



Financial Services Authority

The Money Laundering Theme

Tackling our new responsibilities

July 2001

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Please send any enquiries concerning this paper to:

James London
Project Manager
Money Laundering Theme
Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

1 Executive summary

- 1.1 The Financial Service Authority ('FSA') is charged with reducing the extent to which regulated firms are used in connection with financial crime including money laundering. The Financial Services and Markets Act 2000 ('the Act') gives the FSA a range of explicit powers in this area for the first time.
- 1.2 *A new regulator for the new millennium*¹ was published in January 2000 and explained the FSA's plans to carry out themed projects that look horizontally at issues affecting the FSA's objectives. The Money Laundering Theme is one of four pilot themes.
- 1.3 The main aims of the Theme were to:
 - assess the current level of industry compliance with the Money Laundering Regulations 1993² ('the Regulations') so as to determine the strength of firms' money laundering systems and controls;
 - identify which financial activities and sectors are subject to the greatest money laundering risks and, therefore, pose the greatest risks to the FSA's objective of reducing financial crime;
 - assist the allocation of resources across FSA sectors in order to maximise the FSA's regulatory effectiveness, and to develop regulatory tools to deliver a response that is proportionate to the scale and nature of the non-compliance;
 - set out how the FSA is taking forward its responsibilities in this area; and
 - raise the profile of money laundering within the financial sector and emphasise to firms the consequence of failing to meet the minimum requirements set out in the FSA's Money Laundering Rules³ ('the Rules') and the Regulations.

1 All FSA publications can be found on the FSA Website at: www.fsa.gov.uk

2 The Money Laundering Regulations 1993 came into effect on 1 April 1994. They introduced requirements for money laundering systems and controls on the financial services sector.

3 The FSA Money Laundering Rules were published after consultation in January 2001 in a Policy Statement: Money laundering: The FSA's new role. They are now available on the FSA Website.

- 1.4 Chapter 3 explains the nature of the problems associated with money laundering and outlines the need for firms to take measures to reduce the potential for abuse. This was underlined by the work the FSA has recently carried out concerning money laundering connections with General Abacha. The Theme work showed that a number of firms across different sectors do not have appropriate controls in place to meet the obligations under the FSA's Rules.
- 1.5 Chapter 4 looks at where achieving the FSA's anti-laundering objective might be most at risk. Little research has previously been carried out as to the state of current compliance in industry and intelligence was gathered from a range of sources. These included:
- An independent industry survey (the Regulations Study);
 - Supervisory visits and bilateral meetings with a representative sample of firms;
 - The findings of the FSA's Abacha-related investigation;
 - National Criminal Intelligence Service (NCIS) data;
 - A law enforcement survey; and
 - Consultation with industry bodies.
- 1.6 The independent survey results are presented in Annex A. They are consistent with the FSA's view that the effectiveness of money laundering controls varies significantly between sectors and between different firms within sectors.
- 1.7 The Theme established, by means of onsite visits and discussions with firms, trade associations and others, examples of good practice in terms of effective money laundering systems and controls. These examples of 'good practice' are an important output in terms of showing what can be done and encouraging better practice across the industry. The FSA will initiate a dialogue with the industry on how best this can be achieved.
- 1.8 Chapter 5 outlines the risk assessment and prioritisation process used by the FSA to examine the range of responses to money laundering risk. The general approach taken was that the highest priority should be given to:
- money laundering which reflects criminals seeking to benefit from the proceeds of crime in the UK and especially crime which has an adverse impact upon a relatively large number of UK citizens; and
 - money laundering which would have an impact upon market confidence, including London's role as a financial centre.
- 1.9 Areas potentially most vulnerable to money laundering and areas where compliance with the Regulations was perceived to be weakest were identified. On this basis, a series of 'clustered risks' were identified as leading candidates

for attention. The top six clusters covered specific risks within the following broader sectors:

- International banking
- Domestic banking
- Independent Financial Advisers handling client money from abroad
- On-line broking
- Spread betting
- Credit unions.

1.10 For each cluster identified, a range of regulatory tools is being developed as part of an FSA response. Their application will take into account the principles of good regulation⁴ and, to this end, use will vary across clusters. The tools cover a wide spectrum and range from training and education at one end, to disciplinary procedures at the other end. As part of the toolkit available to FSA supervisors, the Theme has developed a money laundering internal process manual to assist them to conduct focused supervisory visits.

1.11 Chapter 6 clarifies the FSA's regulatory approach to money laundering in the future. In the past, no UK Authority was provided with explicit responsibility for monitoring compliance with the Regulations in the financial sector. In the future, the FSA will fill this gap for regulated firms by monitoring firms' compliance with the Rules and the Regulations, and will have a range of tools to enable it to deal effectively with non-compliance. The FSA will follow a risk-based approach in this area and will expect firms, particularly those engaged in high-risk business, to do the same. This will mean the FSA looks at risk arising both from the absence of controls in individual firms and those arising across a number of firms or a number of sectors.

1.12 The chapter then identifies the internal mechanisms in place within the FSA to ensure that the most appropriate tools are used to prevent and deal with non-compliance. It also highlights the multi-agency approach to which the FSA is fully committed in fighting money laundering.

1.13 Chapter 7 presents the main conclusions from the Theme principally:

- the reduction of financial crime is a new objective and will command a clear regulatory response for non-compliance. Firms need to be aware that a failure to have appropriate systems and controls in place may result in formal enforcement action or may put the firm at risk of prosecution for a breach of the Regulations; and

4 These principles are set out in the FSA's 'a new regulator for the new millennium'.

- in tackling money laundering, the FSA will maintain strong links with the Joint Money Laundering Steering Group (JMLSG), the Treasury, NCIS, relevant international bodies and the industry in order to ensure that compliance requirements are clear. It will provide appropriate Rules and guidance where necessary.
- 1.14 The annexes include the findings of the independent Regulations Study and the FSA's response to the Cruickshank recommendations relating to money laundering (to which the FSA was committed to respond).

