



LexisNexis White Paper

# Overcoming the Challenges of the Risk-Based Approach

**Findings from the LexisNexis Anti-Money Laundering Survey**

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## Executive Summary

Anti-money laundering compliance is a key area for banks, law firms, asset management firms, auditors, accountants and similar regulated service providers. These businesses must be constantly vigilant as criminal gangs, fraudsters, traffickers, terrorists and unscrupulous individuals devise more sophisticated ways to launder their money in a global economy. One of the major priorities for these businesses is to ensure they manage this risk and comply with the regulations to protect both their reputation and the public.

The Money Laundering Regulations introduced in the UK on 15 December 2007 recognised that globalisation and new technologies have contributed to the increasing opportunities for fraud and illegal financial activities and it is now essential for businesses to 'know their customers'.

One of the fundamental changes of the new legislation was the introduction of a risk-based approach. The new method was intended to offer a better, less time-intensive and more cost-effective alternative to the prescriptive approach, enabling firms to focus their resources on high-risk customers and thereby meet compliance requirements more efficiently.

Yet despite the best intentions, the benefits of the new system have been difficult to realise and a struggle for clients to accept. Discrepancies in resources, varying degrees of interaction with the regulators and a lack of clear guidelines have left the process of risk assessment open to an individual firm's interpretation. The new Regulations have also failed to consider the breadth of firms who have been affected by the changes. From small firms to large, multi-national organisations, each has had to implement the legislation and meet the criteria, despite the vast differences in resources. As a result, some businesses, particularly smaller organisations, are more exposed to financial crime than before.

This white paper explores the challenges and opportunities the risk-based approach presents. Following ongoing discussions with our customers, we have examined how routine tasks such as conducting money laundering checks, identifying beneficial owners, monitoring business relationships and determining whether a customer is a politically exposed person (PEP) have been affected and can be improved. Our top ten tips offer guidance on how best to manage the risk-based approach.

*The new Regulations have failed to consider the breadth of firms affected by the changes; from small firms to large, multi-national organisations, each has had to implement the legislation and meet the criteria, despite the vast differences in resources.*

*The survey revealed that 52 per cent of small firms found applying the risk-based approach challenging and that more than half of the smaller firms (52 per cent) also had significantly more trouble “maintaining awareness of regulatory obligations” than medium-sized firms that said this had “no impact at all”.*

## Introduction

According to the latest figures from the Home Office, organised crime costs the UK approximately £20 billion in social and economic harm each year.

Increasingly stringent legislation makes it imperative that firms adhere to the money laundering regulations. Failure to comply could result in irreparable damage to reputation and customer service, severe financial penalties, business closures and even prison. Considering the potentially harmful consequences of the legislation, firms must ensure robust preventative measures are in place. The customer due diligence requirements, including identifying and verifying customer identity and the ongoing monitoring of customer transactions and activities for suspected money laundering or terrorist financing must be met. Businesses have to apply rigorous customer screening and due diligence standards to ensure they know their customers, to maintain identity records and to train staff on their regulatory obligations.

To help alleviate the pressure, the risk-based approach was developed as a more efficient alternative to the former “one size fits all” customer due diligence methodology. The new system was intended to enable organisations to align resources with high-risk situations and reduce workload where the risk is perceived to be minimal.

Yet, six months after the Money Laundering Regulations came into force, an independent survey of 150 senior compliance executives, split evenly among accountancy, finance and law firms, highlighted the gulf between the preparedness of larger companies, who have the resources to establish and maintain updated compliance processes, and smaller firms who are struggling to comply with the new measures. The process has impacted revenue, customer service and in the case of some firms, particularly smaller organisations, it has increased their exposure to financial crime.

