

The Third EU Directive

–Customer due diligence and risk-based approach

As a result of the financial crisis, the importance of effectively combating financial crime has once again been catapulted to the top of the international political agenda. In September 2009, at the Pittsburgh Summit,¹ which set out governance structures to deal with the impact of the financial crisis, the role of anti-money laundering efforts, once again, played a fundamental role in ensuring the future stability of financial and economic markets.

During this summit the G-20 welcomed the progress made by FATF in the fight against money laundering and terrorist financing, but encouraged FATF to help detect and deter the proceeds of corruption by prioritizing work to strengthen standards on customer due diligence, beneficial ownership and transparency.

Although the FATF recommendations are not legally binding, legislation has been enacted within the European Union member states as a result of the EU Third Money Laundering Directive. This article highlights some of the hurdles facing financial institutions with the implementation of the Third EU Directive, and focuses on customer due diligence within the context of the risk-based approach. The article concludes with a case study outlining how a risk assessment might be applied in order to decide whether enhanced customer due diligence is necessary and subsequently to provide assistance in gauging the level of necessary ongoing monitoring.

Third EU Anti-Money Laundering Directive

The Third EU Directive on Prevention of the Use of the Financial System for the Purpose of Money Laundering — following on from the first and the second directives in 1991 and 2001 — was passed in 2005. The implementation of the Third EU Directive was completed by all 27 EU member states in 2009².

Table 1

General Provisions	Simplified Customer Due Diligence	Enhanced Due Diligence
Identify and verify identity from reliable and independent sources	Customer is a credit or financial institution covered by EU Directive or other country subject to equivalent requirements	Customer poses high risk of money laundering or terrorist financing
Identify, where applicable: beneficial owner, ownership & control structure such that the institution is satisfied that it knows the identity	Customer is a listed company trading on a regulated market in member state(s) or listed companies from third countries subject to disclosure requirements consistent with EU legislation	Where customer is not physically present for identification purposes
Obtain information on purpose of the business relationship	Domestic public authorities	Cross-frontier correspondent banking relationships (Shell bank)
Conduct ongoing monitoring of relationships and transactions to ensure knowledge of customer's business, risk profile and source of funds is accurate	Beneficial owners of pooled accounts held by EU notaries or other legal professionals	Transactions or business relationships with PEPs residing in another EU state/non EU
Institutions should demonstrate the extent to which the measures are appropriate with respect to money laundering and terrorist financing risks	Where adequate technical criteria for assessing risk levels have been implemented Electronic money (€150 storage p.a. €2,500)	High-risk products or transactions that may favor anonymity
	Life Insurance where: a) annual premium < €1,000 or the single premium < €2,500 b) insurance policies for pension schemes with no surrender clause where policy can not be used as collateral c) employee pension schemes	

¹<http://www.pittsburghsummit.gov/mediacenter/129639.htm>

²<http://www.anti-moneylaundering.org/EuropeanChart.aspx>

Those who are subject to the Third EU Anti-Money Laundering Directive face a number of hurdles with regard to the interpretation and practical application of the Third Directive; particularly, in relation to the extended 'Know Your Customer' (KYC) requirements within the parameters of the newly outlined risk-based approach.³

In table 1 the key elements of the Third EU Anti-Money Laundering Directive. Focus has been directed toward the KYC principles, as this is key to any anti-money laundering structure. The table outlines the KYC requirements and differentiates between the requirements of a simplified due diligence and an enhanced due diligence.⁴

It should be noted that in May 2008, member states participating in the EU Committee on the Prevention of Money Laundering and Terrorist Financing agreed on a list of equivalent third countries, for the purposes of the relevant parts of the Third Money Laundering Directive. The list is a voluntary, non-binding measure that nevertheless represents the common understanding of Member States for the purposes of simplified due diligence.⁵ The list includes Argentina, Australia, Brazil, Canada, Hong Kong, Japan, Mexico, New Zealand, The Russian Federation, Singapore, Switzerland, South Africa and the United States.

