidance Notes which aid in the interpretation of the Regulations and FSA Rules and are industry best practice.

⁴ ‘Relevant financial business’ as defined in Regulation 4 of the Money Laundering Regulations 1993.

- 3.7 More recently additional burdens have been placed on regulated firms as a consequence of dealing with the aftermath of “September 11”, the Proceeds of Crime Act and the USA Patriot Act⁵.
- 3.8 In summary, whilst the money laundering offences and the requirement to report suspicious transactions have existed since the late 1980s, there has only been a formal obligation on the financial services industry to know its customers since 1 April 1994. The general obligations on firms were then widened (although not significantly) following N2 with the introduction of the FSA Rules concerning money laundering.

Pressures to expand and strengthen UK anti-money laundering regulation

- 3.9 During the last five years the FSA (and its predecessor organisations) have increasingly sought to ensure that the anti-money laundering requirements were complied with and carried out a large number of visits to firms to assess anti-money laundering compliance. These visits identified deficiencies and resulted in a number of firms having to perform full verification exercises to meet the then current standards. Such reviews were not specifically risk based but took into account any concessions and exemptions relating to low risk products and customers that were enshrined in the Regulations and the JMLSG Guidance Notes.
- 3.10 In March 2001, the FSA published the general findings of its investigation into the handling of accounts which were linked to General Sani Abacha, the former president of Nigeria, and used to illegally extract state funds from the Government of Nigeria. The investigation focused on the anti-money laundering controls at 23 banks in the UK where accounts linked to Abacha family members and close associates were identified. The investigation also found that 15 of the banks had significant control weaknesses. Eight of these banks had corrected the weaknesses since the accounts were opened and a further seven banks were ordered to rectify their failings.

⁵ Relevant to those UK regulated firms that have a parent, branch or subsidiary in the US or have a financial relationship with an institution in the US.

- 3.11 The extent of the weaknesses in the anti-money laundering systems and controls at the banks was said by Phillip Thorpe (FSA Managing Director at the time) to be “disappointing”. Furthermore the project undertaken by the FSA in April/May 2002 which reviewed current practices across a number of banks and building societies in the retail banking sector confirmed that the main issues found during the FSA’s investigation into Abacha were not confined to those involved in that investigation⁶.
- 3.12 On 15 July 2002, the six major UK retail banks⁷ (“the big six”) issued a statement of principles for fighting crime and the financing of terrorism. Their statement referred to a commitment to work together to counter money laundering and acknowledged their support for a partnership between government, regulators, law enforcement authorities, banks and the general public, to work together to prevent the laundering of the proceeds of serious criminal activity and terrorism financing.
- 3.13 The big six recognised that the foundation stone of their future KYC controls was to ensure the integrity of their existing customer base in relation to identification. In their statement of principles the big six committed to undertaking a major anti-money laundering initiative to reconfirm the identity of existing customers, irrespective of when they had become a customer. As discussed further in Appendix III, all of the big six have committed to and/or have started to undertake the verification of their existing customer base. As their statement of principles confirms they have also invested heavily in transaction monitoring systems and operational processes and are committed to continuing to do so.
- 3.14 The big six stated that a partnership approach was essential between HM Treasury, the FSA and other agencies to:

⁶ Money laundering – domestic banking (August 2002) published by the FSA

⁷ Abbey National, Barclays, HBOS, HSBC, Lloyds TSB and The Royal Bank of Scotland Group

- Consult with the banks on the practicalities of regulatory changes;
- Take account of the costs and benefits of proposed changes, in particular those involving changes of systems and processes;
- Recognise the potential impact on customer service; and
- Crucially, the likely impact of proposals on the prevention or detection of money laundering or terrorism financing.

3.15 The FSA welcomed the big six initiative and in a speech at a major anti-money laundering conference on the same day⁸, Carol Sergeant (Managing Director, Regulatory Processes and Risk Directorate, the FSA) stressed that it was important for the big six example to be followed more generally in the financial sector and referred to introducing a regulatory rule to ensure this issue was “gripped by all firms” to create a “level playing field” for the regulated community in the UK.

3.16 In the press release on the same day, the FSA said that it intended to discuss both with individual firms and their associations proposals for taking this work forward on a similar basis to the big six. The FSA also said that it would consult later in the year about introducing a rule to ensure that high standards are in place across the whole financial services sector.

Proposed policy options

3.17 Following some initial consultation with firms, the FSA identified its proposed options for reform, detailed descriptions of which are attached at Appendix I.

3.18 There are two approaches to the CCR under consideration by the FSA (Option A and Option B) both of which have common objectives but vary in the detail of the obligation. The principal objective is for all relevant regulated firms to reach a position where they are reasonably satisfied either that their current customers are who they say they are, or that the risk of money laundering by their customers is negligible.

⁸ FSA Anti-Money Laundering Conference “*Money Laundering – A joined up approach*” at Le Meridian Grosvenor House, Park Lane on 15 July 2002.

3.19 Option A is prescriptive and envisages all firms going through a structured process with defined outcomes whilst Option B takes the form of more discursive general guidance and leaves much more discretion to a firm and its senior management to decide the extent and nature of any work that it undertakes. Both options envisage a risk-based approach and therefore it is up to the firms concerned to assess their own risks in the area of customer identification and anti-money laundering and the action required to address these risks.

Option A

3.20 Option A would require firms to carry out a formal, step-by-step review which is adequately managed and resourced with senior management oversight. In essence firms will be required to show that a pre-N2 client is who he claims to be or that the associated money laundering risk in respect of that client is negligible. It is envisaged that any review would be completed by the end of 2005.

3.21 Firms will be able to ‘filter’⁹ out categories of customer either because adequate information should be available to them (perhaps from third parties) or because they are considered to present no or low risk. In cases which are not low or no risk and where identification evidence is not available, firms will be required to obtain adequate identification evidence or to review the customer relationship.

Option B

3.22 Option B takes the form of more discursive general guidance, leaving more discretion to a firm and its senior management to decide the extent and nature of work that it does. Option B does not include a completion date and intends to create an ongoing requirement for firms, who would be expected to consider, and alter if necessary, their behaviour going forward.

⁹ The list of FSA draft filters to filter out certain of the lower risk customers includes “Controlled products, (PEPs/ISAs/Personal Pensions)” and “dormant/static/inactive accounts”.

3.23 Under Option B, a firm will need to form a view as to which of its customers and products present a money laundering risk and identify those customers in respect of which it has inadequate identification information. There are no FSA proposed filters, instead it is envisaged by the FSA that firms will form their own considered view as to the money laundering risks they face. This could include firms defining their own filters and risk categories in deciding the appropriate action that should be taken.

4 Methodology for assessing costs and benefits

Introduction

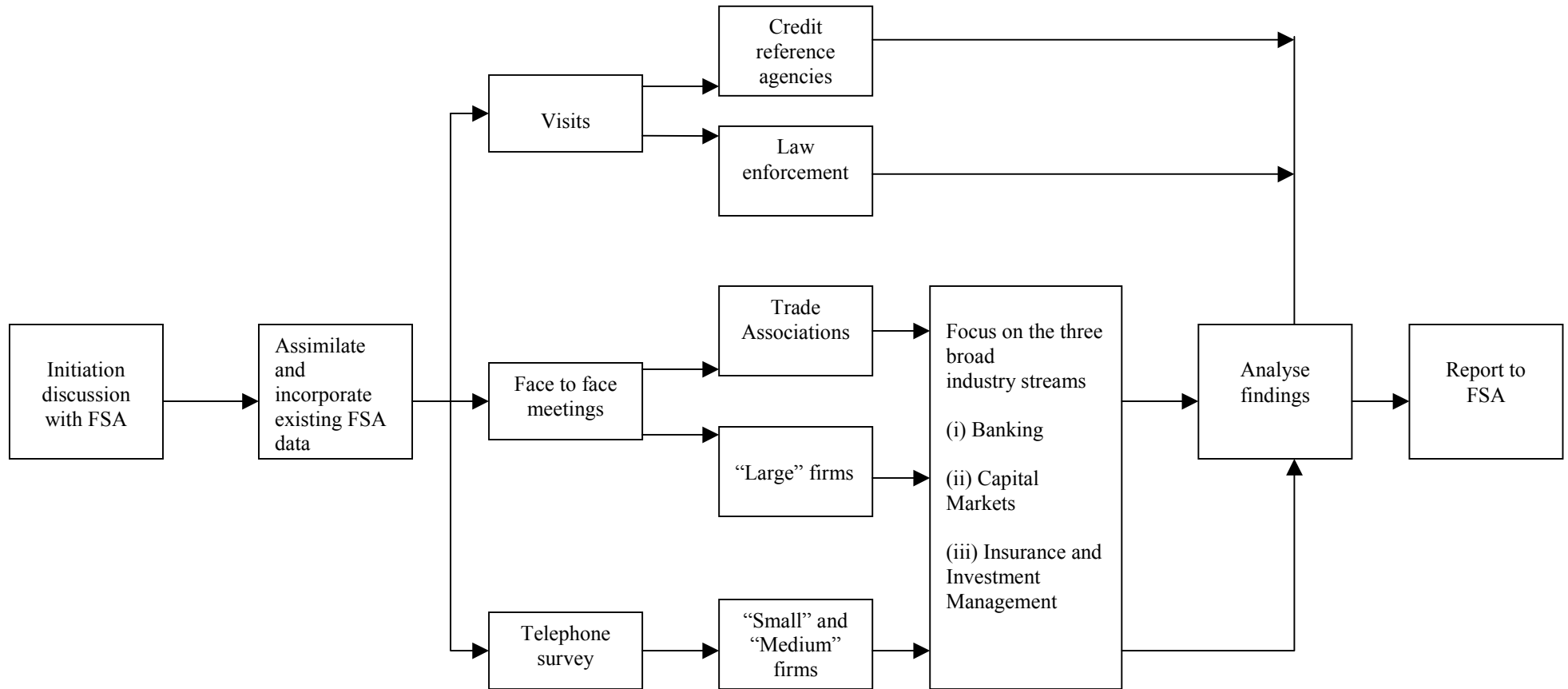
- 4.1 This section sets out in detail our methodology for assessing the total costs and benefits of the CCR. It describes:
- The general approach that we adopted to ascertain information about the likely costs and benefits of the FSA proposed options;
 - How we selected our sample of relevant firms and other organisations;
 - The counterfactual that we considered was most appropriate to this analysis; and
 - The process adopted for scaling up costs for the full population of affected firms.
- 4.2 This section focuses in particular on the approach toward examining compliance costs, for which FSMA requires a quantitative estimate.
- 4.3 The proposed changes to the Handbook will, if implemented, affect most relevant firms undertaking a relevant regulated activity in the UK. They will apply inter alia to all banks, building societies and firms conducting investment business and life assurance business, but will not apply to firms carrying out general insurance business.
- 4.4 As noted in the previous section the anti-money laundering regime has developed rapidly in recent times. Firms have tended to include the costs of their anti-money laundering procedures within the overall costs of general compliance rather than identify them separately. In addition the costs of anti-money laundering compliance rarely feature in any form in the published financial statements of firms, or in any other publicly available information source. Accordingly, with little statistical data available on anti-money laundering costs and trends from an industry wide basis a “top down” approach would not be possible and information needs to be built up on a sample basis. Furthermore the costs of anti-money laundering to a firm will vary

enormously between different industry sectors and any assumptions or estimates should only be extrapolated to the entire financial services sector with care.

Approach

- 4.5 In undertaking the CBA and researching the costs and benefits of the proposed options we adopted a three-stream approach focusing our efforts on the following broad industry streams of the regulated community, Banking, Capital Markets, and Insurance and Investment Management (“I&IM”). Our general approach, which is summarised overleaf sought to obtain feedback from relevant firms and other organisations directly or indirectly affected by the FSA proposed options.

General approach to obtaining information



- 4.6 We adopted a three-stream approach based on our own experience of anti-money laundering advisory work. It was our view that the anti-money laundering issues the financial services sector will face with regard to any CCR were likely to fall into these broad industry groupings.
- 4.7 Within these broad industry groups we ensured that the views of relevant firms from the following key sectors were represented:
- Banking (retail banks, private banks, building societies and a number of international banks);
 - Capital markets (Investment banks, institutional fund managers, derivatives brokers);
 - Insurance and investment management (Life insurance companies, IFAs, retail fund managers, friendly societies, stockbrokers¹⁰).
- 4.8 In this way a view could be formed on the compliance impact for the different sectors of the regulated community.
- 4.9 We also included a mix of large, medium and small relevant firms. Again we considered at the outset that the cost benefit issues might differ between the large, medium and small sized firms. In particular we sought to identify whether the proposed options had a disproportionate effect on the small and medium sized firms.
- 4.10 With no meaningful market data available in the public domain to assist us in the process of estimating the costs associated with a CCR and the fact that it is likely that firms will differ in their interpretation of what costs should be included, we considered that the most appropriate method of obtaining cost and benefit information was to speak directly with firms. We held face-to-face meetings with our sample of large relevant firms and obtained cost benefit information through the use of a telephone survey (with follow-up calls) from our sample of medium and small relevant firms.

¹⁰ Although stockbrokers and friendly societies do not deal in insurance or investment management, they were included in this group as we thought that their anti-money laundering issues were likely to be similar to the IFAs and retail fund managers

Questionnaire

4.11 For both the face-to-face meetings and the telephone survey we designed and made use of a structured questionnaire which was piloted to a number of firms and refined before being used in the survey. Firms were asked to provide information on amongst other things:

- Size of their pre N2 customer base;
- Annual spend on anti-money laundering compliance;
- Estimated total cost of carrying out a CCR under each of the proposed options.

4.12 When discussing the cost implications of Options A and B with firms, we wanted to minimise the danger that firms would include in their cost estimates costs which are not incremental to the exercise, i.e. costs which are not incurred solely and exclusively as a result of the proposed options. Similarly we wanted to avoid the possibility that firms would fail to take account of costs they would in fact face in completing the exercise.

