Challenges of Applying Objective, Quantitative Measures for Formal Risk Appetite Statements in the Financial Crime Compliance Space

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The personnel and teams of the internal audit function at large financial institutions responsible for evaluating the effectiveness of controls pertinent to anti-money laundering (AML), sanctions programs and corruption should assess that management has defined and the board has approved a clear statement of risk appetite. Risk assessments for financial crime within individual lines of business and across the entire enterprise should be regular exercises. However, the logical articulation of the acceptable amount of risk for which one cannot avoid or control, (i.e., the appetite for residual risk), is equally valuable.

**Regulatory Guidance and Comments on Risk Management**

In October 2008, SR 08-8, published by the Board of Governors of the Federal Reserve System and titled “Compliance Risk Management Programs and Oversight at Large Banking Organizations with Complex Compliance Profiles,” recognized challenges to manage and oversee compliance risks despite foundational concepts and standards being identical to other types of risk. It specifically stated that “quantitative limits reflecting the board of directors’ risk appetite can be established for market and credit risks, allocated to the various business lines within the organization, and monitored by units independent of the business line. Compliance risk does not lend itself to similar processes for establishing and allocating overall risk tolerance, in part because organizations must comply with applicable rules and standards” (FRB SR 08-8/CA 08-11, Introduction). The Supervisory Letter further noted that quantitative measures of compliance risk do not often or easily lend themselves to analytical techniques to assess overall and evolving states of risk that one associates with the evaluation of credit or market risks. However, the message from the Federal Reserve also reinforces the importance of risk assessments as the bedrock of a robust compliance program. While acknowledging challenges faced by large financial institutions to quantify both inherent financial crime risks and acceptable levels of those risks following the deployment of controls, a key regulatory body has communicated an expectation that banks will understand and articulate their risk appetite.

More recently, in January 2014, the Office of the Comptroller of the Currency (OCC) released NR 2014-4 titled “OCC Proposes Formal Guidelines for Its Heightened Expectations for Large Banks.” The proposal specifically provided for “A comprehensive written statement that articulates the bank’s risk appetite, which serves as a basis for the risk governance framework. This statement should include both qualitative components and quantitative limits” (OCC NR 2014-4). Subsequently Title 12 Part 30 of the Code of Federal Regulations incorporated those guidelines in Appendix D. This component of safety and soundness standards advises that the board of directors of a financial institution (or an appointed risk committee) must review and approve its risk appetite statement at least annually and that the statement must be communicated throughout the bank for personnel to adopt the appetite statement into their decisions.

Most of the accompanying language and focus of the 2014 OCC guidance about the risk appetite statement refers to limits and testing associated with liquidity and capital. However, in light of the above-referenced compliance risk guidelines from the Federal
Reserve in 2008, one could infer that regulators would expect clear, quantitative metrics for a robust financial crime compliance risk appetite statement. Furthermore, one might anticipate regulatory requirements in the future that apply testing principles of credit and other types of risk to compliance risk management. For example, SR 12-7 titled “Guidance on Stress Testing for Banking Organizations with Total Consolidated Assets of More Than $10 Billion” from the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC) and the OCC in May 2012 advises that banks “should have the capacity to understand fully their risks” (FRB/FDIC/OCC SR 12-7, 1), that testing should be “forward looking and flexible” (FRB/FDIC/OCC SR 12-7, 6), that testing results should be “actionable, well supported, and inform decision-making” (FRB/FDIC/OCC SR 12-7, 7) and that testing “should include strong governance and effective internal controls” (FRB/FDIC/OCC SR 12-7, 8). Perhaps these types of statements point to the direction in which financial crime compliance risk assessments, risk management processes and risk appetite statements will need to evolve.

Zero tolerance for negative outcomes in a board-approved risk appetite statement would necessarily require a nearly infinite commitment of resources to controls or an extremely constricted business environment. Neither of the aforementioned methods represents a sustainable, profitable model. If one assumes that a foundational value of any given financial institution is to not knowingly violate laws or regulations and that the institution will not knowingly conduct business with an entity believed to be engaging in illicit behavior, then trivial cases of zero tolerance exist such as known criminal actors.

Broad avoidance of financial crime compliance related risks in the face of difficulties to manage those risks has not been viewed favorably by regulators. In March 2014, Comptroller of the Currency Thomas Curry criticized the practice of de-risking when deeming overall classifications of business too risky rather than applying risk-based approaches to exercise judgment when assessing individual clients.

Jennifer Shasky Calvery, director of the Financial Crimes Enforcement Network (FinCEN), also spoke to the subject of de-risking in August 2014. She noted that even though a client is high risk it may not necessarily be unable to be maintained as a customer of a financial institution. Similarly to the comments from Curry five months earlier, Shasky Calvery criticized excluding categories of clients as such actions may actually increase the overall financial crime risk to society by forcing those entities into less transparent and regulated options.