2 Introduction

- 2.1 In January 2000, the FSA published ‘a new regulator for the new millennium’ This outlined the FSA’s plans to carry out four pilot themed projects that would look at areas highlighted as priorities for regulatory attention. One of these was money laundering.
- 2.2 This paper presents the findings of the Money Laundering Theme. It is not part of a formal consultation process, as it does not propose changes to the FSA’s Rules. The FSA is thus not specifically seeking comments from the industry on this paper at this stage. However, as part of the continuing work generated from the Theme, the FSA will enter into a dialogue with the industry and with the JMLSG to discuss money laundering and compliance issues. The FSA will consult if it is subsequently agreed that changes to the FSA’s Rules are appropriate.
- 2.3 The FSA would like to thank those who participated in the information gathering exercises undertaken and to those that reviewed the work of the Theme.

3 What is Money Laundering?

- 3.1 The JMLSG defines money laundering as the process whereby criminals attempt to hide and disguise the true origin and ownership of the proceeds of their criminal activities, thereby avoiding prosecution, conviction and confiscation of the criminal funds. The various stages adopted to achieve this are termed placement, layering and integration. At placement 'dirty money' is inserted directly into the financial system. The layering process then attempts to separate the proceeds from their criminal origin by moving them through a series of financial transactions, making it harder to establish the connection between the two. The final stage in the money laundering process is integration, whereby the money launderer creates a legitimate explanation for the source of funds, allowing them to be retained, invested into the legitimate economy or used to acquire assets.
- 3.2 Money launderers are employing increasingly sophisticated techniques, through a variety of transactions and firms in order to legitimise the benefits of crime. The financial services industry provides an important means through which 'dirty money' can be laundered. New technologies such as the Internet offer speed and anonymity, potentially providing distance between launderer and law enforcement. A dramatic increase in the use of offshore financial centres and less well-regulated jurisdictions highlights the alternative channels that can facilitate the laundering process.
- 3.3 Money laundering, by enabling those who break the law to benefit from their illegal activities damages society. It can also damage London's reputation as a major financial centre and thus damage market confidence and the UK economy. It is therefore in the interests of all to work to reduce its prevalence. In addition, of course, firms that do not meet the requirements of the Rules and the Regulations risk criminal prosecution or enforcement action by the FSA, as well as loss of reputation if they fail to take appropriate steps to prevent the likelihood of being used as a conduit for illegal activity.

- 3.4 There have been a number of high profile money laundering cases that illustrate the risks. Most recently, the FSA's investigation into the UK accounts linked to General Abacha highlighted control weaknesses in a number of banks' money laundering controls. Of the twenty-three UK banks investigated because of possible links with Abacha accounts, fifteen were found to have significant money laundering control weaknesses. Within those banks, forty-two personal and corporate account relationships were linked to the Abacha family and close associates and had a total turnover between 1996 and 2000 of US\$1.3 billion.
- 3.5 An FSA Task Force is now monitoring the implementation of remedial plans in the institutions most affected. The FSA is also considering the policy issues that will need to be taken forward in the light of these findings, and further discussions are taking place with the appropriate law enforcement authorities in respect of potential breaches of the Regulations.
- 3.6 The FSA's new and explicit role in relation to money laundering and its new enforcement powers highlight the UK government's drive to tackle financial crime. In the future, the FSA will have a range of tools which it can use to deal with failures in a firms' systems and controls and will have the power to bring criminal prosecutions.
- 3.7 The Proceeds of Crime Bill, when enacted in the UK, will introduce a consolidation of the primary criminal laws governing investigations, money laundering offences and confiscation. There are also a number of international initiatives underway including the revision of the Financial Action Task Force (FATF) 40 recommendations and the proposed Second European Union Money Laundering Directive. Such measures have the common objective of reducing the extent to which firms can be used to launder the proceeds of crime.

4 Money laundering and the risks to the FSA's objectives

The FSA's Objectives

- 4.1 The Financial Services and Markets Act, which will come into force on 1 December 2001, will set four objectives for the FSA:
- Maintaining market confidence;
 - Promoting public awareness;
 - Protecting consumers; and
 - Reducing financial crime.
- 4.2 The Theme's focus was on carrying forward the 'reduction of financial crime' objective and specifically money laundering. The financial crime objective, which is also aimed at fraud and market abuse, requires the FSA to reduce the extent to which it is possible for regulated firms to be used for the purposes of money laundering.
- 4.3 In order to assess the current level of industry compliance with the Regulations, and to identify financial activities and sectors that are most vulnerable to the risk of money laundering activity, the Theme drew on a wide range of information sources. These included:
- **An industry study.** Independent consultants were commissioned to undertake the Study, which received 300 responses. The results indicate the views and attitudes of the Money Laundering Reporting Officers (MLRO) in relation to industry vulnerabilities to money laundering by type of activity, service, firm and country. A summary of the report is included as Annex A to this paper.
 - **A Supervision visit assessment programme.** This involved supervisors visiting sixty-five firms spread across the financial sector. The exercise fulfilled two purposes; firstly to 'roadtest' an FSA internal process

manual;⁵ and secondly to collate and evaluate data to cross-check the accuracy of the findings of the industry study.

- **Bilateral visits.** These gave seventeen firms and trade associations an opportunity to express their views and concerns regarding money laundering. This provided valuable insight into the practical implementation of money laundering procedures. In addition, it identified examples of good practice where firms aim to deliver high standards of money laundering compliance.

