Welcome
Customer Due Diligence – Risk-Based Approach
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Agenda

• Risk Based Approach
• Customer Risk Scoring
• Enhanced Due Diligence
• Case Studies
• Evolution of a CRS Model
• Other Considerations in a Dodd-Frank World
Overview
Institutions should have a Risk Based Approach to managing AML

• The level of Due Diligence depends on the Money Laundering (ML) or Terrorist Financing (TF) risk posed
• Customer risk should be rated, monitored and managed
• Institutions can mitigate their own risk exposure through the risk-based approach and risk exposure
• Risk Scoring also enables institutions to develop benchmarks and risk rating parameters
Customer Risk Scoring
ML/TF Risk should be assessed in order to identify adequate monitoring controls

Identify Risk Categories
Customer Risk
Geography Risk
Activity Risk
Product Risk

Build Risk Profile
Senior PEP
High International Wire Volume
Foreign Low Risk Country
Business Checking

Assess/Rank Risk
High Risk
Senior PEP
Foreign Low Risk Country
High International Wire Volume
Business Checking
Risk Category

Risk category should be identified based on the business tenants

- Risk categories and factors should be identified based on the risk posed by:
  - The products/services offered
  - The customer base to which these services are offered
  - The geographic locations of the customer base or business region
  - The transaction activity of the customer

Customer Risk
- Retail/Commercial
- Relationships
- Ownership
- Industry Sector
- PEPs
- Source of Funds
- Negative News

Geography Risk
- Political Stability
- Legal Status
- Economic Situation
- Standing of the Financial services industry
- Exposure to organized crime and money laundering
- Corruption

Activity Risk
- International transfers
- Actual v/s anticipated activity
- Number of SARS
- Number of suspicious transaction alerts

Product Risk
- Correspondent Bank
- Private Banking
- Structured Finance
- Remote Deposit Capture
- Commodities
- Check cashing services
Risk Scoring
Risk Score is assigned based on ML/TF risk posed by each factor

<table>
<thead>
<tr>
<th>Risk Monitor</th>
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<tbody>
<tr>
<td></td>
<td>Low</td>
<td>Medium</td>
<td>High</td>
<td>Very High</td>
</tr>
<tr>
<td>Ownership</td>
<td></td>
<td>38.50</td>
<td></td>
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<tr>
<td>Political Link</td>
<td>68.00</td>
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<tr>
<td>Business Link</td>
<td>67.00</td>
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<tr>
<td>Management</td>
<td>58.00</td>
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<td></td>
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<tr>
<td>Reputation</td>
<td>49.00</td>
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</tr>
<tr>
<td>Total</td>
<td>60.00</td>
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<tr>
<td>Public Profile</td>
<td>High</td>
<td></td>
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</table>

Risk Grade | Description
---|---
0<...<_20 | No concerns in this particular area; little negative impact if not managed
20<...<_40 | There are some concerns and/or historic issues; could be absorbed in the normal course of business
40<...<_60 | Certain identified risks; could become significant if not managed properly
60<...<_80 | Significant risks; could be harmful if not managed properly

Risk Scoring Example (Customer Risk)
Risk Scoring Example (Overall Risk)
Customer Due Diligence
Level of due diligence depends on the ML/TF risk posed

- **Enhanced CDD**
  - Red Flag Check
  - In-depth Public Record Research & Inquiries
  - Specific Issues
  - Periodic review (90 days)

- **Standard CDD**
  - Red Flag Check
  - Public Record Research
  - Limited Source Inquiries
  - Periodic Review (6-12 months)

- **Simplified CDD**
  - Basic KYC
  - Red Flag Check

- **Limited CDD**
  - Red Flag Check
  - Public Record Research
Case Study – Background
Cayman Island Construction Company

- A small size internet bank received an application for opening a business account.
- From KYC information collected at account opening it was found that applicant is a Construction company incorporated in Cayman Island but with a US address.
- The country into which the funds will flow are the Ivory Coast and East of Europe countries as majority of company’s projects are in these locations.
- The sector in which the transaction is due to take place is the construction sector and therefore, from FFIEC guidance, inherently a high money laundering risk.
- It is unclear whether the directors and shareholders of the company are the beneficial owners.
- Rumors have been identified in the public record suggesting that the two businessmen and the company are linked to a PEP and that the foreign correspondent bank involved in the transaction is a pocket bank of the same PEP.
Case Study
Customer Risk Scoring

The scope of research involve public record research into all parties (individuals and companies) involved. This also included an overview of the business networks and associations of the businesses and the individuals.

A series of discreet inquiries within the local business communities in order to ascertain their overall business reputation and to ascertain whether there is indeed any substance to the allegations of their business being a front-operation for a PEP.

Customer Risk
- Overall background and reputation
- Business interests and practices
- Business associates and networks
- Political Affiliations (PEPs)
- Beneficial ownership and control
- Source of funds

Geography Risk
- Known of weak AML rules
- Known of terrorist financing
- Smuggling & other money laundering activities

Activity Risk
- High International WIRE volume to high risk countries

Product Risk
- Business Checking

Expected Outcome
On the basis of the enhanced CDD that should be undertaken, the Bank could cross-reference the information provided by the customer.