*The risk-based approach was intended to offer a better, less time intensive and more cost-effective alternative to the prescriptive approach, enabling firms to spend time only on customers perceived to be risky in order to meet compliance requirements more efficiently.*

## Understanding the Risk-Based Approach

The risk-based approach assesses potential money laundering and terrorist financing risks on criteria identified by the regulations. Typically, customers are grouped into high, standard or low-risk categories, based on variables such as country or geographic risk, customer risk and product or service risks, all of which may increase or decrease the perceived risk posed by a particular customer or transaction. Customers and circumstances are evaluated on a case-by-case basis, with due diligence checks on prospective clients carried out depending on the level of detail needed. The depth of an anti-money laundering check and the amount of time spent on evaluation depends on how big the risk is perceived to be.

Once the risk of money laundering or terrorist financing has been assessed, appropriate controls are designed and implemented to mitigate the risks. Firms are able to apply greater levels of customer due diligence to those individuals and corporate entities deemed a higher risk to the business. Politically exposed persons, defined as “individuals who are or have been entrusted with prominent public functions” and their “immediate family members”, must be thoroughly examined as they are considered a higher business risk due to their level of influence and exposure to corruption.

## Initial Reaction to the Money Laundering Regulations 2007

Ahead of the Regulations' implementation in December 2007, LexisNexis commissioned two surveys to assess how well prepared accountancy and legal firms were for the legislation. The research, conducted in May and September among 50 accountancy and 50 law firms respectively, interviewed those responsible for risk or compliance within their organisations.

The findings revealed that the cost of compliance was a significant concern for both sectors (52 per cent of law firms and 55 per cent of accountancy firms believed the regulations would require additional financial investment) and, for businesses where additional financial investment was required, overall due diligence costs were expected to increase; (50 per cent of law firms stated this and 35 per cent of accountancy firms).

According to the research, the principal concern for both sectors on the introduction of the new regulatory requirements was the reputational risk if found to be non-compliant (49 per cent of accountancy firms and 38 per cent of law firms listed reputational damage as their foremost concern). The second most important concern for a third of both groups was the financial risk if fined due to non-compliance.

To meet the regulation requirements and avoid the costs of non-compliance (both in exposure to financial crime and the impact on business reputation) both sectors had committed to a considerable focus on training. Prior to the changes, 68 per cent of law firms and 61 per cent of accountancy firms had begun investing in training resources to bring staff up to speed and 48 per cent and 33 per cent had started to invest in personnel to perform due diligence checks.

However, despite the increased costs, investment in training and risk to reputation, both sectors felt the new regulations would mitigate the business risk of being exposed to financial crime and money laundering (50 per cent of law firms and 55 per cent of accountancy firms).

### Law firms' expectations of the Money Laundering Regulations 2007

- 52% believed the new regulations would require additional financial investment
- Out of these, half believed their overall due diligence costs would increase by as much as 10-29%
- 50% believed the regulations would undermine the competitiveness of UK PLC
- 68% of law firms had started to invest in training resources to bring staff up to speed with the changes and 48% had started to invest in personnel to perform due diligence checks
- 50% believed that the new regulations would mitigate the business risk of being exposed to financial crime and money laundering
- The principal concern facing 38% of all law firms was the reputational risk if found to be non-compliant
- The second most important concern for a third of law firms was the financial risk if fined due to non-compliance
- 40% saw no benefits to the new regulations

Findings from an independent study commissioned by LexisNexis in May 2007, amongst a sample of 50 businesses across the legal sector

## Problems with the Risk-Based Approach

Coinciding with the six-month anniversary of the legislation, LexisNexis commissioned a third survey in June 2008 to measure how firms were coping with the new regulations. The results provided insight into the reality of the regulatory experience among 150 senior compliance executives, evenly split across three business areas: accounting, finance and law firms.