4.4 The FSA has used the data received to put together a snapshot of the level of compliance in the financial services industry with the current requirements of the Regulations and the future Rules. This data takes the form of the gap analysis below which illustrates common examples of non-compliance:

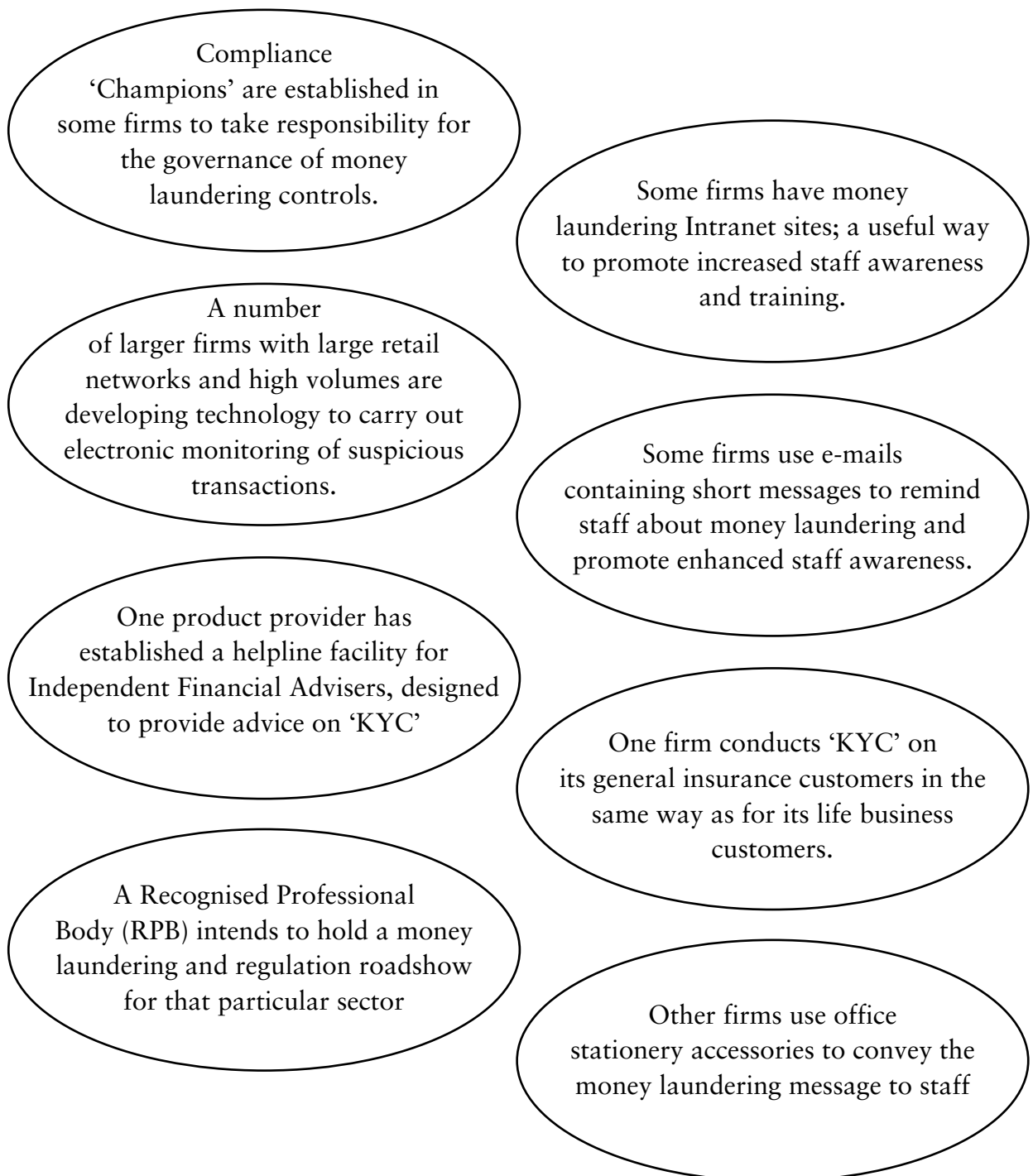
5 The FSA internal process manual is designed to assist FSA supervisors to carry out visits relating to money laundering.

Issue	Key Gaps	Reference ⁶
Know Your Customer / Verification procedures	<ul style="list-style-type: none"> • Failure to conduct, or the inappropriate conducting of 'Know Your Customer' (KYC) checks. • Failure to undertake full identification and address verification for introduced customers. • Failure to verify addresses for customers domiciled overseas. • Failure to carry out adequate verification of beneficial ownership for corporate accounts. • Failure to subject account opening to appropriate management controls where necessary. 	Regulation 7, 9 & 10 4.1 – 4.259 Guidance Notes ML R 3.1.1 – 3.1.9
Awareness & training	<ul style="list-style-type: none"> • Lack of awareness of money laundering risks to business. • Inadequate frequency of training with poor attendance monitoring. 	Regulation 5 6.1 – 6.23 Guidance Notes ML R 6.1.1 – 6.3.3
Internal and External Reporting	<ul style="list-style-type: none"> • Inadequate monitoring and internal reporting mechanisms. • Inconsistent levels of reporting to NCIS. 	Regulation 14 5.1 – 5.56 Guidance Notes ML R 4.1.1 – 4.3.4
Record keeping	<ul style="list-style-type: none"> • Failure to keep records for the requisite time. 	Regulation 12 7.1 - 7.34 Guidance Notes ML R 7.3.1 – 7.3.4
Additional information for establishing source of wealth	<ul style="list-style-type: none"> • Failure to acquire source of wealth information despite a requirement to understand the nature of a customer's business. 	4.9 – 4.11 Guidance Notes
Know Your Correspondent procedures	<ul style="list-style-type: none"> • Failure to carry out sufficient enquiry into the background of those with whom firms have established correspondent relationships. 	4.198 – 4.203 Guidance Notes
The role of the MLRO	<ul style="list-style-type: none"> • Failure to appoint an appropriately senior person as the MLRO, or to appoint a deputy, or to have support staff for the MLRO. • Failure to document MLRO duties and responsibilities appropriately. • Failure to have adequate procedures for internal monitoring, external reporting, training and awareness. 	3.1 – 3.22 Guidance Notes ML R 2.1.1 – 2.1.3 ML R 4.2.1 – 4.2.3
National and International findings	<ul style="list-style-type: none"> • Failure to consider geographical location of customers and to conduct additional due diligence for non-FATF jurisdictions. 	3.23 – 3.34 Guidance Notes ML R 5.1.1 – 5.1.4