The Bank would be in a position to disprove any rumors which had been voiced about links and front operations for a PEP.

The exercise provides a complete and comprehensive documentation trail and supporting case within the scope of the CDD process.

The exercise enables the Bank to decide on the level of ongoing monitoring, given the risks are classified as high.

Very High Risk
Case Study – Background
Local Money Service Business

• A local Money Service Business (MSB) applied for business account (mom and pop grocery store)

• Initial examination found that this MSB also offered check cashing services including monetary instruments

• This MSB had limited identification requirements for it’s customers
Case Study
Customer Risk Scoring

The scope of research
Involve public record research into all parties (beneficial owners, key employee) involved. Inquiries within the local business communities in order to ascertain their overall business reputation Inquiries to know their customer base and business practices and record keeping.

Expected Outcome
On the basis of the Standard CDD that should be undertaken, the Bank could cross-reference the information provided by the customer. The Bank would be in a position to prove source and beneficiary of funds/transactions. The exercise provides a complete and comprehensive documentation trail and supporting case within the scope of the CDD process. The exercise enables the Bank to decide on the level of ongoing monitoring, given the risks are classified as high.

Customer Risk
• Business type
• Business interests and practices
• Source of funds

Geography Risk
• A local business

Activity Risk
• High cash, monetary instrument and check volume

Product Risk
• Business Checking
Evolution of a CRS Process
A Brief Timeline of Change

• 2005: implemented initial Client Risk Scoring (CRS) Process
  – CRS system separate from, but connected to, account-opening platform

• 2006-2008: changing technology, better understanding of CRS results
  – Bank migrated to new account-opening platform
  – Improvements to CRS methodology based on analysis of clients which scored high risk

• 2009: decision to make radical change to CRS methodology and system
Challenges with Model:

- Complex model – requires significant programming effort
- High number of rejects due to missing data elements
- High number of Canadian clients identified who were otherwise low risk
- Clients scored only once
- Identification requires multiple high risk factors before being considered for EDD
- Overly complex model given level of risk that overall Bank and clients posed
Fine-Tuning the CRS Model: An Evolutionary Process

Factors that Led up to Analysis:

- CRS model had strict data requirements which created complexities in an automated, multi-data input environment (client could not be scored without all data, created “defects”)
- Complexity of business rules and costs associated with implementation or changes within CRS model or any systems connected to model
- Desire to add/remove criteria as needed to ensure the appropriate clients are submitted Enhanced Due Diligence
- Data showed that the majority of higher risk customers identified by the CRS application were Canadians with checking accounts
- Desire to improve the quality of referrals with greater focus on individuals and businesses who differ from the “typical” customer
Fine-Tuning the CRS Model: An Evolutionary Process

Objectives of the Analysis:
- Simplify the model to reduce the likelihood of “defects” and support a more sustainable technology support process
- Continue to identify clients we believed were higher risk
- Reduce the volume of lower-risk clients that scored as high risk (the “so what?” factor)
- NOT an exercise in reducing volume

Analysis Criteria:
- Ability of each risk factor to distinguish risk (stratification of client responses)
- Likelihood that individual risk factor resulted in the client being rated high-risk overall
- Individual factors which generate high degree of false positives (unintended identification of high-risk clients)
CRS Methodology
2010 Model: Personal Client

Benefits of Model:
• Simple scoring methodology using data elements generally captured by all source systems
• Reduces impact on branch personnel to follow-up on missing scoring
• Clients continuously scored
• Reduction in maintenance costs
• Resulted in higher ratio of clients being appropriately referred for EDD
## Comparison of Results
### Three Years in Review

<table>
<thead>
<tr>
<th>Year</th>
<th>New Clients Deemed Higher Risk</th>
<th>New and Existing Clients Deemed Higher Risk</th>
<th>Clients Subject to Level 2 EDD</th>
<th>SARs Filed</th>
<th>Clients Demarketated</th>
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<tbody>
<tr>
<td>2008 CRS</td>
<td>11,051</td>
<td></td>
<td>222</td>
<td>1</td>
<td>3</td>
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<tr>
<td></td>
<td>New</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>11,051 New Clients Deemed Higher Risk (7% of the total clients risk scored)</td>
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<td>2009 CRS</td>
<td>13,488</td>
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<td>2</td>
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<td></td>
<td>New</td>
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<td></td>
<td>13,488 New Clients Deemed Higher Risk (9% of the total clients risk-scored)</td>
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<tr>
<td>2010 CRS</td>
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<td>197</td>
<td>2</td>
<td>9</td>
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<tr>
<td></td>
<td>New and</td>
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<td></td>
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<tr>
<td></td>
<td>Existing Clients Deemed Higher Risk</td>
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Note: EDD stands for Enhanced Due Diligence, SAR stands for Suspicious Activity Report.
Other Considerations
AML in a Dodd-Frank World

- Be wary of detracting resources and management attention from your BSA program
- Continue to take a risk-based approach to drive areas of focus
- Ensure that BSA/AML concerns are considered during new product development
- Don’t forget about Fraud-related SAR obligations, especially when the bank is not at risk for taking a loss