4.13 To assist firms in compiling the total cost of each option, the questionnaire focused on the various stages that are likely to make up a CCR conducted under Option A or B and firms were asked to estimate the likely costs involved for each stage. For example, a step by step approach to the CCR under Option A is likely to involve at least some of the following stages:

- An assessment of current compliance (i.e. whether already compliant with the FSA proposals);
- Identification of the full pre N2 customer population;
- A risk categorisation of customers;
- Running the suggested FSA filters;
- Whether to make use of a credit reference agency;
- Manual verification of customers;

- Reporting to NCIS, closing out accounts or terminating relationships; and
- Using trigger events.

- 4.14 We include at Appendix II a description of the above stages.
- 4.15 Option B is somewhat more complex, due to a firm's freedom to choose exactly how it will comply. Therefore, as well as allowing for the possibility that firms might want to undertake a risk-based CCR review similar to that under Option A (if required), our questionnaire also allowed for alternative approaches for example where customer identification documents would be obtained during the normal course of business, upon the occurrence of certain "trigger events", such as the sale of a new product or service or an annual review or meeting. Clearly such an approach may require the establishment of "trigger systems", which have their own incremental cost.
- 4.16 Firms were also asked to identify how the estimated total cost of the CCR was split according to the following broad cost categories: staff, management, systems, hardware and other.
- 4.17 Finally we invited views on the impact of the proposed changes to a firm's business and asked firms to consider some of the potential benefits that might result from the CCR.
- 4.18 Using a questionnaire invites strategic responses, for example firms that object to the proposals may seek to attribute costs to Option A or Option B which are not in fact incremental to them. Identifying incremental benefits is also not straightforward. If benefits arise to a firm from an improvement in its customer information systems, it is only valid to attribute that part of the improvement engendered by the FSA's proposals.
- 4.19 In addition, the hypothetical nature of the questions and the fact that the quantification of the costs involves making estimates about various stages within the CCR process (for example the number of customers who are low or high risk and the

number of customers which will have to be verified manually) mean that the estimates will inevitably be subject to some margin of error.

- 4.20 To minimise the above risks, anti-money laundering specialists conducted the face-to-face meetings and the questionnaire was carefully designed. In addition, where possible we corroborated the quantitative information that we obtained from the firms with the data obtained from those firms that had already completed a CCR and other “hard” data (such as cost data from the credit reference agencies).

Visits

- 4.21 In addition to the telephone survey, we held meetings with a number of trade associations, two major UK based credit reference agencies (“CRAs”), the Metropolitan Police and NCIS.

Other sources

- 4.22 We also made use of the existing cost data which had been collated by the FSA on a sample of some 30 regulated firms and the main trade associations and carried out some additional desk based research.

Sample selection

- 4.23 As explained in our approach, we obtained information regarding the costs and benefits of the proposed options through face-to-face meetings with key staff at a sample of “large” relevant firms and a telephone survey with “small” and “medium” sized relevant firms. For the purposes of our study we required a simple definition for “large”, “medium” and “small” which would allow us to easily identify the firms to be included in our sample. We used “number of employees” for this purpose, applying the standard National Statistics definition that small firms employ less than 50 employees that large firms have over 250 employees and that medium-sized firms have between 50 and 250 employees.

- 4.24 Our sample of relevant firms was selected to ensure a mix of large, medium and small firms and to ensure the following sectors were represented:

- Retail banks;
- Private banks;
- Building societies;
- Investment banks;
- Institutional fund managers;
- Derivatives brokers;
- Life insurance;
- IFAs;
- Retail fund managers;
- Stockbrokers;
- Friendly Societies.

4.25 We included most of the 30 relevant firms that had previously assisted the FSA with their initial research into the costs and benefits of a CCR.

4.26 These firms included a number, which had already commenced or planned customer verification exercises similar to the options proposed by the FSA. We believed that these firms were in a good position to provide an accurate assessment of the likely costs involved in a verification exercise¹¹. We also recognised that these firms' experiences of the practicalities involved in undertaking a customer review exercise and their estimates or calculations of the costs involved would be of interest to those firms that have yet to undertake a CCR. We include therefore at Appendix III an overview of our findings from the big six who are well advanced in the planning for their CCRs.

4.27 Of our initial sample of firms, several of the small and medium sized firms were unable to take part in the telephone survey because of resource constraints. The final

¹¹ Insofar as the costs reported by these firms are already sunk, they have however been excluded from our estimate of the incremental costs of the reform options (refer to paragraph 4.36).

number of firms and other organisations that participated in our research are summarised in the table below.

Table 4.A		Number of firms by industry stream			
		Banking	Capital Markets	I&IM	Total
Analysis of sample	Size of firm				
Detailed face to face interviews	Large	8	8	8	24
Telephone survey	Medium	17	14	15	46
Telephone survey	Small	14	9	16	39
Visits	Trade associations	2	2	4	8
Visits	Credit reference agencies				2
Visits	Law enforcement				2
TOTAL		41	33	43	121

4.28 To encourage frank and open disclosure of costs, benefits and issues, the firms who were asked to participate were given a guarantee of strict confidentiality and this precludes us from including a list of the companies that took part. However further information on how we arrived at our sample of regulated firms and other organisations can be found below.

The counterfactual and proposed options

4.29 An important principle underlying our analysis is that we should only include in our cost estimate those costs which will be incurred as a result of the FSA implementing either Option A or B. These are the “incremental costs” of the options for reform. We therefore wanted to obtain a good understanding of “where firms *are* now”, so that costs, which have already been incurred, could be excluded from the exercise. The counterfactual, against which Options A and B are to be assessed, is simply that firms remain exactly where they are now, in terms of knowledge of their customers and compliance with the existing anti-money laundering requirements.

4.30 In identifying the counterfactual as “where firms *are* now”, we are assuming that amongst the regulated community there is some non-compliance with the Regulations. This is one of the reasons for the FSA’s proposed changes to the Handbook, and is consistent with our own experience of firms’ anti-money laundering compliance and the FSA’s findings from its recent investigation into the

Abacha affair. As a consequence the costs associated with the verification of pre 1994 customers (those taken on before the Regulations came into effect) and the costs associated with the verification of the post 1994 customers (up to N2) are both relevant costs for the CBA because they are both incremental to the options for reform. Under this definition, we are assuming that firms would not incur the costs of assessing and verifying the customers associated with the CCR if it were not for the FSA's proposed Options A and B.

- 4.31 There is an argument however for defining the counterfactual as where firms *should be* now as opposed to where firms *are* now. Employing such a definition would mean that all costs that relate to the verification of the post 1994 customers would be excluded from the CBA because these are costs that should have been incurred under the requirements of the existing legislation.
- 4.32 In practice it would be very difficult, if not impossible, for many firms to apportion the costs of Options A and B between pre and post 1994 (pre N2) customers as this is not how the options have been presented to firms and it is not how firms have planned their exercises. We sought to identify the split of costs between the pre and post 1994 (pre N2) customers, however the sample of firms approached were unable to apportion their cost estimates and many could not identify the number of customers that were taken on before 1 April 1994 and those taken on after. It is worth noting that, even if firms are able to identify those costs which are related to achieving compliance with the existing Regulations, they may be unwilling to share details of their non-compliance, and the costs of rectifying it, even in the context of an anonymous survey.
- 4.33 If the costs and benefits relating to the CCR of the post 1994 customers were excluded from the CBA our estimate of the compliance costs detailed in Section 5 would be reduced and the associated benefits would be similarly affected (Section 6), although for the reasons outlined above it is not possible to quantify these changes.

Scaling-up the results

- 4.34 As noted, the FSMA requires a quantitative estimate of costs. This requires that the answers provided by our sample respondents be scaled-up to produce estimates for the entire population of regulated firms. This was achieved on the basis of data supplied by the FSA¹² about the breakdown of the population of regulated entities and how these divide up according to size and industry stream. In some instances this data was complemented by third party data on the number of customers served by different sectors. This data permitted us to “gross-up” the numbers reported by the respondents in our sample.
- 4.35 In quantifying the estimate of costs for the whole population of regulated firms we have sought to exclude costs incurred by the big six and other firms, which have already completed or planned a CCR (or something similar) or which meet the requirements proposed by the regulatory options. These firms have been excluded from the scaling up calculation, as the costs borne by these firms are not “incremental” to the proposed options. However we have where appropriate used the costs identified (for example the cost per customer) as a cross check on the estimates obtained through the face-to-face interviews and the telephone survey. Refer to Appendix III for discussion on the costs and benefits identified by the big six.

One-off and recurring costs

- 4.36 CBA’s typically require a distinction between on-off and recurring costs. The firms in our sample indicated that they saw the CCR as a one-off exercise, albeit one which in theory could be spread over a considerable period of time under the more flexible Option B. We therefore questioned firms on the time period over which they expected to complete the exercise. Contrary to our expectations, firms overall reported that Option B would be implemented in an even shorter timeframe than Option A. We therefore saw no reason to adjust firms reported expenditure under

¹² The FSA data on the number and types of firms are approximate only due to the difficulties in allocating firms to one simple ‘type’ or sector (for example complex groups and firms carrying out multiple activities).

Option A and B for differential time distribution of costs. Reported expenditures are treated as one-off costs at 2003 prices.

Constraints

- 4.37 While we have taken every care to ensure that our estimates are not biased upward or downward, it would be remiss to suggest that they were not subject to a degree of uncertainty (albeit one which could move the numbers in either direction). This uncertainty results from three inevitable constraints faced during the analysis.
- 4.38 Firstly implementing a CCR is a complex process. This makes it hard for firms to estimate the costs they will face. Further, any survey approach invites some "strategic responses" as firms exaggerate the costs of an exercise they oppose undertaking. We have sought to exclude, or place less weight on responses where this appears to be the case. However, ultimately the complexity of the exercise is such that we cannot "audit" the responses of all firms and have to rely on their own estimates of the costs of the exercise.
- 4.39 A second problem is the wide variety of firms that are affected by the FSA proposals and the numerous different approaches that firms might take to the CCR. This variety again limits our ability to audit responses. It also means that for any one type of firm there is a limited amount of evidence about costs. While this does not bias the estimates, it does increase the level of uncertainty surrounding them.
- 4.40 Finally, our approach to estimating costs relies heavily on identifying a cost per customer relationship. While good information about the number of these relationships is available for some segments of the market e.g. building societies or life insurance, in other instances we have needed to make several assumptions to estimate the number of relationships, relying heavily on our survey sample and data about the number of firms of each type supplied by the FSA. Again these factors should not lead to biased results for we have sought to make unbiased assumptions, although they do introduce an additional source of uncertainty.

4.41 Overall several dozen assumptions have been made and it is not meaningful for us to present a sensitivity analysis to any one set of these assumptions. Our estimates represent our central view of the costs of Options A and B.

5 Findings on costs

Introduction

- 5.1 This section provides our estimate of the total cost to industry and society of the FSA implementing the CCR under Option A or B. In arriving at the total cost¹³ we have estimated (i) the overall compliance cost to the population of regulated firms affected by the FSA proposals, (ii) the administrative cost to customers (resulting from firms contacting them directly to obtain identity documentation) and (iii) the associated cost to NCIS and law enforcement in dealing with the suspicious transaction reports (“STRs”) arising out of the CCR.
- 5.2 Our findings have shown that the bulk of the costs arising out of the CCR fall on the regulated firms. The cost to each firm will vary enormously depending on their circumstances, but the common factor across all industry streams and the different sizes of firms was that the largest proportion of their costs for completing the CCR are likely to be incurred during the detailed manual verification of customers.

Cost per customer

- 5.3 To assist us in the process of estimating the likely cost of completing the CCR, we calculated an expected “cost per customer”¹⁴, based on the responses of those firms included in our sample (as defined in Section 4).
- 5.4 The table below also includes an estimate of the cost per customer for the big six. As part of their anti-money laundering initiative and voluntary arrangement with the FSA, the big six have agreed their own approach to the CCR, which is similar but not identical to that proposed under Option A. Whilst the big six costs are not included in our “scaled up” estimate of the overall cost of compliance for the CBA (for the reasons outlined in Section 4), the results have been included in this section for comparative purposes. The impact of the CCR on the big six is discussed in greater detail in Appendix III.

¹³ We were not asked to consider the direct costs to the FSA of implementing the proposed options.

¹⁴ Total cost of CCR divided by the total number of pre N2 customers

	Banking	Capital Markets	Insurance & Investment Management
Option A	£2.03	£43.57	£1.25
Option B	£0.78	£36.18	£0.81

Big six banks	£1.48
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5.5 The estimated cost per customer for the CCR varies significantly between the three broad industry streams. Some of the factors behind this are considered below.

Insurance & Investment Management (“I&IM”)

5.6 Our findings show that firms in the I&IM stream expect to incur the lowest cost per customer to complete the CCR for a number of reasons, but it is primarily due to the type of products and services they offer, and the customer profile these firms typically have.

5.7 Most products and services offered by firms in the I&IM industry such as savings products or life assurance are generally considered to be at a lower risk of use by money launderers, commonly because they do not provide for third party money transfers. These products are more likely to satisfy the filtering criteria under Option A, or are more likely to be deemed lower risk under the risk-based Option B approach. As a consequence, the number of customers of I&IM firms that will require detailed verification during the CCR is likely to be reduced.

5.8 Similarly I&IM firms typically have a high proportion of UK domiciled personal customers which are considered to be both cheaper and easier to verify, for one or more of the following reasons:

- They can be more easily verified electronically by CRAs (with their electoral roll information for example);

- Any direct customer contact to request documentation is easier and usually quicker as they are located in the UK;
- Branch networks (where appropriate) can be used to facilitate the receipt of requested documentation;
- Compliance staff are more familiar with the UK documentation necessary to verify identity;

5.9 Also, firms in this stream generally have a significant customer base, allowing possible economies of scale to further reduce the per customer cost of completing the review.

Banking

5.10 The responses received from the Banking stream indicate an expected cost per customer of £2.03 under Option A, and 78p under Option B compared to our estimate of the big six cost per customer of £1.48 for their exercise.

5.11 As discussed in Section 4, the Banking stream for the purposes of our analysis includes:

- High street banks outside of the big six;
- Building societies;
- Private banks; and
- UK branches or subsidiaries of international banks.

5.12 The headline numbers for the Banking stream conceal some significant differences between the sectors. For example, our findings indicate that building societies are expecting to incur an average of only 20p per customer, with one society anticipating costs as low as 5p. At the opposite end of the spectrum, international banks are expecting to incur significant costs per customer, with some estimating costs in excess of £100 each.