6 The reference refers to the Money Laundering Regulations 1993, the JMLSG Guidance Notes, which interpret the Regulations and the FSA Money Laundering Rules.

Examples of good practice

- 4.5 The Guidance Notes represent good industry practice for firms to follow in order to meet their obligations under the Rules and Regulations. The FSA will maintain a dialogue with the industry on money laundering related issues, including through facilitating the sharing of examples of good practice thereby helping to raise standards. The sharing process will also provide tangible proof of what can readily be achieved. The Theme, when conducting its information gathering, found the following examples of good practice with current requirements:



5 Money Laundering Risk: Impact, Prioritisation and Mitigation

- 5.1 Chapter 4 outlined the FSA's four objectives. In identifying and prioritising the possible risks to these objectives in relation to money laundering, the Theme utilised the FSA's new operating framework. This is illustrated in Figure 1 below:

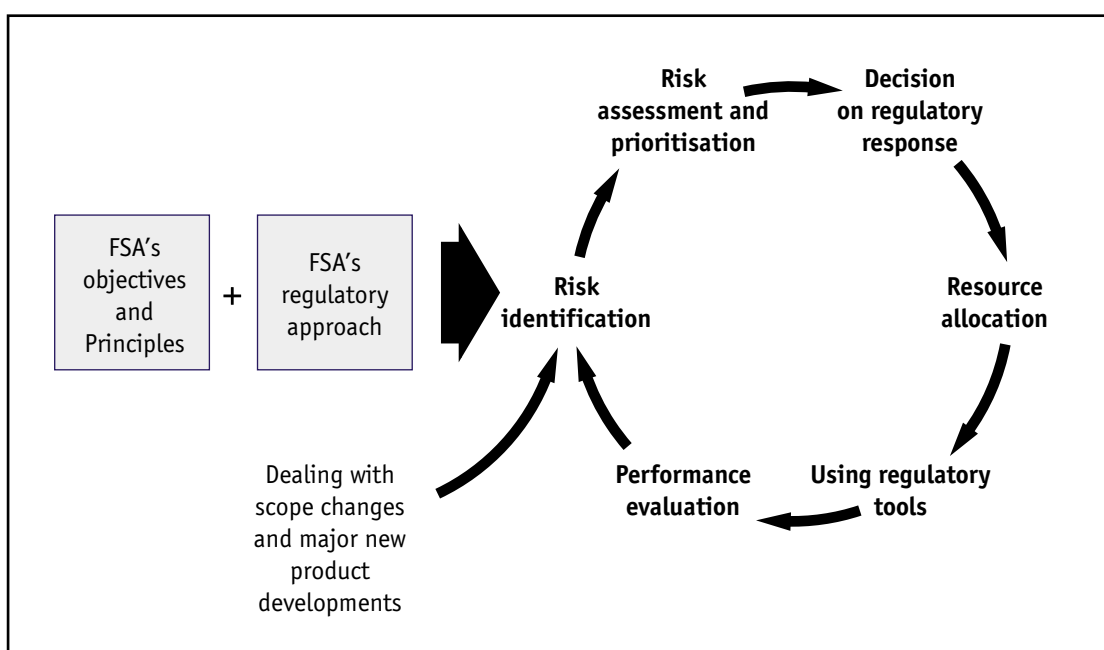


Fig. 1

- 5.2 The operating framework illustrates a standard risk assessment process, which will be applied consistently across all FSA regulated activities and across all types of firm. Risks are assessed against a number of impact and probability factors. The impact factors indicate the scale and significance of the problem, if the event were to occur, and the probability factors relate to the likelihood of the event happening. A combination of the impact and probability factors give a measure of the overall risk posed to the FSA's objectives. This is used to prioritise risks, inform decisions on the regulatory response and, together with

an assessment of the costs and benefits, help to determine the choice of regulatory tool and resource allocation.

- 5.3 This process will take account of the principles of good regulation which, in particular, cover cost considerations both for the FSA and for firms.

Risk Identification and Prioritisation

- 5.4 In the light of the data which the FSA collected (outlined in Chapter 4) the Theme considered how to set priorities for addressing key areas of risk. The first step was to find indicators, to give an idea of the impact that these risks might pose.

These quantitative indicators included:

- the nature of products and the perceived ability of the sector to control these risks;
- the number of customers and the nature of the customer base; and
- the volume or turnover.

- 5.5 Broader environmental factors, which affect the ease with which ‘dirty’ money moves through the financial system, were also taken into account.