Further difficulties regarding the implementation of the Third EU Directive relate to beneficial ownership and the handling of Politically Exposed Persons (PEPs). According to the Third EU Directive, a beneficial owner is defined as follows: "the natural person(s) who ultimately owns or controls the customer and/or the natural person on whose behalf a transaction or activity is being conducted."

It should be noted that there is a difference in the definition of beneficial ownership for corporate and legal entities. In the case of corporate entities, beneficial owners are defined as follows:

- The natural person(s) who ultimately owns or controls a legal entity through direct or indirect ownership or control more than 25 percent of the shares or voting rights of that legal entity, including through bearer share holdings. This is not the case if the company is listed on a stock market.



- The natural person(s) who exercises control over the management of a legal entity.

In the case of legal entities (such as foundations and legal arrangements, such as trusts), which administer and distribute funds, beneficial owners are defined as follows:

- Where the future beneficiaries have already been determined and the natural person(s) is the beneficiary of 25 percent or more of the property, legal arrangement or entity.
- Where the individuals that benefit from the legal arrangement and in whose main interest the legal arrangement or entity is set up or operates, have yet to be determined.

- The natural person(s) who exercises control over 25 percent or more of the property of a legal arrangement or entity.

The risk-based approach and customer due diligence

It is of paramount importance that the principles, controls, security measures and preventive measures used to combat money laundering be instilled in organizational structures. Organizational processes and procedures, as well as relevant codes of conduct, must be defined. Money laundering reporting officers have a key role to play in this process. In the fight against money laundering a regulatory shift has been taking place. It transpires from new regulation, including the Third EU Anti-Money Laundering Directive, which recognizes that a tick-box approach to money

³Dr. Andreas Fuelbier, Duesseldorf, Rechtsanwalt Rolf R. Aepfelbach, Berlin, Rechtsanwalt Peter Langweg, Berlin, Prof. Dr. Christian Schröder, Halle, Petra Textor, Halle, RWS Verlag Kommunikationsforum GmbH, Köln, 2006: Kommentar zum Geldwäschegesetz.

⁴See also: Pieth Mark: Die internationale Entwicklung der Geldwäschebekämpfung, 2006, p.55ff. In: Herzog/Mühlhausen (Hrsg.): Geldwäschebekämpfung und Gewinnabschöpfung, Handbuch der straf- und wirtschaftsrechtlichen Regelungen, Beck Verlag, München, 2006.

⁵http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/documents/financial_services/money/fin_crime_equivalence.cfm

laundering is no longer a best practice and that a shift from a rule-based approach to a risk-based approach is necessary.⁶

In order to implement this risk-based approach, it is key that institutions develop and implement a risk assessment and risk scoring system given that the process of assessing risk has become integral to a solid best practice anti-money laundering compliance program. Each institution needs to define its own level of risk according to a number of factors including the risk attached to its client base, geographical spread of its operations and business dealings, the risk of the products and services being exposed to money laundering and the sectors in which the institution is transacting or active.

KYC procedures sit at the heart of all best practice and legally adapted anti-money-laundering policies. The Third EU Directive, which underlies the risk-based approach, has also highlighted that there is no longer a one-size-fits-all approach to KYC but that a risk-based decision should be undertaken on the basis of an in-depth KYC due diligence assessment.

The risk-based KYC approach is based on the 5th FATF Recommendation. It has been expanded beyond its initial function of defining the identity of a new client at the initial acceptance phase to a continuous risk assessment process for the duration of the client relationship. Therefore, institutions subject to anti-money laundering legislation are obliged to continuously develop their understanding of the client, their relationship with that client and the client's relationships with others⁷. The risk assessment process should be able to identify any suspicious transactions, highlight any red flags and continuously assess the risk attached to any one client or transaction.