5.13 The building society costs are low for many of the same reasons discussed above in the I&IM stream, with most societies offering low risk products to UK personal

customers. The societies core offerings of savings and residential property lending most easily lend themselves to the filtering criteria under Option A.

- 5.14 However, although the product mix and customer profile of the building society sector is similar to typical I&IM firms, the building society costs per customer are significantly lower than those calculated above for the I&IM stream. We believe that this is because building societies have not undergone the series of mergers and acquisitions seen in the I&IM industry over recent years. This has led to some firms in the I&IM industry dealing with numerous issues surrounding the merging of legacy customer databases and differing anti-money laundering policies and procedures, which makes the extraction of customer lists and a review of existing compliance more difficult, and therefore more expensive. These are not issues common to those firms included in the banking stream, particularly for the small and medium sized firms.
- 5.15 The international banks typically have a significant non-personal customer base (limited companies, partnerships and trusts), with many customers located in overseas jurisdictions. These customer types are less likely to be filtered out under Option A, and if located overseas cannot be easily verified by the CRAs. Furthermore, the necessary corporate documentation required to verify customer identity is likely to be difficult and time consuming for firms to obtain, as well as being unfamiliar to UK staff.
- 5.16 Broadly speaking, these firms are also less likely to have a product profile that falls into the lower money laundering risk categories, as the banking facilities required are generally at a higher risk of use in connection with money laundering.
- 5.17 Firms such as international banks, which cannot make widespread use of the FSA proposed filters or electronic verification methods, anticipate higher costs per customer for the CCR. This is because they are likely to be left with a greater proportion of customers to manually verify, an approach which is usually much more expensive.

- 5.18 In addition the verification of identity requirements for the non-personal customers such as corporates and trusts are generally more onerous than those for individuals, as the number and complexity of the documentation required is significantly greater.
- 5.19 Although the costs per customer are significantly higher for the international retail banks than those estimated by the other sectors, the impact on the overall banking stream cost per customer is significantly reduced due to the small number of customers such institutions typically have, particularly when compared to the customer bases of the larger high street banks and building societies.

Capital Markets

- 5.20 At £43.57 under Option A and £36.18 under Option B, the Capital Markets firms expect to incur the highest cost per customer for the CCR compared to the other industry streams.
- 5.21 Many of the issues affecting the costs per customer for Capital Markets firms are similar to those outlined above regarding the international banks, as these firms predominantly have a non-personal, commonly overseas customer base. Such customers are not likely to meet the filtering criteria, and transactions may also be in higher risk products.
- 5.22 Capital Markets firms will commonly have a large number of counterparties that are financial institutions, either regulated by the FSA or an overseas regulator in equivalent jurisdictions. Whilst these are relatively straightforward to verify, many of the counterparties of Capital Markets firms will also be complex, offshore vehicles or trusts dealing in more technical products, which will be both time consuming and expensive for firms to contact and verify.

Other factors

- 5.23 The findings above show that there are a number of industry stream specific issues to consider that will affect the likely cost to firms of completing a CCR. However, our analysis also indicates that there are a number of other, more generic issues for firms

to consider when estimating the likely cost of the exercise, that will have an impact on all firms across the three industry streams, including:

- Level of existing compliance with the Regulations;
- Whether a re-verification or similar exercise has already been completed;
- Quality of customer data and how records are stored;
- Availability of resources to carry out the CCR;
- Number of “old” (Pre 94) customers.

Stages of the CCR

5.24 In order to establish the likely costs for firms to complete a CCR under Option A and Option B, we asked firms to think through what might be involved in the following potential stages of the CCR (described further in Appendix II).

- Assessment of existing compliance;
- Determination of pre N2 customer population;
- Risk categorisation/application of filters;
- Verification of customers (via a credit reference agency, a manual approach or through the use of trigger systems);
- Reporting to NCIS/close out of accounts.

5.25 We also asked firms to consider the various costs that might be involved, including:

- System processing time;
- Software / hardware upgrades;
- Staff / management time costs;
- Training and quality assurance;
- Data cleansing costs;
- Credit reference agency costs / consultancy fees;

- Direct mailing / visiting costs;
- Retrieval costs for archived / stored off-site identity documentation;
- Reporting costs.

5.26 We set out below the main findings of our research under each of the potential stages of the CCR. Our discussion is illustrated with the (anonymous) responses of individual regulated firms from each industry stream in our sample and the main trade associations.

Assessment of existing compliance

5.27 Based on our own experience of firms' anti-money laundering compliance, we thought that our sample might include a number of firms that were already compliant with the FSA proposed options, either because they have completed a recent voluntary review of their entire customer base or because they have been compelled to as a result of supervisory or enforcement action by the FSA.

5.28 In cases where the review had been carried out voluntarily, we expected that some firms might incur an incremental cost to establish their compliance with the proposed changes to the Handbook. Where firms had completed the exercise as a consequence of FSA enforcement or supervisory action, we thought that most firms would have already satisfactorily demonstrated their compliance to their supervisors.

5.29 Of the firms in our sample, 33% said that they were already compliant with the CCR if Option A was adopted. A larger proportion of firms (46%) considered themselves already compliant if Option B was implemented. I&IM firms were the most confident that with their existing procedures and records they were already compliant, with as many as 59% of mainly small and medium firms in this industry stream indicating that they considered themselves already compliant under Option B.

5.30 Firms provided us with a number of reasons to support their view of existing compliance, including:

- A detailed review of the entire pre N2 customer base has already been completed;
- Rigorous systems and controls in place over the KYC process are considered sufficient;
- All client relationships were entered into recently, under the more rigorous KYC regime;
- An ongoing, “close” relationship is maintained with all customers therefore no formal CCR considered necessary.

5.31 One firm in our sample stated that they had already incurred costs separately in assessing their compliance with US guidelines. The results of that exercise indicated their current compliance with any UK requirements without the need to perform any additional work.

5.32 Our analysis of some of the responses we received from the face-to-face interviews and telephone survey suggests that some firms may not fully understand what is required of them under each of the proposed options. As a consequence, we believe that some firms may be incorrect when considering themselves fully compliant. However, it is beyond the scope of this analysis to consider the impact of any incorrect responses to the overall incremental cost of the CCR.

5.33 Furthermore, firms who considered themselves to be already compliant with the proposed rule change were also confident that the costs to establish their current compliance would be insignificant. Regardless of the option chosen, over 85% of firms did not expect to incur costs in excess of £10,000 to establish their existing compliance to the FSA, with a significant number of firms in our sample not expecting to incur any cost at all to prove compliance (and therefore the cost of the CCR for these firms was zero).

5.34 The rest of the firms in our sample anticipated having to perform verification work to a greater or lesser extent on their current customers. Over one third of the firms in our sample (across all industry streams) confirmed that they had already begun the process of scoping a CCR in anticipation of the proposed changes to the Handbook.

Determination of pre N2 customer population

- 5.35 We considered that most firms would need to start a CCR by first identifying a list of unique, pre-N2 customers to determine those which may require some form of verification.
- 5.36 For firms that aggregate data at a “customer level”, this was anticipated to be a relatively straightforward exercise, involving small amounts of system time and possibly some IT staff costs. However, firms with systems that operate only at “account or product level” might experience extra costs in cleaning up their customer lists to eliminate duplicated names. This may occur in circumstances where customers hold more than one product or account with a particular firm.
- 5.37 Additionally, some firms expected to have problems with old or legacy computer systems, or with poor quality underlying static data, which would make determination of an accurate pre N2 customer list difficult. In these cases, it was expected that some firms could incur significant cost to derive a complete list of customers for potential verification.
- 5.38 76% of firms that we spoke to either face-to-face or via the telephone survey were able to generate a clean list of pre-N2 customers at minimal cost. The small firms indicated the greatest ability to generate a clean list of customers. This may be because they have experienced less business consolidation with old, legacy system issues. A large number of firms across the industry streams held data at a customer level and estimated minimal or zero costs for this process. Over 85% of firms in our sample estimated the cost of deriving their pre N2 customer list to be less than £50,000.
- 5.39 A number of firms, particularly in the I&IM stream, could only derive lists of products held by customers, but did not intend to eliminate any duplication of names as a separate exercise. Instead, they planned to subsequently deal with any issues regarding duplication in effort as they arose (e.g. by apologising to customers who complained if they were contacted twice).

- 5.40 During our face-to-face interviews, we identified a number of firms in both the Capital Markets and I&IM streams that anticipated particular problems in determining a customer list. As discussed earlier, these streams have experienced numerous mergers and acquisitions that have required them to integrate a number of legacy computer systems. Some firms have been able to link these systems together, whereas others have had to construct new customer databases.
- 5.41 A common problem was that some data fields had not been transferred and consequently key information such as customer start dates could only be obtained by reference to original paper records. One firm has already spent significant system processing time and staff costs to extract data and review it on a line-by-line basis. The firm estimated that it had incurred costs in excess of £1m to determine the population under review.
- 5.42 Another problem was that firms found it difficult to identify and exclude those customers for whom sufficient KYC evidence was already held by the current firm. Some of the legacy systems indicated that “sufficient” KYC documentation had been obtained from the customer at the time the account was opened, but the definition of sufficient varied widely across the legacy firms.
- 5.43 Where firms experience these types of problems, it was considered to be a time consuming and costly exercise to retrieve the original paper records in order to update their systems. This point is considered further below in the paragraphs on the manual verification stage.
- 5.44 A number of firms in our sample, particularly in the I&IM stream, were unsure what constituted a “customer” for the purposes of the review and in relation to IFAs, they were unsure of the term of ‘current’. For example, a number of IFAs and retail fund managers cited individuals who may have made a one-off purchase of, say, a long-term savings product 10 years ago via an IFA. These IFA’s and retail fund managers questioned the validity and suitability of contacting these “inactive” individuals for documentary evidence of their identity as part of the CCR. From the IFA perspective, because they were not “current”, and from the fund manager’s

perspective because the product had been held for such a long period and were therefore considered low risk to money laundering.

Risk categorisation

- 5.45 Under each of the proposed options for the CCR, firms must consider whether to make an assessment of the level of money laundering risk associated with their customers. Such risk categorisation is more likely to occur under Option B, which is a far less prescriptive approach to the CCR. The money laundering risk of customers and products is addressed under Option A via the application of filters, which is discussed in greater detail below.
- 5.46 Most of the firms in our sample intend to apply some form of risk categorisation to their customer base, with over 80% of our sample across the three industry streams indicating an intention to risk categorise customers as part of the CCR process.
- 5.47 Significantly fewer firms judged themselves as *able* to effectively categorise their customers, with only 63% of firms considering themselves currently capable of completing this exercise. Capital Markets firms felt most able to determine the risk profile of their customer base, with over 71% of firms responding that they were currently able to do so.
- 5.48 Of those firms who responded that they were unable to determine the risk profile of their customers, a number indicated that they would upgrade their systems in order to do so if a CCR was undertaken. A number of firms considered this to be an expensive exercise, with some small sized banking firms estimating costs over £100,000. The remainder generally did not consider risk categorisation to be a necessary stage in the CCR process.
- 5.49 Following our face-to-face meetings with the large firms, we also identified certain differences in approach according to which industry stream the firm operated in. The Banking and Capital Markets streams are expecting to focus more on customer risk than product risk when determining the risk profile of their firm. Most intend to categorise individuals on the basis of address location as a minimum, and non-personal customers using information held by the firm regarding (principal) location

of business and type of business conducted (eg through use of SIC code information).

- 5.50 Interestingly, most firms expect to perform this exercise regardless of whether Option A or Option B is implemented. By implication, it appears that under Option A firms will apply risk analyses to those customers which would otherwise be filtered out and re-include them in the residual population for verification, if they are considered to be high risk for any reason. This approach is consistent with that agreed by the big six banks as part of their voluntary exercise (See Appendix III).
- 5.51 Most firms in the Banking and Capital Markets streams felt able to risk categorise their customers along these lines without incurring significant costs.
- 5.52 Information from the face-to-face interviews with the I&IM stream indicated that under Option A there would be little customer risk categorisation because the permitted filters would be applied. However, under Option B, where there would be no prescribed filters, firms still intended to categorise by risk using products as the basis of the risk determination. Thus, in effect, there is little difference between the approach to be taken under Option A or B in this stream.
- 5.53 Some I&IM firms stated that they had the capability to identify high-risk customers (i.e. country of origin, multiple account holders etc) but would probably not do so due to the low number of customers who would meet these criteria (as these firms consider themselves to have a predominantly UK based customer profile and a low risk product offering).

Application of filters

- 5.54 Under Option A, the FSA propose to allow firms to apply a number of “approved” filters to their customer base, narrowing the number of customers requiring more detailed verification. These “risk based” filters seek to eliminate customers where the level of identity evidence already held by a firm is sufficient, or seek to eliminate certain products where the associated money laundering risk is low or negligible.

- 5.55 The intended approach to the application of filters differs from firm to firm and across industry streams. The application of filters was widely endorsed by the Banking and I&IM firms in our sample, with the Capital Market firms showing more indifference.
- 5.56 The types of cost that are likely to be incurred in applying the filters will differ according to the filters being run, and the sophistication of the relevant firms' underlying computer systems. Where sufficient information is stored electronically to allow the filter to be run automatically, the cost to firms is likely to be relatively small. However, where significant upgrades are necessary, or where filters can only be applied manually, staff costs will increase significantly the overall cost of applying the filters.
- 5.57 13% of firms intend to run all of the "approved" filters if Option A is implemented, whilst a further 70% stated that they would probably run only some of them. These views appear to be broadly consistent across the different sizes of firms as well as the industry streams.
- 5.58 For some firms in our sample, running the filters was not considered to be cost effective. For example a number considered it too expensive to upgrade systems to store extra information electronically so as to allow electronic filtering (eg records of home visits to customer addresses). Similarly, it was also too expensive and time consuming for some firms to manually review their customer base to apply the "existing customer" filter. Instead, firms considered that it would be cheaper and easier to apply other filters or to simply verify the customer using, say, a CRA.
- 5.59 A number of firms have indicated further filters they would be keen to see included in the rules should Option A be adopted. For example, building societies would like all those customers included in the society AGM register to be filtered out of the process. Similarly a number of IM firms have indicated that they would like to have extra filters which are more appropriate to their industry, including:
- Use of shareholders lists following de-mutualisation;

- Lists of customers contacted in other regulatory work (eg endowment mis-selling);
- Larger de-minimus values for low risk products (eg £75,000 was proposed by one trade association); and
- A “Length of customer relationship” filter (filtering customers which had made long term, regular contributions to, say, a savings product.).