These included:

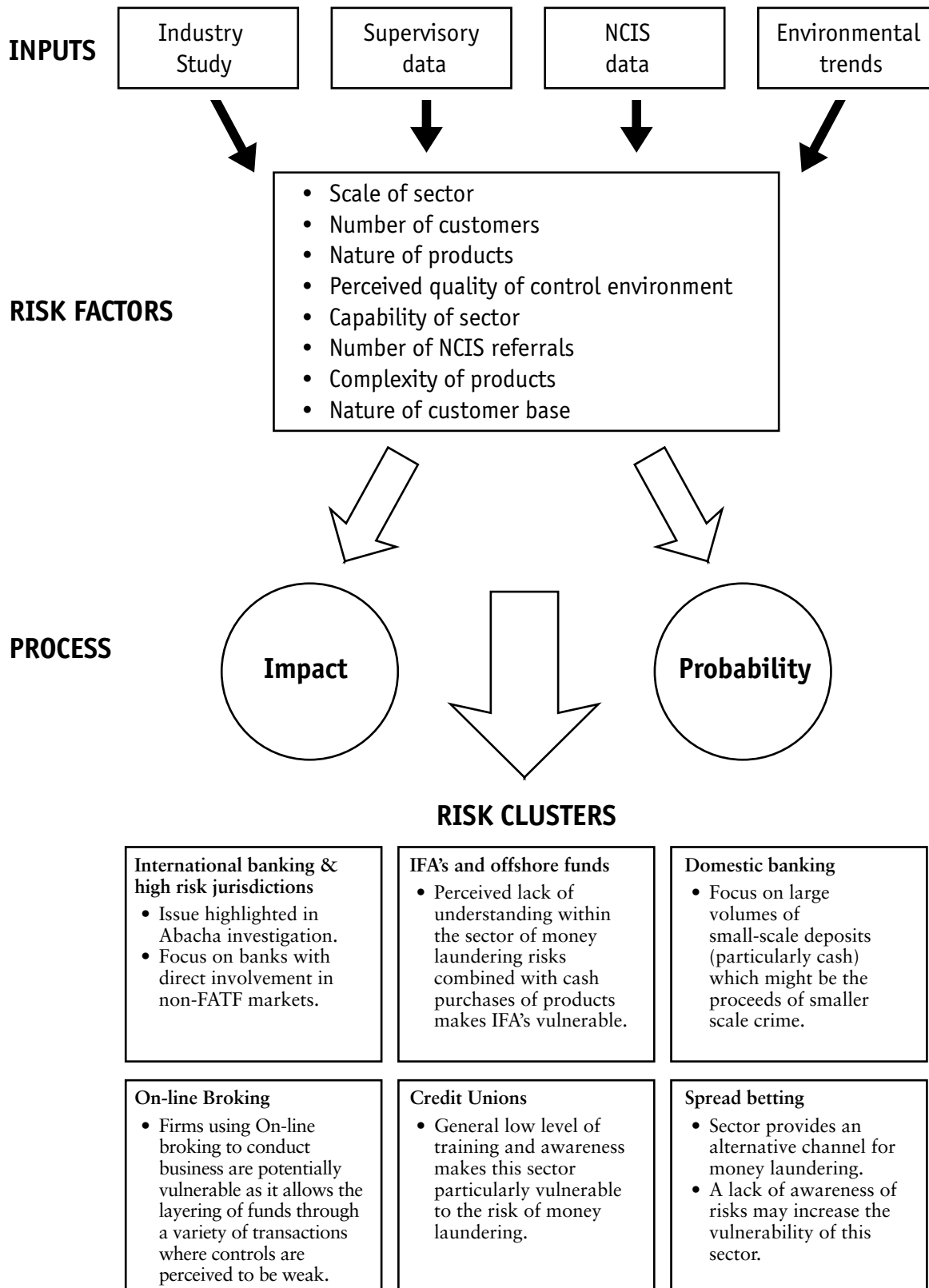
- the globalisation of international markets and the relaxation of national borders, which have facilitated an increase in the flows of illegitimate funds between countries;
- new electronic commerce and information technologies that allow funds to be transferred with increasing ease and speed, providing criminals with greater anonymity; and
- the increasing use of complex financial instruments and the role of offshore financial centres and FATF non-co-operative jurisdictions.

- 5.6 The Theme identified key risk ‘clusters’, each cluster representing activities most vulnerable to money laundering and where compliance with the Regulations is believed to be the weakest. Due to the multi-dimensional nature of money laundering, each cluster combined various dimensions associated with significant money laundering risk.