Risk assessment and enhanced customer due diligence

The following case study will illustrate the risk-based approach to assessing the level of risk attached to a client. Secondly, the risk-based approach to Enhanced Customer Due Diligence (ECDD)⁸ also will be illustrated.

A financial institution subject to EU member state legislation was looking to engage in a private banking relationship with a successful Eastern European businessman who retained a wide range of business interests in a number of sectors including the financial services industry, real estate, retail and media. The financial institution had some concerns regarding the potential exposure to money laundering

activities in relation to the potential Client because he claimed to own a bank and an insurance company, both of which he also used to finance his real estate transactions. Furthermore, the ownership structure and the beneficial ownership remained unclear to the financial institution, and the overall structure of his business empire was rather opaque. Rumors identified in the public record suggested that the potential Client had been involved in questionable activities prior to 1989. The financial institution was also aware of rumors that a PEP retained a silent interest in one of the Client's media companies, which was at the time reportedly under investigation for having defrauded a partner firm in order to support a political slush fund in the lead up to the national elections.

Risk assessment

A risk assessment was undertaken using a specific methodology including both qualitative and quantitative elements. The results of the risk assessment in this specific case revealed that 'Significant Risks' were identifiable in both the 'Client', 'Sector' and 'Product' areas. 'Certain Risks' were identified in the 'Country' area. The results of the risk assessment were summarized as follows:

Client Risk Overall background and reputation Business interests and practices Business associates and networks Political affiliations (PEPs) Beneficial ownership and control Source of funds	Country Risk CEE country
Sector Risk Real Estate	Product Risk Private Banking

Enhanced due diligence

As a result of the risk assessment, the financial institution decided that enhanced due diligence was necessary. On the basis of the ECDD, the financial institution could cross-reference the information provided by the potential Client and was in a position to verify his claims. They could also confirm the identity of the beneficial owner and map out the ownership structure of the potential Client's business empire. The institution was also, as a result of the research undertaken, in a position to disprove the PEP rumors reported in the media which were allegedly part of a negative media campaign in the lead up to the


national elections. The research did not find any confirmation of the allegations to the potential Client's questionable activities prior to 1989.

Furthermore, research uncovered that the investigations by the Anti-Corruption Agency had been closed on the grounds of lack of evidence. The exercise provided a complete and comprehensive documentation trail within the remit of the ECDD process.

Finally, the enhanced due diligence investigation enabled the institution to make decisions with regard to the level of ongoing monitoring. Because rumors of the potential Client's questionable activities pre-1989 could not be disproved, and also, given that there was a risk that the investigation might be reopened following the national elections, the financial institution identified the potential Client as high risk. It also noted that, should he be taken on as a private banking Client, that he would be subject to regular monitoring. Thus, through the ECDD process, the financial institution had met the requirements as set out in the EU directives' general provisions for ECDD and was in a position to make an informed decision on the potential Client.

Outlook

The complexity of money laundering schemes, the number of individuals, companies, jurisdictions and financial instruments involved require AML professionals to look at the bigger picture. In order to glean the information needed to make an informed decision regarding a Client's risk, one must go beyond the immediate target company and look at its business networks, partners and business interests. Therefore, combating money laundering requires a solid investigative approach, whereby analysts always think creatively while being comprehensive, exhaustive and meticulous in their approach.

Given the importance of customer due diligence, not only through the FATF principles and through legislation such as the EU Directive, but also underlined at the Pittsburgh Summit in 2009, further development of KYC processes and procedures and the design of early warning systems must continue to play an important role in the day-to-day management of anti-money laundering programs. 

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⁶See also: Pieth Mark: Die internationale Entwicklung der Geldwäschebekämpfung, 2006, p.53-54, In: Herzog/Mühlhausen (Hrsg.): Geldwäschebekämpfung und Gewinnabschöpfung, Handbuch der straf- und wirtschaftsrechtlichen Regelungen, Beck Verlag, München, 2006.

⁷See above p.375

⁸CDD is used as a synonym for KYC.