5.60 These extra filters could have a significant impact on costs for large and small institutions alike were they adopted. Many firms saw this as one of the benefits of Option B over Option A, as they could decide unilaterally to implement the above proposals in order to reduce the number of residual customers requiring detailed verification.

5.61 There was some criticism by firms across industry streams of the list of filters. Although some filters were prima facie relevant to each of their industry streams, firms felt there was insufficient guidance regarding their implementation. If Option A was chosen for adoption, firms would like detailed guidance to accompany any list of suggested filters (eg a number of firms requested an explanation of the ‘Pre-N2 business with paper records’ filter.)

Making use of credit reference agencies

5.62 It is envisaged by the FSA that firms will contact customers as a last resort during the CCR and only once other avenues have been explored. Instead, the FSA is encouraging other options, one of which is to use a CRA or a similar information provider to provide electronic verification of their customers’ identity (eg by reference to electoral roll data).

5.63 48% of the firms in our sample intend to use a CRA or similar under either option. This view appears to be broadly consistent across the different sized firms. Of the firms who were planning to use them as part of the CCR process, many viewed them as a relatively cost effective method of verifying a significant proportion of customers, without resorting to direct contact with customers.

- 5.64 The building society sector appears to be the most likely to use the services of a CRA, with over 90% of building societies in our sample considering their use. This is not an unexpected finding as building societies typically have a UK domiciled personal customer base, which most easily lends itself to electronic methods of verification.
- 5.65 CRA's have access to a range of information that can be used to confirm the customer name and address information held by the firm. In addition to the electoral roll, other sources of data include BT "192" directory information, Royal Mail address data and prior credit application searches. The process of verification involves undertaking a matching exercise between the customer lists provided by the firm and the various databases available. The various organisations can also advise on the quality of the match, with the level measured primarily by the number of matches they have found for each name and address provided, and the reliability of the information sources they have used to generate each match.
- 5.66 Firms experience of using CRAs both in day-to-day use as well as in a piloted trial have reported "hit" rates ranging from 70% to 90%. The 'hit' rate has a direct impact on the number of customers that enter the manual verification stage and as this is considered to be the most expensive stage, has a significant impact on cost.
- 5.67 A number of firms would expect this 'hit' rate to increase if they used confirmation of Credit Application Data as part of the search criteria. This rise in 'hit' rate would reduce the numbers of customers requiring manual verification.
- 5.68 However, CRAs and similar organisations are of limited use to those institutions with significant overseas or non-personal customers. The CRAs are primarily UK focused and consequently have limited access to overseas data sources. Where overseas data is available, the costs involved in accessing the data are significantly increased. This is supported by the responses we received from both the Capital Markets and international banking firms, who were mostly negative on using the CRAs.

- 5.69 Similarly, the increased complexities of verifying non-personal customers mean that the “hit” rates are lower than that generally experienced for personal customers. Firms operating in the Capital Markets industry stream and those firms in the Banking stream with an increased focus on corporate and/or overseas customers, are therefore less likely to use CRAs. These firms are more likely to use external databases focusing on corporate information, such as Dun & Bradstreet or Bloomberg, to assist in the verification exercise.
- 5.70 CRAs also generally operate a volume-pricing model with the result that small firms will incur higher unit costs to verify their customer base than their larger competitors. However, it is likely that even the unit cost of verifying the customer using a CRA will be significantly less than the costs involved in implementation of other methods of detailed verification.

Trigger events

- 5.71 Under Option A, the FSA have proposed the use of trigger events to defer the verification of certain customers to a more convenient time in certain circumstances. For example, a firm could defer verification on customers holding dormant account(s) until such time as the customer reactivates their relationship. Firms would be required to monitor for these “trigger events” and carry out the verification process when they occur.
- 5.72 Firms appeared to be split over their existing ability to monitor trigger events, with 29% of firms stating that they did not intend to use them.
- 5.73 There appeared to be some lack of clarity over the level of work that would be needed should a trigger event occur. Firms appeared to be divided as to when a customer needed further verification if they had already been filtered out.
- 5.74 In order to reduce the number of customers which would experience a trigger event, a firm suggested that it would run a CRA search on all of its customer base before applying any filters. This would have the advantage of obtaining a bulk discount from the CRA and reduce the number of potential trigger events that could occur. Thus, trigger event monitoring costs and the associated costs of dealing with them

would be reduced (i.e. staff costs and individual credit reference search costs). The potential for missing a trigger event would also be reduced.

- 5.75 In line with these differing views, possibly demonstrating some misinterpretation of trigger events, very few firms were able to estimate if the potential cost of dealing with the trigger events would be either minimal or significant. 71% of firms were not able to give a response. Where firms stated that they would enhance their systems to deal with trigger events, the costs ranged widely from £2,000 to £250,000.

Manual verification of customers

- 5.76 Firms are typically treating direct customer contact as an act of “last resort”. However, there will inevitably be a proportion of a firm’s population of customers that cannot be classified as low risk, do not satisfy the filtering criteria, or could not be verified electronically using a CRA or similar. At this stage, firms will have to consider manually verifying their remaining customer base.
- 5.77 Most firms in our sample have indicated that the bulk of the costs for completing the CCR will be incurred at this stage of the exercise. Our findings indicate that firms expect a large portion of the costs incurred to be staff related. For example, small and medium firms expect staff costs to relate to 72% of their overall costs. The expected range of costs for those expecting to perform manual verification varied widely from several thousand pounds to several million, for the small and medium sized firms the costs ranged from less than £5,000 to £100,000.
- 5.78 The method and hence the cost of manual verification procedures undertaken by the firms was found to vary across the institutions, largely being dependent on the type of customer.
- 5.79 Responses from firms across the whole industry indicated that some firms would consider a review of paper-based records already held to be a manual verification step (not filters) and not to be cost effective. Typically, this is because KYC evidence is archived off-site, held by compliance divisions out-sourced to third parties, or at branch level where firms operate with an extensive branch network.

However, some firms would still want minimal direct customer contact and anticipate using staff to review the quality of paper based KYC records before any contact was made.

- 5.80 As mentioned above, the costs and approach appears to be split in accordance with the type of customer. The Capital Markets stream (along with some of the Banking firms) generally has a high number of corporate customers. These firms state that their initial verification approach would be to obtain information from data sources such as; Dun & Bradstreet, Bloomberg, Regulatory and Stock Exchange websites, Juniper and Bankers Almanac.
- 5.81 Further examples of the types of cost that firms expect to incur in this verification process are licenses for research providers, translation charges in respect of identity documents, staff time, management time, training, as well as general overheads.
- 5.82 Where no information can be obtained on a customer, or a non-personal customer cannot be verified in the above manner, firms are likely to make direct contact with the customer to request information. This is expected to be predominantly by post initially, and then by telephone.
- 5.83 With regards to the treatment of non-personal customers, no significant difference in responses by sector or size of firm were noted between Options A and B.
- 5.84 Firms with predominantly personal customers, (largely those from the I&IM and Banking streams), stated that they would contact their customers directly, unless they could find existing adequate KYC documentation on file. Of those firms in a group, most (68%) said they would not use information from other group companies.
- 5.85 Some firms stated that this potential lack of information sharing was primarily driven by the firms' view that the problems and associated costs that would be encountered with different computer systems would prevent any cost effective method of extracting and matching information.

- 5.86 Some firms feel that customers will not look favourably on them when asked to supply additional information, especially when taking into account the current poor performance of world markets. In addition, some firms (in the I&IM stream) expressed concern that they would need to go through an IFA or broker, which would increase costs and time incurred.
- 5.87 The low response rate to direct mailing of customers was considered to be a potential problem. One firm mentioned the possibility of using some incentive for the customers to return information to them.
- 5.88 One I&IM firm stated that their costs would be significantly reduced if they could include any requests for information from customers along with their Annual Statement. As the response rate was still expected to be low, the firm thought it would take several years to achieve the task and thus would only be a realistic possibility under Option B.
- 5.89 At least 13% of firms in our sample are likely to outsource the manual verification procedure to a third party.
- 5.90 Approximately 27% of firms, predominantly being small and medium size, stated that they would have no residual balance of customers left to verify after manual techniques had been used under Options A and B. 9% of firms did not make a response, possibly reflecting the level of uncertainty as to the residual numbers. The remaining 64% of firms expected some clients to remain un-verified at the end of the manual verification techniques. The extent of this “rump” varied across firms and no consistency in expectation has been identified in any particular sectors.

Reporting to NCIS and close-out of accounts/relationships

- 5.91 Overall, only 31% of firms felt that the level of suspicious transaction reports to NCIS would increase as a direct result of the CCR. Very few firms expected there to be a decrease in reporting.
- 5.92 This view was generally consistent between the size of firms and across the industry sectors with the exception of Capital Markets, who felt that there would be slightly

less of an increase in the level of reporting. Due to the comparatively low number of customers in the Capital Markets stream, any increase in reporting is not expected to have as large an impact on the CCR as the other two streams.

- 5.93 There appeared to be no significant difference in the expected level of reporting under Options A or B. However, one firm in the I&IM stream felt that there would be considerably fewer STRs under Option B than A. They stated that if they followed an open ended transaction monitoring approach under Option B, they would be able to provide NCIS with a much higher quality, lower volume of reporting, rather than simply referring the policy holders they could not verify.
- 5.94 In addition, some firms within the Banking stream did not anticipate reporting to NCIS and/or closing out accounts, except in particular circumstances (e.g. if the customer directly refuses to send the requested documentation). Instead, firms anticipate placing the “silent” non-responders under increased account monitoring.
- 5.95 In comparison to this, one firm stated that as it could not use electronic verification methods and expected a poor return from customer correspondence, it would have no choice but to report a significant number of customers to NCIS. They expressed concern that an “if in doubt, report it” culture may evolve rather than an intelligence led system. The firm felt that they and other firms may be forced to take this approach in order to avoid any future criticism from the FSA.
- 5.96 Approximately 46% of firms anticipated closing at least some of their unverified customer relationships. However, although this did not appear to vary between the size of firm and there were no significant differences noted between the two options, the level of expected close-out appears to vary between the industry streams.
- 5.97 Within the I&IM stream, 26% of firms stated that they would expect to close out some accounts or terminate relationships. These responses were primarily from IFA’s and stockbrokers and commonly ranged from 1% to 5% of the customer base.
- 5.98 Many firms in the I&IM stream stated that it was not in the terms of their contracts to close out customer relationships and they would not be able to do so. They felt

that they would not return funds, but would prefer to ‘flag’ the customer, continue suspicious transaction monitoring and obtain sufficient documentation before funds were paid out.

- 5.99 51% of Banking firms anticipated closing some relationships as a result of the exercise. Where firms were able to give a response, some estimated the affected customers to range from 1-7% of the customer base.
- 5.100 65% of the Capital Markets sample stated that they would expect to stop trading with some of their customers as a result of an inability to verify them. The expected level of close-out was commonly reported to be about 1%. Some firms expected to use the suspension in trading to clear out potential dormant accounts. The process of closing out accounts may also lead to previously uncooperative customers producing adequate documentation. Some firms stated that they would have to take legal advice before closing out any accounts.
- 5.101 Across the whole industry, where firms expected to close out accounts or terminate relationships, approximately 58% of them expected there to be marginal cost and a further 33% expected there to be no cost. This split appears to be consistent between the small, medium and large firms. For many firms, all that was required to close an account was correspondence with the relevant department once approval had been given.
- 5.102 31% of the firms in our sample stated that if they were unable to complete the verification exercise they would report the relevant customers to NCIS. This may indicate that firms perceive a report to NCIS as absolving them of their potential obligations under the proposed rule changes.
- 5.103 In instances where firms thought there would be additional reporting, the majority only thought there would be “marginal” costs in doing so.
- 5.104 Some concern was raised over the existing level of feedback received from NCIS (and other authorities). Given this perceived lack of feedback, some firms went on to state that they felt they saw little benefit in any further reporting.

Suspicious transaction monitoring

- 5.105 For accounts/relationships where firms are unable to complete the verification exercise, some firms would rely on suspicious transaction monitoring as an alternative to reporting to NCIS and/or closing out accounts.
- 5.106 50% of firms stated that any implementation of the CCR was unlikely to affect their decision on whether to enhance their transaction monitoring systems. Firms were similarly split over whether they would enhance their suspicious transaction monitoring systems if the CCR was introduced. No significant differences were noted between Options A and B.
- 5.107 Across the industry streams, firms are already considering developing suspicious transaction monitoring systems outside the CCR, therefore, the implementation of a CCR is expected to have limited impact on the overall transaction monitoring strategy of firms. There also appeared to be a general interest in implementing such systems in close association with a CCR. The implementation of a transaction monitoring approach would have the benefit of being applied to post N2 customers as well as pre N2 customers.
- 5.108 Many firms within the I&IM stream do not have the ability to terminate relationships and they believe the money laundering risks to the I&IM industry arises on payout and can therefore be monitored relatively easily.

Timescale for the CCR

5.109 The firms in our sample were asked how long they thought it might take them to complete the CCR under Option A and Option B. The responses are summarised below:

	Option A	Option B
Less than 6 months	20%	25%
6 months to 1 year	34%	37%
1 year to 2 years	31%	22%
2 years to 5 years	4%	6%
> 5 years	-	1%
No answer	11%	9%
Total	<u>100%</u>	<u>100%</u>

5.110 The above table indicates that the majority of firms expect to be able to meet the deadlines imposed under Option A. Under Option B firms in general anticipate that it will take less time to complete the CCR. This may be due to the more flexible approach being offered, i.e. the use of appropriate risk classification. However, a small number of firms stated that Option B would take longer to complete, thus taking full advantage of the open-ended timetable available.