The aforementioned comments by Curry and Shasky Calvery chronologically straddled the issuance of a Staff Report in May 2014 from the U.S. House of Representatives Committee on Oversight and Government Reform titled “The Department of Justice’s ‘Operation Choke Point’: Illegally Choking Off Legitimate Businesses?”. This report, sponsored by the office of California Representative Darrel Issa, the chairman of the issuing committee, called into question efforts by the Department of Justice (DOJ) to pressure financial institutions into terminating relationships and services for entire categories of business that while legal were deemed to be high risk. Specifically flagged
businesses included coin dealers, sellers of firearms, sellers of ammunition and in particular payday or short-term lenders.

Published comments from a discussion in October 2014 of the Financial Action Task Force (FATF) addressed the practice of avoiding the financial crime risks posed by categories of clients in lieu of risk-based practices by noting that maintaining those types of relationships benefits the operationalization of AML controls by permitting funds to travel through regulated pathways.

Furthermore, in January 2015, FDIC published financial institution letter FIL-5-2015 (later amended in February 2015 to address incorrect contact information) titled “Statement on Providing Banking Services,” that discouraged wholesale treatment of business categories versus a risk-based approach to stratify potential clients within those categories. Key points of the issuance included an assertion that individual customers within classifications present varying levels of risk and an expectation that financial institutions will assess risk at the more granular level of clients. Based on those case-specific assessments, the bank should deploy controls in line with the determined risks.

Risk Appetite Statements in the Context of Risk Assessments

Generally, a statement of risk appetite developed by the management of a large financial institution and approved by the board should dimension the acceptable residual risk remaining when controls have been deployed against assessed inherent financial crime risks. Herein represents the role of internal audit within a large financial institution. The Institute of Internal Auditors (IIA) defines the practice in the 2013 edition of the International Professional Practices Framework as an independent, objective assurance activity that provides value through the evaluation and improvement of the effectiveness of risk management, controls and governance processes (IIA IPPF, 2). Has the bank sufficiently identified and assessed financial crime compliance risks? Has the institution defined the amount of risk inherent to its business pursuits that it is willing to accept? Have controls been adequately designed to address the gap between the defined inherent risk and the accepted residual risk? Have those controls been effectively operationalized?

The November 2014 edition of the Federal Financial Institutions Examination Council (FFIEC) Bank Secrecy Act/Anti-Money Laundering (BSA/AML) Examination Manual states that “Banks may have an appetite for higher risk activities, but these risks should be appropriately mitigated by an effective BSA/AML compliance program tailored to those specific risks” (FFIEC BSA/AML Exam Manual, 25). The exam manual advises that initial stages of AML risk assessments should address the following: products, services, customers, entities and geographic locations. Complementing the aforementioned demographic information, a financial institution must consider transaction activity and expected activity to understand the risk environment. The FFIEC overview states that “detailed analysis is important because within any type of product or category of customer there are accountholders that pose varying levels of risk”
These multiple steps to the approach of assessing risk to the large financial institution for the segments highlighted by the FFIEC may lead to some of the following considerations of risk appetite.

**Products and Services**

Opportunities for revenues and profit for a financial institution that offers products or services that may be associated with elevated financial crime risks because those offerings can obfuscate a clear understanding of the nature and purpose of activity. Listed products and services in the FFIEC Exam Manual include the usual suspects linked to the rapid movement of funds and to anonymity: funds transfers; online banking; private banking; trusts; monetary instruments; foreign correspondent accounts; trade finance; currency exchange; concentration accounts. The decision to provide one or more of these offerings to clients assuming the bank has the requisite operational capabilities may come down to the algebra of whether or not sufficient possibilities for profit remain after inherent financial crime risk has been assessed and after adequate controls have been implemented to deter, detect and report circumstances with no lawful purpose, designed to evade reporting thresholds or involving illicitly derived funds. Qualitatively, internal audit functions addressing compliance with financial crime regulations, policies and procedures shall assess the effectiveness of the controls from both a design and implementation perspective and shall evaluate whether or not both the assessment of and the stated appetite for risk is reasonable. A quantitative evaluation reconciling residual financial crime risks to the board-approved risk appetite statement depends on analyzing products and services in conjunction with other components discussed below.

**Customers and Entities**

Some categories of clients typically present a greater risk of financial crime to a large financial institution such as politically exposed persons (PEPs), nonresident aliens, foreign financial institutions, non-bank financial service providers, cash-intensive enterprises, charitable organizations, entities with opaque beneficial ownership (private investment companies, shell companies, etc.) and certain service providers (deposit brokers, attorneys, accountants, etc). In line with the previously cited comments from Curry and Shasky Calvery that were critical of generalizations of client categories associated with the practice of de-risking, the FFIEC Exam Manual stresses a risk-based approach to assessing the risk of persons and entities within a defined category rather than necessarily equating them. The assessment of customers and entities and its relationship to the accepted appetite for this narrow subset of financial crime risk faces interesting challenges. If controls have been designed based on a measure of the aggregate client risk, then what is the inertia to change those controls as the universe of clients evolves over time? Do mergers, expansions, new product offerings, marketing campaigns or demographic shifts increase or decrease the risk of the ‘average’ client more quickly than incremental controls can be deployed or existing controls can be relaxed? If stratified controls have been developed according to the risk rating of a client, then how does the financial institution respond to shifts in the perspective of the
inherent risk of certain customer categories? If risk assessments or control are sufficiently nimble to keep up with evolving risks, does robust governance and informed approval align with such changes?