The findings confirmed that the new approach has led to considerable strains on a firm's revenue and resources (including staffing), tension with customers and mixed feelings on the perception of regulatory support. Challenges in meeting the compliance requirements include the time and cost of training staff, loss of trust from clients and the short time frame to implement the changes, leading to a loss of earnings and business due the fact it now takes significantly longer to do each check. However, while all firms have felt the impact of the new regulations, the burden has been disproportionately experienced by small

firms. *The survey revealed that 52 per cent of small firms (50 to 100 staff) found applying the risk-based approach challenging and that more than half of the smaller firms (52 per cent) also had significantly more trouble "maintaining awareness of regulatory obligations" than medium-to-large sized firms (101 to 250 staff and 251 to 500 staff, respectively) that said this had "no impact at all".*

Larger, global firms tend to be extremely well organised and benefit from strong representation in industry associations along with ongoing dialogue with the regulators. The smaller the firm is, the less of a community or peer network they have to draw upon. When asked what was needed to help better manage the regulations, several respondents, and particularly those from small to mid-size organisations, said they would have benefited from clearer guidelines and increased support from the regulators. Comments included: "we were not given enough information on the changes so we were unable to implement them correctly – we need more help in understanding them", we would like to "see more examples of things gone wrong so we can learn from mistakes", and "we should be in constant contact with the regulators about any future changes".

### Accountancy firms' expectations of the Money Laundering Regulations 2007

- 55% believed the new regulations would require additional financial investment
- Out of these, 35% believed their overall due diligence costs would increase by as much as 10-29%
- 61% of accountancy firms had started to invest in training resources to bring staff up to speed with the changes and 33% had started to invest in personnel to perform due diligence checks
- 55% believed that the new regulations would mitigate the business risk of being exposed to the threat of financial crime and money laundering
- The principal concern facing 49% of all accountancy firms was the reputational risk if found to be non-compliant
- The second most important concern for a third of accountancy firms was the financial risk if fined due to non-compliance
- 35% saw no benefits to the new regulations

Findings from an independent study commissioned by LexisNexis in September 2007, amongst a sample of 50 businesses across the accountancy sector

## How could your Regulator have supported you more?

- *“There were too many grey areas and not enough clarity.”*- Partner, mid-sized law firm
- *“I think sometimes they weren’t interested in our queries so it took too long to deal with.”* – Partner, small law firm
- *“By getting involved in the business so they could fully understand the issues.”* – Compliance Director, mid-sized financial services firm
- *“They should be better educated in their job, as they did not always seem to fully understand the regulations themselves.”* – Director, mid-sized financial services firm
- *“They will not commit themselves to the job, too scared to do their job properly.”* – Partner, small accountancy firm
- *“They could have let us know about amendments much earlier” and “extra time should have been made for allowances of the re-training of new staff.”* – Partner, mid-sized accountancy firm

In addition, lack of budget and resources makes it harder for smaller firms to assess the risks, leaving them vulnerable to the consequences of non-compliance and financial crime. While accurately assessing risk is of critical importance to the health and longevity of the firm, it is typically only larger firms that have been able to make the necessary investments in personnel and training to effectively perform due diligence checks. Resulting issues included “the time constraints put on our staff” and the fact that “we were unable to take on the work we have been so there was a loss of earnings”.

Smaller firms also encountered problems trying to independently assess the risk profile of a business to meet the ambiguous measures set out in the regulations and apply a consistent policy to satisfy the regulator. *Identifying PEPs and their associates was disproportionately difficult for 54 per cent of small firms and 45 per cent revealed that identifying the beneficial ownership of companies was arduous.* Screening against sanctions and watch lists was also frustrating, with sentiments including: the “loss of business due to the fact it now takes longer to do each check”, “extra questions which cause customer tension”, and a general feeling that “our customers often don’t understand the changes”.

## What financial impact have the Regulations had on your business?

- *“The loss of revenue was a big problem as we just didn’t have the resources to deal with the extra work that was created.”* – Partner, mid-sized law firm
- *“The amount of work has increased with no financial reward.”* – Partner, small law firm
- *“The time taken to train new staff has been unbearable as we don’t have the resources to do it properly.”* – Director, small financial services firm
- *“The loss of potential business due to the fact that we can’t turn over projects fast enough.”* – Partner, small law firm

### Other issues faced in implementation include:

- *“Getting all the documentation together”* – Money Laundering Reporting Officer, mid-sized financial services firm
- *“Time, as we don’t get paid to train our staff so their knowledge can grow.”* – Partner, small law firm
- *“The time constraints as we’ve had to use them [the Regulations] without fully understanding them.”* – Director, small financial services firm
- *“The regaining of trust from customers we have had a lot of dealings with.”* – Partner, mid-sized law firm

In fact, while the implementation experience has largely been affected by size, *one fifth of all firms agreed that the Regulations have been negative from a customer perspective.* Respondents felt that customers had not been supportive of implementing the legislation, leading to ongoing friction and dissatisfaction.