Total compliance costs by industry

5.111 Our estimate of the total cost of the CCR under Option A and Option B, split out by industry stream, is summarised in Table 5.C below. We have also calculated this cost as a proportion of estimated annual recurring expenditure incurred by firms in complying with the anti money laundering (“AML”) requirements.

Table 5.C: Compliance costs by industry	Option A		Option B	
	£'m	CCR/AML %	£'m	CCR/AML %
Banking	41	105	16	38
Capital markets	29	62	19	40
I&IM	82	374	51	234
Total	152		86	

	£'m	CCR/AML %
Big 6 banks	118	196

5.112 Our findings show that the largest compliance cost will be incurred by the I&IM industry and the lowest by the Capital Markets firms. This is principally because I&IM firms have the largest population of customers on whom a review would need to be performed and a large number of Capital Markets firms consider themselves compliant with the FSA proposals already.

5.113 A number of the larger firms in this stream have undertaken, or are currently undertaking a detailed review of their customers, assessing, and where necessary increasing their existing levels of compliance. Also, this is commonly to a standard beyond that anticipated by the CCR. This has had a significant effect, reducing the overall estimated costs for Capital Markets firms to complete the CCR.

5.114 The vast majority of Banking customers are covered by the big six review, which does not form part of our CBA hence the lower than expected aggregate cost for the Banking stream.

5.115 The Option B approach to the CCR is estimated to be cheaper than the Option A approach for all firms. The I&IM firms (and building societies) have indicated that, due to the perceived lower money laundering risk of their products and customers, they believe that a much smaller number of their customer base would require detailed verification under Option B.

5.116 For the Capital Markets firms, the prescriptive approach under Option A is expected to result in a large proportion of the customer base requiring detailed manual verification, as their customers would not generally satisfy any of the filtering criteria. Option B on the other hand would allow them to tailor their approach to address the particular issues of their customer profile.

Comparison of estimated CCR costs to annualised anti-money laundering spend

5.117 Table 5.C above also shows that firms in the I&IM stream are likely to incur the greatest 'cost' to comply with the proposals, when the estimated cost of the CCR is considered as proportion of their streams current annual expenditure on AML compliance. This is the case regardless of the option adopted by the FSA.

5.118 The reasons for this are, in fact, similar to those that explain the lower unit costs experienced by this industry stream (explained above). Due to the lower risk products and customer profiles of these firms, the compliance departments are generally not as large (or as well established in terms of anti-money laundering compliance) as those found in Banking and Capital Markets, and therefore are less expensive to operate. However, the large numbers of customers that these firms have makes the total costs of complying with the proposed changes significant when compared to their usual expenditure on AML compliance.

5.119 Capital Markets firms typically have a much smaller customer base in numeric terms, but firms in this stream commonly operate larger compliance departments. Counterparties of Capital Markets firms can be complex, offshore vehicles or trusts and the products they deal in can be highly technical. This places increasing demands on the compliance department, which commonly results in increased operating costs. Consequently, the costs of completing a CCR as a proportion of such a firms annual AML expenditure is the lowest of all streams under Option A.

5.120 Firms in the Banking stream have estimated costs to complete the CCR as a proportion of AML spend to be 105% under Option A and 38% under Option B. This estimate is lower than that anticipated by the big six banks, who anticipate expenditure on this project to equate to almost 200% of its annualised AML cost.

5.121 Whilst we anticipate the big six to enjoy some economies of scale when completing this exercise, this illustrates the added complexities and associated costs faced by some of the larger institutions. The big six will incur added costs to extract accurate customer lists, especially where the firm has suffered from system integration problems as a consequence of past mergers or acquisitions.

5.122 Also, recent reports show that the majority of businesses in the UK use banking services provided by the big six. Corporate customers are significantly more complicated (and therefore more expensive) to verify. This is likely to increase the relative costs for the big six to complete the CCR, compared to the remainder of the Banking stream.

Summary of total costs

5.123 Our estimate of the total cost of the CCR under Option A and Option B is summarised in the table below:

	Option A	Option B
	£'m	£'m
Compliance cost to firms (see Table 5.C)	152.3	85.7
Cost to customers	20.8	6.3
Cost to NCIS/law enforcement	0.9	0.3
Total	<u>174.0</u>	<u>92.3</u>

5.124 The table shows that the CCR under Option A is likely to be a more expensive option for all parties affected by the proposals, the regulated firms, customers, NCIS and law enforcement agencies. This is consistent with our early expectations as Option A is a highly prescriptive approach that does not take into account firms' individual circumstances and as such is likely to result in more customers requiring detailed verification.

5.125 Firms undertaking a CCR under the guidance proposed by Option B have the opportunity to adopt an approach which is more attuned to their customer profile and

range of products and services offered. This can significantly impact on the overall cost of the CCR, for the reasons outlined in detail earlier in this section.

- 5.126 It is useful to compare the total cost of the CCR to the annual spend on anti-money laundering compliance, which we have estimated at £109m for all industry streams. On this basis, firms carrying out a CCR can expect to incur a cost in the region of 139% of their recurring, annual AML expenditure if Option A is adopted, and 79% of their annual spend should Option B be implemented.
- 5.127 To put these estimates of cost into context, it is also a useful exercise to compare these expected costs with the results of the CBA to CP 46 (which estimated the costs to comply with the new (at the time) FSA Rules on money laundering which introduced a small number of new obligations on firms including the requirement to produce an annual report on anti-money laundering compliance and to make use of national and international pronouncements on money laundering).
- 5.128 In CP46, total anti-money laundering compliance costs (excluding FSA costs) were estimated in a range from £9m to £48.4m. The anti-money laundering compliance cost for firms, which made up a substantial element of this estimate, was calculated in a range from £4.4m - £26.6m. On this basis, it appears that both the total cost, and the cost to firms, to meet the requirements of the proposed CCR will be significantly greater, although it will be a one-off rather than an annually recurring cost.
- 5.129 The estimated compliance cost to firms under the CCR can also be assessed against the expected costs of the big six banks voluntary exercise. As indicated in Table 5.C, we estimate a likely compliance cost for the big six of £118m, which represents 77% of the estimated combined cost to firms to meet Option A, and 136% for Option B.
- 5.130 We have not included in the compliance figure above any cost for firms that already consider themselves compliant with either Options A or B, unless firms expected to incur incremental costs to prove compliance as a direct consequence of the proposed amendment to the Handbook. A large number of firms considered themselves to be already compliant, and this is discussed further below.

Consideration of the options

- 5.131 Interestingly, Option B is not the preferred option of a significant number of the firms that we sampled during the course of our analysis, although the results suggest that it offers a significant cost advantage to firms.
- 5.132 This view was most prevalent in the banking stream, with 54% of firms stating a preference for Option A. Firms in the other industry streams were more in favour of adopting Option B, but with a significant minority of firms (40% of capital markets firms and 28% of I&IM firms) preferring Option A.
- 5.133 Firms cited a number of reasons to explain their preference for Option A. However, the most common reason was that firms preferred the greater certainty that a prescriptive approach provided. As well as providing more of a level playing field in terms of compliance (there was some concern that firms may view Option B as a “do nothing” option), Option A also provided reassurance to firms that their approach to the CCR was acceptable to the FSA.
- 5.134 Firms from all three industry streams expressed some concern that the FSA are keen to encourage firms to adopt a risk-based approach, but are quick to penalise those firms which cannot subsequently show 100% compliance with the rules. The firms perceive a lack of acceptance among some supervisors that a “risk-based” approach will inevitably lead to some problems that with the benefit of hindsight appear to be due to errors of judgement.
- 5.135 Overall, more firms did cite Option B as their preferred Option. This view was common in the I&IM stream, where firms considered themselves to be at lower risk of use in connection with money laundering. Many firms in this stream believed it would enable them to use a combination of industry specific filters, suspicious transaction reporting and controls over the payout stage to meet the requirements. The open-ended time scale would enable them to utilise this technique over the remaining lives of the policies / relationship.

Other compliance costs

5.136 In addition to the compliance costs faced directly by the regulated firms, there will be two other main categories of compliance costs arising out of the CCR: those faced by customers and those faced by NCIS and law enforcement.

Costs to customers

5.137 Customers will face costs directly as a result of the CCR under Options A and B as and when they are required by firms to provide identity information during the manual verification stage. Combining information from our survey, and the data on the number and type of regulated firms from information provided by the FSA, we were able to estimate the number of customers who would be contacted under Options A and B.

5.138 In both cases we assumed a cost per customer of £2.40 allowing for time required, the opportunity cost of that time, and any materials (stamps, envelopes, photocopies) required. This was based on an assumption of that 15 minutes was required, valued at the average net full time hourly wage plus 35p for materials. This assumes that customers are not required to supply certified or notarised copies of documents, in which case the requirements in terms of time and costs would be many multiples of our assumed figure.

5.139 For both Option A and B we assumed that 80% of the customers requiring manual verification (ie after the application of risk categorisation, filters and credit reference checks to the customer base) are directly contacted by firms and hence face the assumed cost. The key difference between Options A and B is in the number of customers who must be contacted (11m for Option A and 3.3m for Option B). This explains why the costs under Option A of £21 million are so much higher than the £6.4m under Option B.

Costs to NCIS and law enforcement

- 5.140 We also considered the possibility that the options would create costs for NCIS and law enforcement. We envisaged that such costs could arise if the CCR resulted in an increase in STRs to NCIS. We therefore asked the firms in our sample if they thought the CCR would have this result.
- 5.141 64% of firms that answered the question indicated that they expected the number of STRs made to NCIS by their firm to remain unchanged following the CCR. This was because they expected to be able to verify virtually all their customers electronically or manually and they felt that, even if there were customers they could not identify, this would not, itself, provide grounds for submitting an STR. On this basis the incremental cost to NCIS and law enforcement is virtually zero.
- 5.142 However, some firms responded that they intended to “defensively report” to NCIS all customers which could not be verified by the firm during the CCR.
- 5.143 To account for these two extremes, we have assumed that 1% of those customers who would remain unidentified at the end of the CCR exercise would be reported to NCIS.
- 5.144 Assumptions were then made about the time required to deal with an STR (2 hours), the opportunity cost of this time¹⁵ and the cost of other factors¹⁶ used in dealing with an STR. At a resulting unit cost of £43, the costs to NCIS were estimated at £922,000 under Option A (21,000 STRs) and £281,000 under Option B (6,500 STRs.)
- 5.145 NCIS reported¹⁷ that they received 31,251 STRs in the year ending 31 March 2002 and 63,000 are estimated for the year ending 31 March 2003. The projected number of STRs which could be generated by a CCR would therefore have a significant

¹⁵ based on the gross average hourly wage for full time public administration employees with a 20% addition for non-wage labour costs.

¹⁶ Assumed to be 50% of labour costs, accounting for office space, IT, materials etc.

¹⁷ NCIS Annual Report 2001 - 2002

impact, with Option A estimated to increase the number of STRs handled by NCIS in the last year by over 30%.

5.146 Our estimated cost figure also assumes that the STR does not result in a criminal charge. We did not seek to take account of the costs and probabilities that STRs result in criminal proceedings. Clearly if defensive reporting of unidentified customers is commonplace the costs would be multiples of those we have calculated. However it is our judgement that the number of STRs would be more limited.

6 Findings on the potential benefits

Introduction

- 6.1 This section sets out the views obtained principally from relevant firms and trade associations on the potential incremental benefits of the CCR. As FSMA does not require quantification of the benefits we have not sought to arrive at a quantitative estimate of the benefits in our CBA. In any event, the difficulties involved in quantifying incremental benefits for a CBA such as this¹⁸ and assessing the extent to which they are due to the CCR would prevent us from doing so. Instead we provide a qualitative analysis of the findings we obtained. Generally, the feeling of most firms that we spoke to was that the benefits were modest and those firms facing the greatest cost implications from the CCR were the most critical of the likely benefits.

Overview

- 6.2 While a number of benefits can be envisaged, the actual incremental benefits will depend on the individual circumstances within any particular firm. The firms and trade associations in our sample were asked for their views on what they considered the benefits of the CCR would be. They were then asked to consider a number of statements describing potential benefits of the CCR and to confirm how strongly they agreed or disagreed with the statements being made. We also sought to understand whether the potential benefits were affected by which approach to the CCR (Option A or B) was adopted.
- 6.3 Based on our discussions with firms and the feedback we received in the telephone survey we consider that the potential benefits arising from the CCR can be broadly categorised into three areas:

¹⁸ For example, consider the possibility that the CCR results in preventing a serious terrorist incident. The probability of this may be incalculably small, the cost, should it occur could be incalculably large.

- (a) Improvements in the level of regulatory compliance;
- (b) Commercial benefits;
- (c) Increase in the prevention or reduction of financial crime, providing benefits both to firms and to society.

6.4 In summary each of these three areas was viewed differently by the firms we spoke to. Some 33% of firms considered that they were already compliant with the KYC requirements envisaged by the CCR if Option A were adopted, with the remainder tacitly admitting that they were either not compliant or were not satisfied that they could demonstrate compliance. When considering benefits of the CCR 65% of the firms thought Option A would increase the level of compliance with the Regulations and the Proceeds of Crime Act (“PoCA”), although pointing out that there were no regulatory requirements pre 1994. 90% of those firms in our sample thought that the identification of pre N2 customers was an issue which needs to be addressed by the FSA, our findings suggest however that many firms do not consider the CCR with its retrospective approach to be the best solution. This is somewhat surprising given that just over 90% of the firms in our sample thought that the FSA proposed CCR was both risk based and proportionate under Option A and Option B.

6.5 In respect of the potential commercial benefits the firms were generally less enthusiastic about the actual value of the likely benefits arising from the exercise, with little in the way of differences between the views of industry streams or different sized organisations.

6.6 Under the general heading of the reduction of financial crime the initial response from most of the large Banking and Capital Markets firms when asked to consider the possible incremental benefits of the proposed options was that there were no or few benefits to firms or society arising out of a CCR of pre N2 customers and that any benefits that could be identified were likely to be “marginal” or “nebulous”. Firms said that they would be in favour of the CCR if they thought that it would stop even one terrorist act, but they thought that the likelihood of this was so low that any benefit was negligible. Firms were of the view that any STRs identified as part of

the CCR were likely to concern customers (and activities) too old to be of any real use to NCIS and law enforcement.