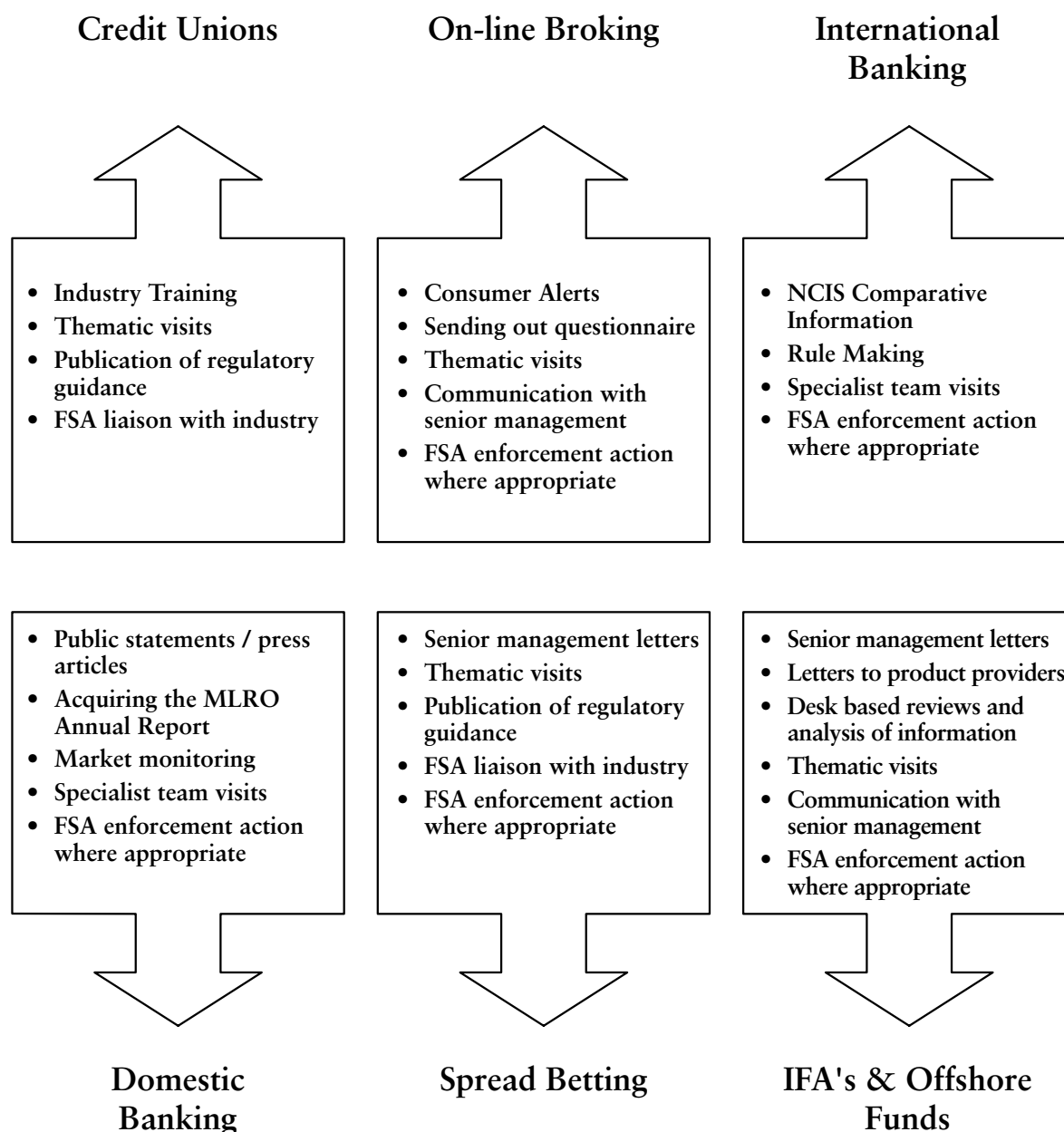
- 5.7 Having identified risk clusters these were fed into supervisory operational plans to be prioritised and incorporated into operating plans for the coming year.

5.8 The clusters illustrated below represent the top six identified and the characteristics particular to each. They are designed to be as specific and focused as possible in order to ensure that regulatory efforts are efficient, effective and measurable.

IMPACT AND PROBABILITY ASSESSMENT PROCESS



5.9 The diagram below shows an example of a range of regulatory tools developed by the FSA that could be used as part of the mitigation process to reduce the risks to those financial sectors most at risk from money laundering. The use of these tools will vary depending on the characteristics and degree of non-compliance. The FSA will revisit which regulatory tools will be most effective in carrying forward work on these areas.



6 The FSA's regulatory approach to money laundering

- 6.1 In the past, no UK Authority was provided with explicit responsibilities for monitoring compliance with the Regulations in the financial sector. Post N2,⁷ the FSA will bridge this gap by monitoring firms' compliance with the Rules and Regulations.
- 6.2 As explained earlier, a number of firms may not be meeting current standards and therefore will not be in a position to satisfy post-N2 requirements. Some will require remedial action to address shortcomings. Communication, improved training and related measures will have an important role to play in ensuring that minimum standards are met across the financial sector.
- 6.3 The FSA will, as in other areas, adopt a risk-based approach to monitoring money laundering. This approach will need to be consistent and proportionate. In addition to the resources that will be applied to baseline⁸ monitoring, the FSA intends to focus efforts on the risk clusters identified. These will be taken forward, over the next year, as project work .
- 6.4 To help deliver an effective supervisory regime, the FSA will establish the following internal framework:
- A Money Laundering Co-ordination Committee - which will ensure effective coordination of money laundering activities being undertaken by the supervisory and other areas of the FSA;
 - A Financial Crime Policy Unit – responsible for setting policy relating to the FSA's Money Laundering Rules and guidance;
 - Enforcement Teams – responsible for policy in relation to the investigation of non-compliance with the Rules and Regulations; and responsible for the formal investigation of potential breaches of the Rules and Regulations;

⁷ Term used to describe the date, 30 November, when FSA will receive its powers.

⁸ Baseline refers to routine FSA supervision applied to individual regulated firms.

- The Risk Review Department is in the process of developing a risk review team to assist supervision with thematic visits relating to financial crime, which will work with the Financial Crime Policy Unit and Enforcement Teams; and
- The Intelligence and Records Department – responsible for liaison with NCIS, Law Enforcement and with international agencies.

- 6.5 The FSA also recognises the vital role played by industry and professional bodies, in particular the JMLSG in promoting compliance with the Rules and the Regulations. The FSA will continue its efforts to co-operate with such bodies and will enter into a dialogue with individual firms to encourage the implementation of good practice standards. The FSA will encourage firms to work with their representative trade bodies to raise general standards of industry compliance.
- 6.6 The FSA hopes to create an effective partnership between all those involved in dealing with money laundering in the UK. The FSA will also work proactively to raise international standards and work with other international regulatory bodies and law enforcement involved in combating money laundering.