### What customer service challenges have you experienced as a result of the Regulations?

- *“It’s difficult when we’ve been friends with our customers for nearly 30 years to then ask them to perform ID checks is ridiculous.”* – Director, large accountancy firm
- *“Existing customers feel offended by the extended checks on them.”* – Partner, mid-size law firm
- *“We found that customers couldn’t understand the changes.”* – Head of Risk, large financial services firm
- *“It’s wrong to ID existing customers.”* – Director, small financial services firm

Feedback on the implementation experience to date illustrates that the lack of concrete rules has left some firms, particularly smaller ones, struggling to make decisions. More practical, and less generic, guidance and regulation support is necessary if the benefits of the risk-based approach are to be utilised by all firms. Ambiguity has created differing perceptions of risk as each firm applies their own procedures leading to potential weak points that could be exploited. Firms need regulators to provide practical guidance that is more aligned to daily business scenarios and less of a broad brush approach. There also needs to be regular contact between the regulators and industry, to ensure firms are up to date on the requirements and to enable sufficient time for staff training. The regulators also need to recognise the substantial cost of the Regulations and to provide, wherever possible, free training.

## Effectively Managing the Risk-Based Approach

According to the survey, 66 per cent of firms are using a combination of electronic and paper-based processes for anti-money laundering checks while only six per cent of small businesses are using electronic processes. As the pressure to conduct due diligence continues to increase, firms need to find ways to manage the process more efficiently and are adopting electronic ID verification tools to improve the process.

Keeping staff up to date on the regulations through training continues to be a concern for firms of all sectors and sizes along with maintaining customer relations and getting clients to conform to ID checks.

LexisNexis has been working with clients across the financial services, legal and tax markets to develop effective solutions to combat anti-money laundering, assist with customer identity verification, safeguard reputation and reduce financial risk.

Based on our industry experience and ongoing dialogue with customers facing the challenges of the risk-based approach, we have identified ten tips for success.

### Looking back, what has been the greatest challenge in implementing the Money Laundering Regulations 2007?

- *“The loss of revenue was hard to swallow.”* – Partner, large law firm
- *“Dealing with older accounts before the regulations were introduced.”* – Compliance Director, large financial services firm
- *“It was very difficult re-training all staff adequately so they meet new standards.”* – Director, large financial services firm

### Other challenges expected by the survey respondents in the next year include:

- *“Keeping records up to date.”* – Compliance Director, large accountancy firm
- *“I think we have to be on top of our game to regain customer trust.”* – Partner, large law firm
- *“I think some customers will feel unhappy about the amount of checking we have to do.”* – Partner, mid-sized law firm
- *“Making sure staff are up to speed”* – Director, large financial services firm
- *“Time to train employees.”* – Partner, large law firm
- *“More regulation partners.”* – Partner, large accountancy firm
- *“Maintaining customer relations”* - Director, large-size financial services firm
- *“Letting customers know of the changes”* – Director, small financial services firm
- *“Getting clients to conform to the ID checks”* – Director, small accountancy firm
- *“I think that the biggest problems we will face will be getting to grips with even more regulation that will happen”* – Director, mid-sized financial services firm