- 6.7 Amongst the large I&IM firms there was a high degree of cynicism towards the crime prevention benefits of the CCR. They were most insistent that any benefits to be gained from carrying out a CCR were likely to be nil or negligible and were far outweighed by the costs which will have to be borne by policyholders and shareholders. One I&IM firm said that they had no confidence in the CCR exercise.
- 6.8 The I&IM firms questioned the need for a retrospective CCR across the industry when such a review has already been initiated by the big six banks. They argue that as a large percentage of the customers in I&IM firms pay from and receive payment back to a UK bank account there is little to be gained from I&IM firms carrying out a review of the same customers.
- 6.9 A number of trade associations said they feared smaller firms might suffer. However, only one firm in our sample said that if the Option A approach to the CCR were adopted then they would not be able to afford it and would be forced to close their business.
- 6.10 Mixed views were expressed by the small and medium sized firms during the telephone survey, although almost half of the small and medium sized firms were able to identify some potential benefits to firms and society of carrying out the CCR. The positive views expressed by the small and medium sized firms in the banking and capital markets streams include the following:
- “It would allow us to check the integrity of customers”
 - “It will make it easier to get independent confirmation from brokers”
 - “Clearly the more information you have the better, any customer review is a good thing”
 - “It will create more customer confidence”.
- 6.11 The following negative comments (from the small and medium I&IM firms) were also made:

- “No benefits for us but perhaps for private banks and other sectors where money laundering may be a factor”
- “No benefits whatsoever. It would have a disastrous effect on the insurance and financial services industry.”

6.12 Broadly speaking the firms in our sample believed that the benefits, if any, of a CCR were likely to be much the same under the prescriptive Option A approach and the ongoing Option B approach. The one exception to this is that firms thought that any deterrence effect of the CCR on money launderers, criminals and terrorists was more likely under the Option B approach perhaps because it is more risk based.

6.13 When the statements of potential benefits were read out to firms, there were mixed responses on the extent of the potential benefits and on which statements were more likely to be benefits. To give an overall picture of the extent of the views that were expressed by the firms in our sample, we summarise below the average response that we received.

Table 6.A

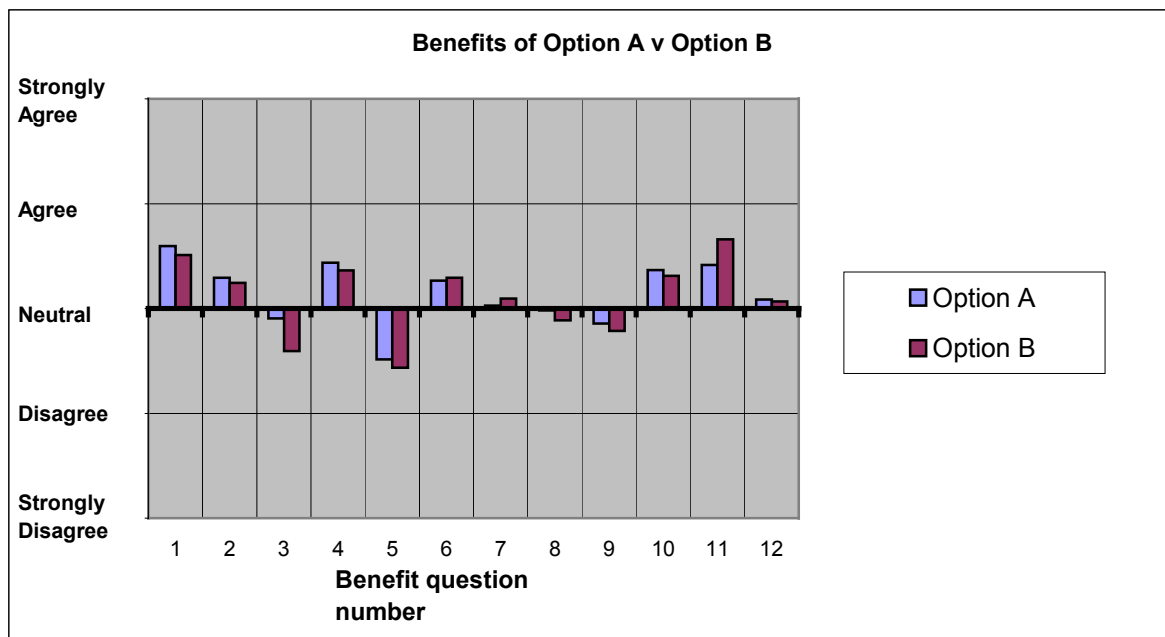


Table 6.B

1	Increase the level of compliance with the Regulations and the Proceeds of Crime Act
2	Reduced reputation risk
3	Create a level playing field in terms of the costs of compliance
4	Improved customer databases, systems or record keeping
5	Increased knowledge of customers leading to more effective marketing and reduced marketing costs
6	Increased awareness and commitment to money laundering
7	Lead to more effective account monitoring
8	Detect and prevent fraud against the firm
9	Deter money launderers, criminals and terrorists
10	Raise levels of consumer awareness of the necessary approach to assist in combating money laundering and the financing of terrorism
11	Widen the use and effectiveness of the risk based approach to anti-money laundering
12	Strengthen the UK's position as a financial centre

6.14 The above graph suggests that firms believe that there are some incremental benefits to the CCR under each of the proposed options. However as can be seen and as discussed below most firms view any benefits beyond improved regulatory compliance of the CCR as marginal. The potential benefits 1 to 12 correspond to the statements discussed further below.

- 6.15 The detailed findings of our research gained from the face-to-face visits with large firms and the telephone survey of the small and medium sized firms are discussed further below. Where relevant we also include the views of some of the trade associations. The percentage of firms who agreed or strongly agreed that the benefit was likely under each of the proposed options to the CCR (A & B) is shown in brackets after each statement.

Detailed findings – Improvements in the level of regulatory compliance

1 Increase the level of compliance with the Regulations and the Proceeds of Crime Act (64%, 61%)

- 6.16 More than half of the firms thought that the CCR would increase their compliance with the Regulations and PoCA however some firms had concerns that the CCR would considerably reduce the available resources to deal with existing anti-money laundering compliance.
- 6.17 Generally, those firms which had not undertaken a CCR style exercise acknowledged that compliance around the identification of pre N2 customers could be improved. Some 90% of firms in our sample thought the identification of pre N2 customers was an issue requiring attention from the FSA. Over a third of the firms we spoke to indicated that they have already started scoping a CCR type exercise. There was an acknowledgement that the CCR exercise was a lower cost alternative when compared to some of the remediation exercises that have been recently undertaken by some firms, where the customer identification and verification documentation has been compiled for pre N2 customers to the standards applicable at the time of undertaking the exercise. However many of the firms in the sample pointed out that the inclusion of the pre 1994 customers took the requirements of the CCR beyond the demands of the Regulations, which they did not consider to be a benefit in terms of improved levels of compliance.

2 Reduced reputation risk (55%, 51%)

- 6.18 Just over half of the firms in our sample thought that the CCR would help them to reduce their reputation risk with some firms saying that most of the incremental

benefits arising out of the CCR come from reduced reputation and regulatory risk - firms do not want to be known for having defective anti-money laundering controls or being associated with money laundering.

6.19 Some firms view the CCR as a way of “drawing a line” under their pre N2 customers as far as regulatory risk is concerned and look forward to being able to focus their efforts on their anti-money laundering controls for new customers.

6.20 A number of the large firms were negative regarding the potential reduction in reputation risk, as they believe that the increase in customer complaints likely to arise out of the CCR will actually have the reverse effect.

3 Create a level playing field in terms of the costs of compliance (37%, 25%)

6.21 Many of the firms in our sample thought that creating a “level playing field” in terms of anti-money laundering compliance was important in the financial services industry. Less than half however thought that this was likely under the Option A approach to the CCR and even fewer firms thought it likely under Option B. There was some scepticism amongst firms that their peers might regard Option B as a “do nothing” option therefore the costs incurred and approach followed might vary considerably between firms leading to very differing levels of compliance across the industry.

6.22 One large firm thought that the changes in money laundering compliance brought about by N2 had already addressed the “level playing field” issue. A number of the other large firms that compete in the global market place expressed greater concerns about the “playing field” between the UK and other countries.

Detailed findings – Commercial benefits

4 Improved customer databases, systems or record keeping (56%, 52%)

6.23 Our experience of large-scale customer verification exercises has shown that one of the potential benefits of revisiting old customer records and where appropriate verifying customer identities is an improvement to customer databases and records.

This is because such a process often involves data cleansing, merging and updating of existing customer data and the addition of new information about customers.

- 6.24 Just over half of the firms in our sample agreed that the CCR would lead to an improvement in customer databases and related records and they thought that this was likely under both of the proposed approaches to the CCR. However, while this was considered to be beneficial it was not considered particularly valuable commercially as the improvements were seen as a low priority issue.
- 6.25 Our findings suggest that improvements to customer records are more likely to arise when firms choose to verify their entire pre N2 customer population (rather than make use of many of the proposed filters) since any cleansing of data and additional customer information obtained relates to the entire pre N2 customer base. Similarly if a CRA is used early on in the CCR process (which is the approach that some of the banks and building societies said they would adopt), improvements to customer databases are more likely.
- 6.26 Conversely those firms that are able to make use of a large number of filters (for example firms in the I&IM industry) are likely to be left with a much smaller “rump” of customers to identify and therefore any additional information obtained on these customers is likely to result in minimal improvements to customer databases and records.
- 6.27 A number of firms in our sample had already undertaken large-scale projects to update customer data (for example a number of building societies had undertaken data cleansing exercises and updated their customer databases as a consequence of changes in the Building Society legislation). As a consequence, for a number of the firms in our sample any improvements to their customer records arising out of the CCR are likely to be minimal.

5 Increased knowledge of customers leading to more effective marketing and reduced marketing costs (25%, 22%)

- 6.28 If firms know more about their customers, it follows that they know better how to attract new customers, can cross-sell more to existing customers and attract more of

the same business from existing customers. Such increased knowledge could therefore lead to more effective marketing and ultimately reduced marketing costs.

- 6.29 Around a quarter of the firms in our sample thought that the CCR (under either approach) would lead to reduced marketing costs or improved marketing effectiveness because of the increased knowledge about customers. However a few of the small and medium sized firms in the capital markets sector thought that they would be in a better position after the CCR to tailor their services to meet customers' requirements and that because of improved records there would be some marketing benefits. A number of other firms saw the opportunity of re-establishing contact with customers as attractive for marketing new products.
- 6.30 The consistent view of most of the large firms in our sample however was that any information that would be useful for marketing purposes was unlikely to be obtained in the CCR.

Detailed findings – Reduction of financial crime (benefits to firms)

6 Increased awareness and commitment to money laundering (49%, 50%)

- 6.31 If all relevant firms have to carry out a CCR and commit time and resources to undertaking it properly this might lead to an increased awareness of the anti-money laundering issues and more commitment amongst staff and firms to the fight against money laundering.
- 6.32 Half of the firms in our sample thought that the CCR would increase awareness and commitment to anti-money laundering under both options. Conversely, many of the large firms thought that the awareness of financial crime and money laundering had already been raised by the FSA since N2 and that this had been further increased with the recent PoCA. They thought therefore that the CCR was unlikely to have any additional impact on awareness and commitment.

7 Lead to more effective account monitoring (45%, 45%)

- 6.33 If firms are able through the CCR to reach a position where they are reasonably satisfied that their current customers are who they say they are, it follows that this

could lead to more effective account monitoring particularly if the CCR has resulted in improvements to customer databases.

- 6.34 Whilst the above percentages indicate that almost half of the firms in our sample thought that the CCR (under both approaches) was likely to lead to more effective account monitoring, this was not a benefit that was actually mentioned by any of the firms themselves.

8 Detect and prevent fraud against the firm (42%, 39%)

- 6.35 The benefit analysis in CP46: Money laundering the FSA's new role concluded that measures to combat money laundering also have an impact on detecting and preventing fraud against firms, their customers and counterparties. It follows therefore that the CCR exercise may reduce the risk of firms becoming involved in potentially expensive incidents of fraud.
- 6.36 There were mixed views on whether the CCR would help to detect and prevent fraud against a firm, most firms thought that the CCR was unlikely to assist in this.
- 6.37 A number of firms thought that using the CRAs to assist in the verification process could have some effect on fraud prevention as they are able (as part of the data cleansing stage) to identify deceased customers, dormant, liquidated entities, and those companies which have been struck off. One firm said that concentrating on core or active clients would help to reduce the risk of financial fraud.

Detailed findings – Reduction of financial crime (benefits to society)

9 Deter money launderers, criminals and terrorists (40%, 56%)

- 6.38 Few of the large firms in our sample thought that the CCR would improve the deterrence of money launderers, other criminals and terrorists. Some of the firms (for example the IFAs) did not see themselves as particularly vulnerable to money launderers in any event. Some of the large firms were concerned that the CCR did not address the real risks posed by money launderers and there was little conviction that the CCR would deter or stop any money laundering due to the apparent ease with which false documentation can be obtained. The I&IM firms in particular find

it difficult to appreciate the deterrent effect of the CCR because they see their products as lower risk and less attractive to launderers. The view of a number of the large firms was that transaction monitoring would be a more effective deterrent.

6.39 Firms across the sectors have concerns that there are insufficient resources within NCIS and law enforcement to fully utilise the information provided in the STRs and provide effective and timely feedback to firms. They believe that the deterrent effect of the CCR will be minimal if these issues are not addressed.

6.40 However the deterrent effect was one of the benefits mentioned by a number of small and medium sized firms. Some thought that the CCR would “weed out” less reputable customers and “clean up” the industry.

10 Raise levels of consumer awareness of the necessary approach to assist in combating money laundering and the financing of terrorism (56%, 53%)

6.41 The firms in our sample were evenly split as to whether the CCR might lead to increased levels of consumer awareness. Some firms thought that awareness would be raised but only for those that are directly contacted as part of the CCR. Others thought that as the vast majority of consumers are likely to be filtered out any increase in consumer awareness is likely to be negligible under Option A and nil under Option B. Even if the CCR did lead to a rise in awareness, firms thought that there were more effective ways of educating consumers.