7 Conclusions

- 7.1 The reduction of financial crime, in particular to money laundering, is a new objective for the FSA but deterring money laundering should not be just a concern for the regulator. Making it more difficult for criminals to benefit financially from their activities should be of concern to all UK citizens and should also be important to firms' senior management. The reduction of financial crime presents a real challenge not only to the FSA but to the industry as well.
- 7.2 In tackling money laundering, the FSA will maintain close communication with the JMLSG, the Treasury, NCIS, relevant international bodies and industry in order to ensure that compliance requirements are clear, and will provide appropriate Rules and guidance where necessary.
- 7.3 The Regulations require that systems and controls be in place to protect firms against being used to facilitate money laundering and, where suspicions arise, to make a report to NCIS. The FSA believes that regulated firms are familiar with these legal requirements. However, the heightened political and regulatory interest in money laundering underlines the urgency for the financial sector to implement appropriate systems and controls to combat money laundering in line with the Rules and the Regulations.
- 7.4 The FSA intends to improve the effectiveness of the UK's money laundering regime through a regulatory focus on appropriate systems and controls. The new regulatory framework that will be in place at N2 will not involve conflicting or extensive additional requirements on firms but should ensure that the UK's regime is both practical and robust.
- 7.5 Firms need to be aware that a failure to comply by not having the appropriate systems and controls in place will be met by a clear regulatory response from the FSA. It may result in formal regulatory enforcement or leave the firm open to the risk of prosecution for a breach of the Regulations.

- 7.6 If the FSA is to be successful in meeting its objective, identification of key vulnerabilities and risks to money laundering is imperative. By conducting the risk prioritisation exercise and commissioning the Regulations Study, a number of important areas have been identified as ‘clustered risks’ and highlighted for increased regulatory attention. Part of the FSA’s future effort will be concentrated on these cluster projects with a series of thematic visits across sectors, in addition to day-to-day baseline monitoring of money laundering compliance. The risk assessment and prioritisation process will be repeated periodically in order to identify and review money laundering risks.

The Regulations Study

- A.1 Independent consultants⁹ were commissioned by the Theme to conduct an industry-wide study on firms' attitudes to the Regulations and preventing money laundering more generally.
- A.2 The object of the study was to assess the perceptions of Money Laundering Reporting Officers (MLROs) as to the general level of compliance with the Regulations and on other areas that could affect the FSA's new role in relation to money laundering.
- A.3 This information would help the FSA to target its resources and regulatory efforts effectively, by identifying areas in the financial sector where potentially significant compliance problems may arise and by profiling money laundering risk.
- A.4 A questionnaire was sent to twelve hundred firms. The questions sought MLRO feedback on perceptions regarding compliance and also on perceptions of how staff that conduct business with clients view the compliance requirements. MLROs were also asked to comment on how they believed the industry as a whole complied with the Regulations.
- A.5 The study had 300 responses, which is sufficient to highlight general patterns of compliance and non-compliance. A breakdown of respondents is provided in figure 1, below.
- Thirty-five percent of respondents were multi-product providers; and most of the firms were active in more than one country, including Europe, the Channel Islands, Cayman Islands, South America, Middle East, Africa and Australia.

Figure 1:

Accountant	2%	Corporate Finance	1%
Lawyer	4%	Credit Union	1%
Broker	19%	Venture Capital Firm	2%
Retail Deposit Taker/Lender	7%	Other Derivatives Firm	4%
Corporate Deposit Taker/Lender	2%	Friendly Society	4%
Private Bank	2%	Fund Manager	13%
Insurance Company	11%	IFA/Network/Appointed Representative	28%

The study focused on five important Regulations, namely:

- Internal Controls
- Customer Identification
- Awareness and Training
- Record-Keeping
- Internal and External Reporting

A.6 The study produced a compliance profile for each of these Regulations, giving an indication of the vulnerabilities perceived by MLROs in respect of compliance.

Report findings

A.7 The study highlights that respondents perceive spread betting contracts for differences and foreign exchange as being the activities most vulnerable to money laundering. Those activities perceived as lower risk from money laundering were mortgages and pensions. Respondents also viewed customer identification and staff awareness and training as important areas where day to day issues arose. Maintaining appropriate records was also raised as an area of potential concern.

A.8 The study identifies areas where there was a high risk of non-compliance with the Regulations. These included:

Activities:

- Dematerialised instructions
- Enabling or facilitating deals
- Underwriting (of corporate business not insurance contracts).

Service/products:

- Rolling spot forex
- Corporate finance
- Contracts for difference.

Geographic area of operations:

- South America
- Africa
- Offshore centres

- A.9 In general, the findings indicate that respondents have a strong desire to comply with the Regulations. However, where firms believe that they would need to implement additional systems in order to raise the level of compliance, this presented genuine cost difficulties.
- A.10 However, the study also indicates that the sanctions for a breach of the Rules or Regulations that the FSA would implement post N2, and the potential reputational damage to a firm engaged in money laundering activity provided strong incentives to ensure future compliance.
- A.11 Closer monitoring by the FSA is also seen as a powerful reason for firms to ensure that they are compliant with the requirements. One of the possible reasons highlighted for the current perceived lack of compliance in some sectors with the Regulations, has been the apparent absence of close monitoring and enforcement action.
- A.12 Of those firms surveyed, 44% had no group money laundering policies. Also, 40% received no internal reports over the last year, with 60% saying that they had made no suspicious transaction reports to NCIS. This may indicate that firms need to review their internal policies and procedures to ensure that reporting lines within the firm are clear and that staff are aware of their duty to report suspicions to the MLRO.
- A.13 On the whole, respondents did not believe that it is difficult to achieve compliance with the Regulations. Customer identification and staff awareness and training appear to be the two areas that require most attention.
- A.14 The data from the study suggests that the FSA should:
- increase its education programme to improve the industry's overall compliance with the new Rules, drawing attention to appropriate systems and controls;
 - re-examine complex compliance issues and clarify the FSA Rules and / or guidance to ensure firms cannot misunderstand their responsibilities.
 - make use of new powers, where appropriate under the Act, to make Rules; and
 - ensure enforcement action is taken against firms that fail to comply with the Rules or Regulations.
- A.15 The study's findings were combined with other work undertaken by the Theme to establish which areas of the financial sector are the most vulnerable

to money laundering and require closer regulatory attention. This information was used to help set out the FSA's new role in respect of money laundering and constructing the risk clusters outlined in Chapter 5.