## Top Ten Tips on Managing the Risk-Based Approach

- 1)** Assess the level of risk posed by the clients you work with.  
Examples of risk assessment criteria often include:
  - Jurisdiction of origin
  - Industry sector
  - Political prominence of individual
  - Reputational profile of entity
  - Your previous knowledge of client
- 2)** Assess the level of risk posed by the type of work you undertake. Examples of risk assessment criteria often include:
  - Face-to-face or remote customer engagement
  - Nature of transaction being conducted
  - Level and method of financing
- 3)** Tap into both informal and formal peer group networks to benchmark your risk-based approach against those of other firms with a similar business profile. Create a policy document setting out your firm's approach to risk. Share this document via your intranet or company handbook.
- 4)** Put in place a workflow process (paper or online) guiding your staff through the customer due diligence process.  
Set out:
  - The minimum level of checking to be conducted before any client is accepted
  - The red flags that indicate a higher level of risk and the further checks that are then required
  - The acceptable point at which to stop checking
- 5)** Add anti-money laundering training to your induction process for appropriate members of staff. Two levels of briefing aimed at partners and administrators will often suffice. Cover:
  - The individual's obligation to conduct anti-money laundering checks
  - Where to go for guidance if staff have a money laundering concern
- 6)** Set up a process to update staff on anti-money laundering changes. This could be an annual e-mail or a face-to-face briefing with refresher training, dependent on the level of risk you have identified.
- 7)** Enforce an effective process to record all checks carried out. A comprehensive audit trail is essential to demonstrate compliance. Even nil results must be dated and filed.
- 8)** Remember that the verification process does not end when a client is accepted. Set up an ongoing monitoring routine to highlight any changes in the status of individuals within your customer base.
- 9)** Consider the benefits of electronic identity verification and customer due diligence tools to reduce the paper trail, minimise the compliance burden on clients, speed business take-on and maintain your competitive edge.
- 10)** Look at how you can add value to your firm by identifying new business opportunities when due diligence uncovers more detailed profiles of your clients.

Our survey of 150 senior decision makers working within accountancy, finance and law, including directors, partners and heads of compliance, has reinforced the industry sentiment that the Money Laundering Regulations risk-based approach is not working. Although 26 per cent of all firms have found the legislation difficult to implement, small firms have been most disadvantaged.

Limited resources, fewer employees and minimal contact with the regulators have made small firms increasingly vulnerable to financial crime and terrorist activity. Unclear guidelines and the lack of a uniform approach from the regulators have put undue pressure on firms to interpret and assess customer risk profiles. As the pressure of compliance continues to increase, firms who are unable to meet the legislation requirements may incur significant fines, a loss of business and even imprisonment. Even amongst larger firms, 55 per cent of respondents asked for “better help” with managing the Money Laundering Regulations requirements.

The risk-based approach was designed to make customer due diligence faster and more cost effective. However, despite the best intentions, the system does not recognise the significant

discrepancies in the market and puts too much onus on individual firms, leading to inconsistencies and an increased exposure to financial crime.

Firms need to be prepared for the regulations as authorities will penalise businesses that do not comply. At the same time, this provides an opportunity to review existing due diligence processes – and potentially to improve business efficiencies and save money along the way.

History shows us that an economic downturn signals a rise in the crime rate and businesses need to raise their guard against not only money laundering, but the increasing threats of fraud, identity theft and wider financial crime. It is critical that firms operating across the industry spectrum from the high street to global emerging markets are given the practical advice and support required to manage their risk and ultimately safeguard us all.

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November 2008*

## About the 2008 LexisNexis Anti-Money Laundering Survey

LexisNexis commissioned the 2008 Anti-Money Laundering Survey. The national study questioned senior executives at 150 companies, evenly split across three business areas: accountancy, finance and law. It was fielded by Research Insight, a UK-based marketing research consultancy, specialising in the collection and analysis of quantitative and qualitative data.



Let us focus on the risks,  
so you can focus on doing business.

### LexisNexis KYC

LexisNexis KYC is the international due diligence and identity verification tool that gives you the confidence you are doing business with the right customers – every time.

### Contact LexisNexis

To find out more about our anti-money laundering solutions please speak to your account manager or contact us on:

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