6.42 Firms see that any increase in consumer awareness is likely to be more than offset by the complaints. Firms are concerned about the possible reactions they might receive from consumers particularly those consumers who have multiple accounts/financial products at a number of different firms. A number raised the possibility of a consumer education programme to help reduce the level of complaints and many are looking to FSA to assist with this education programme.

11 Widen the use and effectiveness of the risk based approach to anti-money laundering (56%, 63%)

6.43 More than half of the firms in our sample agreed that the CCR would widen the use and effectiveness of risk based approach to money laundering and they thought that

this was more likely under the Option B approach where they are able to define their own filters and risk categories.

12 Strengthen the UK's position as a financial centre (42%, 39%)

- 6.44 Less than half the firms thought that the CCR would have any incremental benefits on the UK's position as a financial centre. A number were concerned that the CCR might make the UK so prescriptive that it becomes un-commercial.

Benefits to NCIS and law enforcement

- 6.45 In discussions with NCIS and law enforcement regarding the possible benefits of the CCR, they were of the view that overall it was a worthwhile initiative and that the more information that could be obtained on customers the better.
- 6.46 The benefits to NCIS and law enforcement would consist of improved information held by the firm should an investigation ever be initiated into a particular customer in the future, and an increase in STRs caused by increased scrutiny of customer details. They acknowledged however that any information obtained on the older pre 1994 customers was likely to be less useful, both to firms and, NCIS and law enforcement in the event of any STR. Whilst they supported the exercise, they were keen for it not to detract from firms other anti-money laundering activities.
- 6.47 They also expressed some concern that any defensive reporting of STRs by firms arising from the CCR exercise could obscure those reports made out of genuine suspicions.

7 Market impacts

Introduction

- 7.1 Frequently changes in the FSA's regulation will have a significant impact on the incentives firms make when deciding which products or services to offer, or which customers to serve and how. These decisions will ultimately affect the quantity, quality and variety of transactions undertaken between firms and their customers. Changes in regulations can also affect the strength of competition in the market. For example a new regulation, which makes it more expensive to enter a market, might be expected to soften the level of competition, to the potential detriment of consumers.
- 7.2 For these reasons, the FSA's CBA framework explicitly asks that the impact of a change in regulation on the quality, quantity and variety of transactions, as well as the efficiency of competition be considered.
- 7.3 Our view is that the greatest impact of the proposed options is on the compliance costs of firms. There will be little impact on the firms' incentives regarding which products to offer, and which customers to serve and how. Overall there will be little impact in the areas of quality, quantity and variety of transactions, and the efficiency of competition.
- 7.4 The reason for this is that only certain kinds of cost will affect firms' incentives regarding which products to offer, and which customers to serve and how. This section first explains what these costs are. We then consider the results from our research, which suggest that while costs may be significant, firms did not believe they would affect their incentives.

Costs and firms' incentives

- 7.5 Economic theory and business experience suggests that firms' business decisions are only affected by incremental costs – i.e. those costs which are caused by those decisions. For example, in considering whether to continue a particular business

relationship, firms will consider the expected costs of continuing that relationship, and the benefits (in terms of expected revenues). Another example would be that a firm deciding whether to launch a particular service will consider both the incremental costs of launching the service and the incremental revenues the offering is expected to generate.

- 7.6 The first thing to note is that for a wide variety of business decisions, the costs caused by Options A and B cannot be considered incremental. The costs relate to a firm's *existing* customers. They do not, therefore, affect the costs involved with attracting *new* customers or the extent of the revenues that can be earned from these customers. With regard to the identity of new customers the costs of dealing with new customers are determined by the Regulations, the FSA Rules and the JMLSG Guidance Notes. If a new relationship or product was profitable in the absence of Options A and B, they remain profitable despite them.
- 7.7 By contrast it is clearly true that Options A and B could affect the cost of continuing relationships with pre-N2 customers. In theory, the costs of obtaining the required information on a specific customer could be sufficient to make the relationship no longer profitable, encouraging the firm to end the relationship. Similarly, in theory, a firm may offer a particular product or service, the customers for which would be particularly expensive to identify. This could lead the firm to drop the product. Each of these scenarios would have clear, negative implications for the quantity, quality and variety of transactions undertaken, while also making the affected markets less competitive.
- 7.8 We specifically allowed for this outcome in our research, by asking firms if they expected options A or B to lead them to drop customers, services or products. The results, suggest that the impact, if any, would be small. Some 92% of firms did not foresee that Option A would lead them to narrow the range of products or services offered, while the figure for Option B was 94%. The firms which did indicate product range and services would be affected, suggested that, on average 10% of their customer base would be affected. These firms were few in number and relatively small in size. We conclude that the impact on the functioning of the UK's

financial services markets will be limited. Consumers will perceive strictly limited impacts, if any in terms of the quality, quantity or variety of the products on offer. The impact on competition will be minimal.

- 7.9 One exception to this result we considered was the impact on international banks, for whom customer identification can be a very expensive exercise. We assessed whether the costs involved in the CCR could, potentially, cause them to reconsider their position in the UK. Several pieces of evidence lead us to conclude that the impact on the decisions of international banks to locate and operate in the UK will be limited. First, the high cost per customer of performing the CCR must be seen in the context of the high amount already being spent (on a per customer basis) by these institutions on AML compliance. In fact, the average reported cost of compliance per customer under Option A for the international banks in our sample (£112.15) was almost identical to the average £112.50 they reported they spent on AML compliance, per customer on an annual basis. Second, we note that only 25% of international banks surveyed reported that they disagreed with the statement that the CCR would “strengthen the UK’s position as a financial centre”, compared to the 58% of all firms in our sample which agreed with this statement.

Findings in relation to wider market impacts

- 7.10 An additional market impact which should be considered is the impact on CRAs. From an economic perspective it appeared possible in theory that, because of the limited number of CRAs (there are three main suppliers: Experian, Equifax and Call Credit) these firms would either have difficulty in meeting the demand for electronic verification services engendered by the CCR due to capacity constraints or they could take advantage of the increase in demand through increased prices.
- 7.11 The effect of capacity constraints would be to push up the CRA’s unit costs, as they struggle to meet the excess demand, resulting in higher prices and potentially an inability to process the custom within the timeframe implied by Option A. We discussed this possibility with a leading CRA. They expressed the view that their on-line facility for running checks already serviced thousands of customers and the number of new users created by the CCR (which we estimated in the range 1,500-

2,000) would not be a problem. They also felt that they would be able to handle electronic verification projects outsourced by this number of firms within the required timescale, so long as firms did not all leave their requests until the end of the compliance period.

- 7.12 Regarding the possibility that the CRAs would take advantage of the increase in demand to raise their prices, we note that there are only three main players in the market. In theory increases in demand, in a market which is less than perfectly competitive, will generally imply increased profit margins. However, we note that the firms in the market will face some constraint on their pricing. The existence of Call Credit as a new entrant (in 2001) into the market, seeking to build market share, will act as a constraint on the other two players. To the extent that CRAs do have an incentive to raise prices as a result of the CCR we note that the effect of this is primarily to redistribute resources (from customers and shareholders of financial services firms) to the shareholders of CRAs, rather than to create additional social costs.

Options A and B

Current Customer Review; Policy and Options Note, March 2003¹⁹

Objective

- 1 The objective of the policy is for all relevant regulated firms to reach a position where they are reasonably satisfied either that their current customers are who they say they are, or that the risk of money laundering by certain customers is negligible.
- 2 This is likely to require firms to review the risks they face in the area of customer identification and anti-money laundering and take adequate steps to address these risks. This action will be taken under the high level requirements in SYSC 3.2.6 R for firms to establish and maintain effective systems and controls for countering the risk that they might be used to further financial crime.
- 3 The objective of the policy is not to achieve a precise standard of customer identification, for example an exact percentage of customers who have been successfully identified.
- 4 The objective is not to achieve strict retrospective compliance with the law, or to apply the standards (eg JMLSG Guidance Notes) which apply for new customers.

The Two Options

- 5 The two policy options share this common objective but vary in the detail of the obligation. The essential difference is that Option A envisages all firms going through a structured process with defined outcomes, whilst Option B would leave more discretion to a firm and its senior management to decide the extent and nature of work which it does.

¹⁹ As drafted by the FSA.

6 **Note:** The policy options A and B to be assessed are described here for the purposes of the cost benefit analysis exercise, and may be open to further revision/development.

Option A

7 Option A would require firms to carry out a formal, step-by-step review. This work would need to be adequately managed and resourced, with senior management oversight.

8 Option A envisages that work would need to be complete by the end of 2005.

9 This would incorporate provisions in the Money Laundering Sourcebook (ML) which:

- (a) require firms to be able to show that a pre-N2 client is either who he claims to be or is unlikely to be, or to have been, engaged in money laundering;
- (b) for this purpose enable firms to ‘filter’ out categories of customer either because adequate information should be available to them (from any source) or because they present no or low risk (see attached schedule of possible standard ‘filters’);
- (c) require firms in the assessment of the level of risk to consider factors such as the nature of the relationship with the customer; the volume / amount / nature of transactions carried out between firm and customer; whether payments can/have been made on behalf of the customer to third parties; geographical location etc;
- (d) in cases which are not low/no risk, and where identification evidence is not available, require firms to obtain adequate identification evidence or to review the customer relationship;
- (e) would allow firms to use third parties, e.g. credit reference agencies, as an alternative source of information to the customer himself (which we would wish to see as a last resort);

- (f) envisage that firms would end the relationship with the customer and / or make a Suspicious Transaction Report to NCIS where that seemed justified having regard to the lack of information obtainable;
 - (g) envisage that firms do any remediation in a way which prioritises action according to risk; and
 - (h) would envisage completion of reviews by the end of 2005.
- 10 Although the provisions would be in ML, they would probably be for the most part additional guidance (and probable Evidential Rules) on the application in this context of SYSC 3.2.6 R (the requirement – an enforceable rule – that ‘*a firm must take reasonable care to establish and maintain effective systems and controls for ... countering the risk that the firm might be used to further financial crime*’).

Filters and triggers

- 11 Point 9(b), above, indicates that firms would be able to use ‘filters’ – agreed criteria/categories of customer which suggest that either the firm can be reasonably confident as to the identity of the customer or the risk of money laundering is minimal. A list of draft filters is included at the end of this Appendix. These include key filters agreed during the discussions with the Big 6 banks and those agreed in principle between the FSA and the main trade associations.
- 12 The list of draft filters also lists some example triggers – events which trigger a review of the identification position of a customer who has previously been filtered out of any review work.

Option B

- 13 This would also appear in the Handbook but would take the form of more discursive general guidance.
- 14 Option B does not include a completion date. The intention is that it will create an ongoing requirement for firms, although there may well be initial work at the outset to ensure that a firm ‘catches up’ with the requirements. Under Option B, firms

would be expected to consider – and alter if necessary – their behaviour going forward. However firms would not be criticised for past behaviour in relation to the guidance.

15 The intention is that this guidance should:

- (a) remind firms of the reasons for the KYC obligation and remind firms of their legal and regulatory obligations (including the obligation in SYSC referred to above);
- (b) indicate that firms should be considering – on an ongoing basis – the identity of existing customers and the nature of transactions carried out on behalf of these existing customers in order to counter their financial crime risk;
- (c) indicate that some firms may already be confident, with adequate reasons, that they have adequately identified their customers and reviewed transactions carried out on their behalf;
- (d) suggest that other firms should review their customer information in a risk-based way;
- (e) indicate that, in cases in which customer information is inadequate, the firm should take appropriate action;
- (f) indicate that, where appropriate given the nature of transactions carried out on behalf of the customer, a firms should submit an STR;
- (g) indicate that the FSA will have regard to the consideration which firms have given to SYSC 3.2.6 and this guidance in the context of our risk assessment and ongoing supervision of individual firms, in accordance with our risk-based approach to the supervision of firms.

Proposed Filters

Current identification records are valid or retrievable

Regulations / guidance

- Exemptions in FSA Money Laundering Sourcebook (customer is a financial institution, one-off transactions less than €15,000 etc)
- Customers listed on a recognised stock exchange or a subsidiary

Product types

- Controlled Products (PEPs/ISAs/Personal Pensions)
- Long-term protection insurance policies
- Industrial branch insurance policies
- Mortgage accounts
- Endowment policies that are, or have been, assigned to a UK lending institution
- Basic bank accounts
- Pre-N2 business with paper records
- Accounts in probate/administration
- Dormant/static/inactive accounts
- Individual accounts subject to close review by MLRO

Third party verification

- Verification by Electoral Register or Credit Agency (including customers with credit facilities)
- Record of BACS payment (salary/pension/benefit/utility direct debit)
- Record of electronic transfers to/from government departments (eg Inland Revenue, VAT, Customs)
- Customer introduced by a regulated Group member subject to AML standards equivalent to UK

Minimum value thresholds

- £20k turnover for current accounts in the last 12 months
- £5k max balance for savings accounts in the last 12 months
- Regular investments/payments not more than £100 per month
- plus other minimum value thresholds appropriate to different sectors

Customer contact

- Customer's home or place of business has been recently visited

Proposed triggers

Verification to be deferred (either because low risk or excluded by a filter) and carried out when a trigger event happens.

Sale of new product/service
Annual review or meeting
Pay-out / transfer of insurance policy
Reactivation of dormant accounts

The stages to consider in the CCR

- 1 To assist firms in compiling the total cost of each option the questionnaire we used to obtain information focused on the various stages that are likely to make up a CCR conducted under Option A or B. Based on our practical experience of customer verification exercises and our understanding of the proposed options achieving full compliance under Option A or B is likely to require the completion of some (if not all under Option A) of the 9 stages detailed below (although not necessarily in the exact order as listed). Firms were asked to consider the costs if any that might be incurred in each of the stages.

Stage 1: Assessment of compliance

- 2 Firms were asked to confirm whether they were already compliant with the FSA's requirements under the options²⁰. Any firms that thought they were compliant must undertake the necessary steps to be in a position to prove compliance for which there may be a cost involved. If they are not compliant, they move to Stage 2.