FSA's Response to the Cruickshank recommendations

- B.1 In Consultation Paper 46, Money Laundering: the FSA's new role, the FSA stated that the Theme would consider the recommendations relating to money laundering set out in the Cruickshank report published in March 2000 on competition in UK banking. The report wanted the money laundering requirements to be proportionate and to minimise the distortions to competition, in particular to:
- reassess the requirement that customers opening an account by a non face-to-face method should provide four separate pieces of identification;
 - investigate the scope for one financial supplier to verify the identity of an individual to another supplier; and
 - examine the role of new technological developments, such as digital signatures, in providing alternative means of identification.
- B.2 The FSA in designing its Rules examined these recommendations. The use of new technologies as a means of identifying customers was considered by the Theme.

Non face-to-face customer identification

- B.3 The report was critical of the non face-to-face customer identification requirements set out in the Guidance Notes. The responses to CP46 highlighted the financial sector's concern over the current customer identification requirements and the desire for the FSA to create a new approach and one that was less onerous on firms and customers. The Treasury and the FSA felt that a reduction in the number of remote identification checks required to identify a potential customer was appropriate. The JMLSG revised the Guidance Notes in February 2001 and the updated version is ready for use by firms to help them meet their responsibilities post N2.

- B.4 The Guidance Notes require firms to have procedures to identify and authenticate the customer and ensure that there is sufficient evidence, either documentary or electronic, to confirm address and personal identity and to make at least one additional check to guard against impersonation fraud. The emphasis is now upon the quality of the information used and not simply on the number of sources which should be used to identify a customer's identity. The Rules and the Guidance Notes reflect the need for firms to adopt a risk-based approach in dealing with the identification of customers. The degree of checking needed, for example, to identify a customer undertaking risky business in a FATF non-co-operative jurisdiction will be different to that required for someone opening an account with a high street branch into which they will pay a monthly salary.

Reliance on third party customer identification

- B.5 Many firms rely on third parties to undertake identity checks or supply information on personal or address verification. These are vital to the industry in being able to check a customer's identity quickly and effectively.
- B.6 The degree of assurance a firm can place upon information supplied will vary. In order for a firm to rely upon 'KYC' checks carried out by a third party it must be assured that the third party is bound by either the Rules, the Regulations, the EU Directive or are subject to regulatory oversight by a relevant overseas regulatory authority and to legislation equivalent to the EU Directive (ML 3.2.5R).
- B.7 If the third party supplying the information is not so covered, the responsibility to obtain satisfactory identification evidence rests with the firm entering into the relationship with the customer. For example, in the case of insurance business an insurer may accept evidence of identity collected by an intermediary but the ultimate responsibility rests with the insurer and not with the third party undertaking the identification checks.
- B.8 In such circumstances, if the third party supplying the evidence of identity failed to establish the true identity, the regulated firm entering into the business relationship with the customer would be liable for a breach in the Regulations and may be subject to criminal prosecution and/or civil or regulatory action by the FSA.
- B.9 Where a customer is introduced by one part of a financial services group to another, provided that the identity has been verified by the introducing parent company or branch in line with UK money laundering requirements or equivalent standards, and provided that the records are retained in accordance with the Rules and Regulations it is not necessary for identity to be re-verified or for records to be duplicated. For one off transactions from non-co-operative

or non-equivalent countries where a new business relationship is being established, a group introduction certificate should be completed.

Electronic signatures

- B.10 The use of electronic signatures as a means of evidencing identity for the purposes of conducting business on-line has raised a number of concerns regarding the UK money laundering requirements. The FSA's E-commerce and Money Laundering Themes have co-ordinated efforts to identify the legislative, regulatory and prudential risks associated with the use of electronic signatures. A full explanation of the risks and the FSA's initial thoughts as to whether it is possible for a regulated firm, as defined by the Rules, to rely upon an electronic signature backed by an electronic certificate to identify a potential customer is set out in the E-commerce Theme Discussion Paper published in June 2001.
- B.11 The Theme has raised the subject of electronic signatures with the JMLSG because the Guidance Notes will heavily influence the extent to which electronic signatures issued by third parties can be used for identity verification purposes. The February 2001 edition of the Guidance Notes, whilst setting out what kinds of electronic checks may be performed on a new customer, does not address the acceptability of electronic signatures. This is not a serious omission at present, as electronic signature infrastructures for the financial services industry are still being established. However, electronic signatures do raise important questions which need to be tackled and on which the FSA is interested in receiving views. The FSA will ensure that it takes these issues forward with the JMLSG and other appropriate bodies to establish whether it will be possible for a regulated firm to rely upon an electronic signature backed by a certificate to identify a potential customer.

The Financial Services Authority
25 The North Colonnade Canary Wharf London E14 5HS
Telephone: +44 (0)20 7676 1000 Fax: +44 (0)20 7676 1099
Website: <http://www.fsa.gov.uk>

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