Given the noted regulatory pressure to not adopt practices of excluding whole classifications of clients as a mechanism to avoid financial crime risks, the option of excising a category of client to decrease aggregate customer risk does not represent a preferred option.

*Geographic Locations*

Both domestic and foreign locations can be characterized as higher risk geographies based on several factors, including sanctions programs, jurisdictions of primary money laundering concerns, locales cited by FATF as having inadequate regulatory environments to combat financial crimes, and designations of greater exposure to drug trafficking. As referenced both with products and services and with customers and entities, geography is a component of assessing financial crime risk and not a data point that necessarily defines something as low or high risk. Large financial institutions can often utilize external resources such as reports from the U.S. Department of State, lists published by the U.S. Treasury Department’s Office of Foreign Assets Control (OFAC), ratings from financial industry groups (Basel AML Index, FATF High Risk and Non-cooperative Jurisdictions, etc.) and other providers (Know Your Country, Transparency International Corruption Percentage Index, World-Check, etc.) to assess financial crime risks for geographies across the globe. Banks with international affiliates may leverage information and resources of those partners to enhance their risk assessment related to the geography of clients, counterparties and transactions. Determination of whether or not to conduct business in a particular locale, to establish relationships with clients of a given location or to conduct transactions associated with a particular geography based on an appetite for financial crime risks should consider the aforementioned resources in aggregate.

*Multidimensional Analysis*

As risk assessments benefit from analyzing products, services, customers, entities and geographies as interrelated factors, a financial crime compliance risk appetite statement will have more value as those data points are evaluated with respect to one another rather than in an isolated manner. Identifying client types that are more likely to utilize certain products and services or sets of products and services may reveal combinations of concentrated risk that warrant enhanced controls. Conversely, do certain clients in a category partake of products or services not typically associated with those clients? Assessing client risk versus geographical risks could highlight typologies that exceed the risk appetite of an institution; such judgment would not be an example of the criticized practice of de-risking a broad customer category. Mapping product risks or of client risk to higher risk locations over time can demonstrate and assist in projecting the evolution of risks into the near future for forward looking risk assessments and enhancement of the relevance of statements of risk appetite.
In addition to combinations with one another, customer, product and geographic financial crime compliance risk assessments and risk appetites should be understood in the context of transaction patterns. Do account purpose types correlate positively or negatively to other data points? Is historical or expected activity inconsistent with certain high-risk services, with categories of higher risk clients or with regions associated with weak financial crime regulations?

Another layer of quantifying risk assessments and determining risk appetite can be found with evaluating exceptions and overrides. Do metrics exist to identify the frequency at which management or client selection committees deviate from risk rating models or retain client relationships that have been initially determined to fall outside of the risk appetite of the bank?

Operational characteristics associated with financial crime risks provide further breadth to articulating a statement of risk appetite. Have a minimum threshold of required personnel completed mandatory training in a timely manner? Do training assessments in the aggregate reflect adequate understanding and retention of the underlying material? Are volumes and significance of policy exceptions revealing an increasing, stable or decreasing trend over time? Have transaction monitoring and sanctions screening models generated numbers of alerts at sustainable levels given available resources? Are those alert scenarios of sufficient quality to yield suspicious activity rather than false positives? Do scenarios address all points of AML risk exposure that impact a financial institution considering products, services, clients and geographies? Do gaps in coverage exist (either unintended omissions or strategic ones)? Do the number and complexity of scenarios reflect varying amounts of assessed exposure to those categories? Are staffing levels in financial crime compliance position adequate to planned and assessed requirements? Do openings or turnover rates correspond in a meaningful way to key roles?

**Conclusion**

A clearly defined statement of financial crime risk appetite from a large financial institution does not excuse or justify the maintenance of relationships with known bad actors or the facilitation of transactions believed to be of an illicit nature. Rather the development of a risk appetite statement requires an assessment of the inherent risk of financial crime that a bank faces given its offerings of products and services, its overall population of clients and the locations involved with the transactions it facilitates.

Subsequently, management must articulate and the board must approve the design and deployment of controls to reduce residual risks to an accepted level. The internal audit function providing assurances and assessments related to financial crime risk for the financial institution must evaluate whether or not those controls are effective in addressing the assessed risk and whether or not the risk appetite statement itself is an effective communication to provide qualitative and quantitative guidance to personnel responsible for managing the AML, sanctions and corruption risk of the bank.
Works Referenced and Cited

Board of Governors of the Federal Reserve System; Supervisory Letter SR 08-8/CA 08-11; On Compliance Risk Management Programs and Oversight at Large Banking Organizations with Complex Compliance Profiles; October 16, 2008; http://www.federalreserve.gov/boarddocs/srletters/2008/sr0808.htm


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