Stage 2: Identifying the full pre N2 customer population

- 3 Firms must identify their pre N2 customers. For many firms particularly the smaller organisations this may be relatively straightforward but where customer information is held on an account or product basis or where there have been amalgamations of customer data because of mergers and/or acquisitions the task of identifying a full list of customers with full name, address and what date the relationship was established is likely to be more difficult or even impossible (in which case all customers would have to form part of the CCR).

Stage 3: Categorising customers according to risk

- 4 Firm must consider whether to make an assessment of the level of money laundering risk associated with each of their customers and whether to divide them into

²⁰ A firm will need to assess whether it "knows" all of its customers taken on before the FSA's Rules came into effect. This includes those customers taken on before 1 April 1994.

high/medium/low risk. This requires an assessment of factors such as the nature of the relationship with the customer, the volume/amount/nature of the transactions carried out between the firm and the customer, whether payments can or have been made on behalf of the customer to third parties and the geographical location of the customer and, under Option B, the nature of the product.

Stage 4: Running the suggested FSA filters²¹

- 5 Under Option A, firms must decide whether to make use of the filters prescribed by the FSA to filter out the low risk customers. These include key filters agreed during the discussions with the big six and those agreed in principle with the main trade associations. A firm's use of filters is likely to depend on the relevance of the prescribed filters to its customers and products and whether its computer systems can effectively run the filters.

Stage 5: Using a credit reference agency to undertake the verification of customers

- 6 Firms must decide whether to make use of a credit reference agency to verify those customers that remain after the risk assessment and/or after filters have been run²². This is typically much cheaper than other means of verification and can be used to identify a large proportion of UK domiciled personal customers.

Stage 6: Manual verification of customers

- 7 Those remaining customers which cannot be electronically verified must be manually verified. It is envisaged by the FSA that customers will be contacted as a last resort. Other sources such as using information available in other parts of the group, verification by third party databases, websites are seen as preferable to minimise customer inconvenience. As a last resort it might involve writing to customers to obtain the requisite identity documentation.

²¹ Filters are agreed criteria/categories of customer, which suggest that either the firm can be reasonably confident as to the identity of the customer or that the risk of money laundering is minimal.

²² Some firms may choose to use a credit reference agency at the start of the process before undertaking any risk assessment or running any filters.

Stage 7 and 8: Reporting to NCIS and closing out accounts or terminating relationships

- 8 Where the appropriate customer identity documentation is not forthcoming, and where it seems justified, some customers may be reported to NCIS and relationships may be terminated where it is possible to do so.

Stage 9: Using trigger events²³

- 9 The FSA has also identified a number of proposed ‘triggers’ – events which trigger the review of the identification position of a customer that has previously been filtered out of any review work. For example, verification of a low risk customer is deferred until a trigger event, such as the sale of a new product or service, at which point they are then verified. Firms will have to consider the extent to which they are able to monitor these trigger events in their systems.

²³ Events that trigger the review of the identification position of a customer that has previously been filtered out of any review work.

Our findings from the big six banks

Introduction

- 1 As discussed in Section 3, on 15 July 2002 the six major UK retail banks (the “big six”) issued a joint statement of principles for fighting crime and the financing of terrorism. This statement reconfirmed their commitment to strong anti-money laundering systems and controls, including a commitment to sustaining high standards of identification and “Know Your Customer” information across their entire customer base.
- 2 In particular, the big six undertook a voluntary initiative to re-confirm the identity of existing customers, irrespective of the date at which they became a customer. This exercise therefore included all customers taken on by the banks before the Money Laundering Regulations 1993 came into force on 1 April 1994.
- 3 As part of our review, we met with four of the big six to identify the cost implications and possible benefits arising out of the CCR. As discussed in Section 4, these costs have been excluded from the scaling up exercise within this CBA as the costs which will be borne by the big six are not “incremental” to Options A and B. We consider however that this cost information, and the views of the big six on the potential benefits of the CCR, are relevant to any consideration of the validity of the CCR. The information obtained from the big six is also likely to be of interest to those firms that have yet to undertake the CCR.
- 4 The big six have agreed their own approach with the FSA to complete the review. It is similar to the FSA Option A approach but, as well as utilising filters, the big six are also categorising their customers according to their money laundering risk. Those customers that satisfy the filtering criteria, but are considered higher risk, are returned to the residual population of customers to be verified either via a credit reference agency (“CRA”) or through direct customer contact.

- 5 To enable us to compare the big six findings with our findings from the other firms in our sample, the banks were asked to consider the likely costs of their exercise using the staged process described in Section 4 of the report.

Analysis of costs

- 6 We have estimated the cost for the big six to complete their agreed CCR exercise at approximately £117.5m. We have derived this estimate from information collated via our face-to-face interviews with four of the big six.
- 7 Total project costs estimated by the banks in our sample ranged from £13m - £50m. The wide range of responses are caused by significant differences in customer numbers between the banks, different customer profiles, (personal versus non-personal mix, location of customers etc) and the quality of the bank's underlying systems and static data. All of these factors have a significant impact on the overall cost for an institution.
- 8 Our sample of four big six firms anticipate "costs per customer" in a range between 70p and £2.94. The average has been calculated at £1.48.
- 9 The big six benefit from some economies of scale when approaching the CCR. These can be most easily seen in circumstances where customers are submitted to CRAs for electronic verification. We understand that CRA's operate a volume-pricing model, which charge a reducing "cost per customer", as the number of customers submitted for verification increases. Due to the number of customers represented by the big six, the banks will benefit from this pricing structure on a cost per customer basis.
- 10 However, these economies of scale are counterbalanced by the increased complexity the big six face in carrying out a CCR. Some banks are experiencing problems as a consequence of consolidation in the market seen over recent years which creates difficulties in determining customer lists and assessing the quality of KYC evidence already held.

- 11 However, the big six do not enjoy the lowest cost per customer in the industry as a whole, or even in the Banking stream. The Banking stream category is made up primarily of the other high street banks, building societies and international banks with a UK presence – either via a UK branch or UK incorporated subsidiary.
- 12 Building societies typically offer simpler, lower risk products such as deposit accounts and residential mortgages. Furthermore, societies tend to have a customer profile made up primarily of UK resident individuals that allows for a far simpler approach to performing a CCR. Consequently, building societies are anticipating average costs per customer of only 20p.
- 13 Firms in the I&IM sector can also have large customer bases, and therefore also benefit from economies of scale. As reported in Section 5, I&IM firms are estimated to incur costs per customer of £1.25 to complete Option A and £0.81p for Option B. The big six cost per customer is estimated at slightly higher because banks have a larger proportion of corporate or other non-personal customers compared to I&IM firms which are typically more expensive to verify.
- 14 The big six have experienced some difficulties in establishing likely costs of the exercise with any accuracy. One of the main difficulties experienced is that there are numerous unknown factors for them to consider (such as the percentage of customers that will be filtered out, the percentage of customers that will have to be manually verified etc). Although their overall approach has been agreed, we understand that there is still scope to propose, for example, the application of additional filters.
- 15 Some banks are still reviewing the filtering process and performing their own “cost benefit analysis” on possible additional filters. In essence, this involves comparing the costs of upgrading computer systems or adding new data fields to their customer database against the benefit of increasing the number of customers filtered from the residual population. The removal of a few thousand extra customers from the residual population, via the introduction of an additional filter, could have a significant effect on the overall cost of the project, for reasons discussed below.

Customer determination, risk categorisation and filtering

- 16 Three of the four banks included in our sample stated that they had no real difficulty in assessing the total customer base affected by the review. However, one bank indicated that problems with legacy customer systems meant that significant costs would have to be incurred to extract the relevant customer population. Legacy system issues also added extra costs to the project to cleanse some of the static data to allow proper risk categorisation. The bank in question estimated the cost to be in the region of £5m.
- 17 None of the banks in our sample anticipated particular problems with or significant expense in the running of filters. As discussed above, the banks have agreed their filters directly with the FSA and they do not necessarily correlate with those included under Option A. Logically, the banks will only seek to implement filters which are cost effective, and therefore did not anticipate there to be significant costs in this regard.
- 18 All of those surveyed intend to use a CRA to some extent although two of the banks raised concerns regarding infringement of the Data Protection Act in this respect.

Manual verification

- 19 All of the banks anticipate that the bulk of the costs will come in the manual verification stage. Each bank is approaching their residual population in a slightly different way and expectations of success vary.
- 20 None of the big six included in our survey anticipated more than 5% of their customers remaining for verification after determining the risk profile of customers, the application of filters and the use of CRAs. However, due to the large customer bases these institutions have, the numbers of customers remaining for manual verification are still significant.
- 21 The banks in our sample anticipated a residual population of between 100,000 and 500,000 customers. At least one institution was still undecided on how to approach

this rump and is awaiting the results from filtering, risk analysis and CRA customer matching before assessing the scale of the manual review

- 22 Consideration has been given by some of the banks in our sample to contacting their customers by post – or by telephone for customers that are considered to be of higher remunerative value. Others have considered employing temporary staff to review the paper records held by the bank or using branch staff to review KYC records held locally, before contacting customers as a last resort.
- 23 One bank in our sample has estimated that the manual verification stage would represent 97% of the entire project cost. Based on the bank’s anticipated residual population of 2% after filtering and risk analysis, this extrapolated to a possible cost per customer of £30. Another bank has calculated an expected figure of £50 per customer for manual verification, although at this stage they cannot be sure of the size of the affected population. It is apparent that cost reductions can be achieved by reducing the rump of customers for manual verification to as small a number as possible.

Complex groups

- 24 During the face-to-face meetings, we asked our sample of four of the big six to consider whether there were any benefits arising from being a member of a large group (eg through the sharing of CCR responses across the group).
- 25 The majority view suggests that the benefits were, at best, marginal. Three banks in our sample confirmed that there existed some incremental benefit across the group from shared information or through improved customer databases. However, one bank described the benefit as un-quantifiable and not worth considering.

Time factor

- 26 The big six have agreed their own timetable with the FSA and none of the banks in our sample have identified any problem complying with the 2005 deadline.

Benefits

27 Our sample of four big six banks were asked for their views on the possible benefits of the CCR. With one exception, they were generally neutral on the benefits of the CCR beyond achieving improved regulatory compliance, both in terms of benefits to themselves individually and to society at large.

Benefits to the firm

28 We received a variety of views on the possible benefits of the CCR. One bank indicated that a major benefit from completing the CCR was that it drew a line under the issue of KYC documentation currently held on existing customers. The bank intends to flag electronically on its customer systems every customer who has been dealt with under the CCR. When a flagged customer decides in the future to take out a new product, branch staff will not be required to assess whether updated KYC identity documentation is necessary. They considered that this will reduce the significant number of complaints they currently receive from long-standing customers when such requests are made.

29 One institution was broadly positive. Despite the fact that Option A was “mechanistic”, it was felt that the CCR was a good opportunity for the industry to generate “patterns of thinking” with regard to anti money laundering which should lead to increased use of a risk based approach by firms.

30 One bank noted that the CCR could be viewed as a “cheap” solution to the industry’s current deficiencies in KYC. The bank stated that the CCR would effectively draw a “line in the sand” with regard to compliance for existing customers and, at a cost approximately five times cheaper to complete than a full examination of their customer base. On this basis, they would be reluctant to see the CCR proposals withdrawn for being considered too costly.

31 We then asked our sample of four big six banks to consider a number of specific possible benefits to the firm and the industry as a whole. We ranked their answers to the questions in a range from strongly agree to strongly disagree and a summary of their responses is below.

- 32 Two of the four banks in the sample strongly disagreed that there would be any improvement in their computer databases, systems or record keeping as a result of the CCR exercise. The other two banks surveyed anticipated only a marginal improvement, if any, in this respect.
- 33 None of the banks anticipated any incremental marketing or other benefit arising from an improved knowledge of their customers following the CCR. More than once, it was pointed out that due to the filtering process, not all customers would be either contacted directly or verified by a CRA. As such any benefits arising from, say, the cleansing of customer static data would be limited, as the results would not cover the entire customer population.
- 34 Three of the four banks either slightly or strongly disagreed with the possibility that the CCR would lead to any improvement in account monitoring. The remaining bank thought that the CCR would lead to more effective monitoring of its corporate customer base due to the risk categorisation of customers.
- 35 Two banks strongly disagreed that the CCR would lead to any improvement in the firm's reputation. One institution believed that the CCR would in fact have a detrimental effect on their reputation as they would inevitably have to contact long-standing customers asking them to provide identity documentation. It was felt that most customers would not appreciate and understand the reasoning behind the request, even with the promised advertising campaign by the FSA. The other two banks surveyed acknowledged a possible benefit to the reputation of the bank but did not expect it to be particularly significant.
- 36 The four big six banks in our survey did not believe the exercise would increase the awareness or commitment within the bank to anti money laundering issues. This was primarily for two reasons, and depended on the proposed approach to the CCR. The first reason was that banks believed the awareness and commitment within their organisation to anti money laundering issues was already high, and had recently been strengthened by the training given to staff following the enactment of the Proceeds of Crime Act. Secondly, some banks were approaching the CCR purely as a back office exercise and were not intending to use branch or other customer facing staff to

assist with the review. Therefore, most of the employees within the organisation would remain unaware of the CCR exercise and what it entailed.

- 37 The four big six banks in our sample were generally neutral on whether the proposals would lead to a “level playing field” in terms of costs of compliance. Some felt that there was no “level playing field” amongst the big six with regard to the CCR because the banks have agreed different approaches with the FSA. Others commented that a “level playing field” would be even less likely if Option B was adopted as it was felt that a number of their competitors outside the big six would use this as a virtual “do nothing” option despite the FSA’s statement that this would not be the case.

Wider benefits to the industry and society

- 38 The four big six banks in our sample were generally more positive on the benefits to society arising out of the CCR. Most banks felt that the proposed CCR would strengthen the UK as a financial centre. It was also generally agreed that the CCR would act as a deterrent against criminals using UK financial institutions as a base for laundering the proceeds of crime. A number commented however that it would probably only move the problem overseas.
- 39 Many also thought the exercise would raise levels of consumer awareness of the necessary approach in combating money laundering. This would certainly be the case for those customers who were directly contacted by their bank to provide additional documentation, but it was also felt that the advertising campaign proposed by the FSA linked to the CCR would have a beneficial effect.

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