

The Fourth  
EU AML/CTF  
Directive:

A holistic  
risk-based  
approach



Two high-profile cases, namely the Charlie Hebdo and the Fédération Internationale de Football Association (FIFA) investigation, which have dominated news headlines over the course of weeks in the first half of 2015, have once again generated discussions around the importance of combating crime.<sup>1</sup> At the June 2015 G7 meeting in Germany, one of the issues leaders discussed was the global problem of money laundering and the increased action needed to combat it. In his speech, the former Financial Action Task Force (FATF) president, Roger Wilkins, noted that in order to respond to the continuing evolution of the risks and methods of money laundering and terrorist financing, a global response to combat such abuse of the international financial system is necessary. The FIFA scandal, amongst many others, underlies the importance for international organizations, nation states and actors therein to implement effective risk assessment tools and adequate customer due diligence (CDD) procedures from which risk management strategies can be derived.

This article will focus on one of the most recent initiatives by the EU, which underlines the continued importance of revising and improving existing anti-money laundering/counter-terrorist financing (AML/CTF) legislative frameworks both within the individual member states and also in a cross-border context in terms of the cooperation between relevant national authorities.

### Key elements to the Fourth EU AML/CTF Directive

The EU Directive on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing—more commonly known as the Fourth EU AML Directive—was passed by the European Parliament on May 20, 2015, and came into force on June 25, 2015. The EU member states must implement the required changes in their domestic legislation by June 26, 2017.<sup>2</sup>

Although the Fourth EU AML Directive includes a number of revisions and the development of concepts (in particular the involvement of the supervisory authorities and cooperation amongst the member state financial intelligence units [FIUs]), this article will focus on the aspects fundamentally relevant to the topic of CDD, and in particular the requirements for enhanced due diligence (EDD).

The topic of risk assessment plays a prominent role in the Fourth EU AML Directive and marks something of a coming of age of a comprehensive and holistic approach to mitigating money laundering and financial crime risks. For the first time it not only involves obliged entities, but also the regulators on the national and supranational level, which makes the Fourth EU AML Directive something of a stakeholder project.

### Risk-based approach (RBA)

Turning back the wheel to the birth of AML/CTF legislation, we have seen not only a widening of the playing field with regard to methods and approaches, but also increased inclination to include other predicate crimes such as corruption and tax evasion, as well as a movement well beyond the financial institutions to include corporations and other professional services providers.

Given the G7's commitment to step up their efforts to combat tax evasion and tax avoidance strategies (on the part of major companies with international operations) and to enforce measures to clamp down on tax structuring and transfers of profits, the

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inclusion of tax evasion as a predicate offense for money laundering will play an important role in the coming years.<sup>3</sup>

The shift away from a purely rules-based approach to a RBA is not new (see Figure 1). What is new is that the requirements of implementing a RBA have changed. Although some might say that they have become more flexible, many would argue that it has become more complicated for organizations attempting to define what exactly they need to do in order to ensure that they are compliant and meeting the regulatory expectations.

One thing is clear: Organizations need to identify, understand and comprehensively manage their money laundering risks without referring to a rulebook that might assist in defining when simplified due diligence is appropriate or when EDD is necessary. Each organization will have to define their parameters, knowing that they will be held accountable by regulators for any decisions they make under their so-called enhanced RBA.

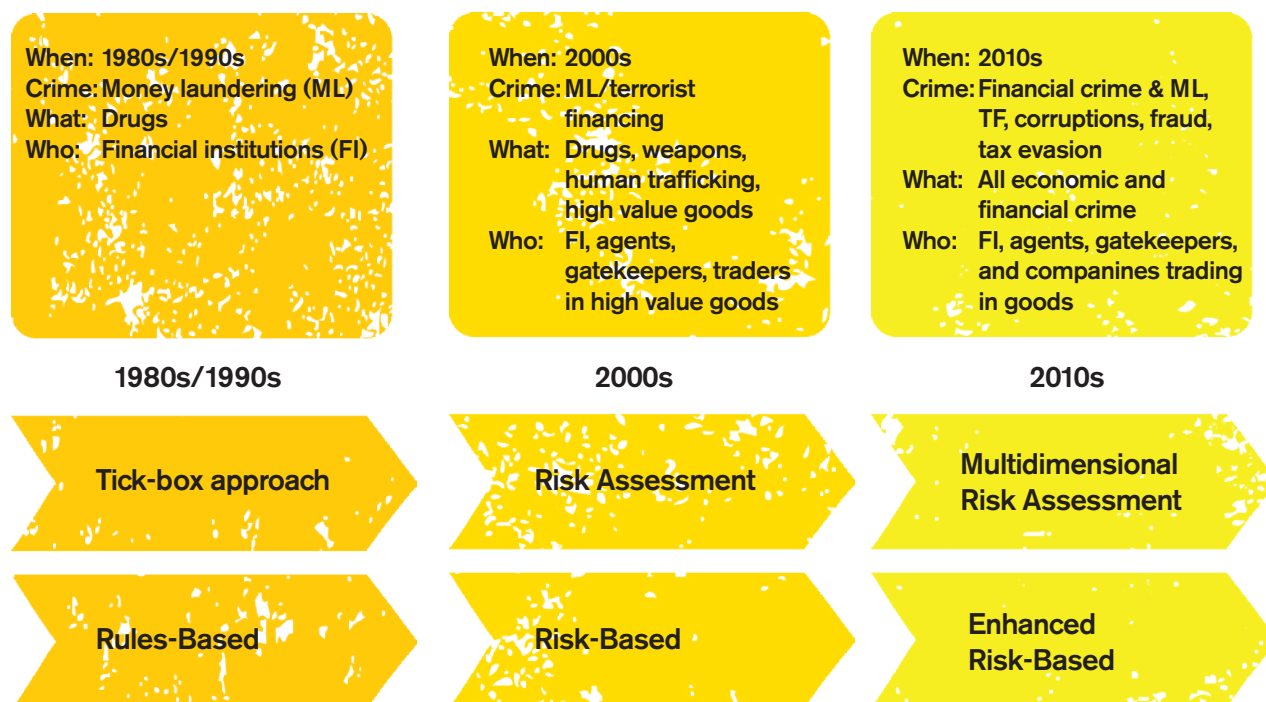
<sup>1</sup> "G7 Germany: The Schloss Elmau Summit," June 2015, <http://www.g7g20.com/eBooks/G7-Germany-The-Schloss-Elmau-Summit-2015.pdf>

<sup>2</sup> "Directive (EU) 2015/849 of the European Parliament and of the Council," *Official Journal of the European Union*, May 20, 2015, [http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L\\_.2015.141.01.0073.01.ENG](http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2015.141.01.0073.01.ENG)

<sup>3</sup> G7 Finance Ministers Meet in Dresden: Growth Without New Borrowing, The Federal Government, May 29, 2015, [http://www.bundesregierung.de/Content/EN/Artikel/2015/05\\_en/2015-05-29-g7-finanzministertreffen\\_en.html](http://www.bundesregierung.de/Content/EN/Artikel/2015/05_en/2015-05-29-g7-finanzministertreffen_en.html)

<sup>4</sup> "EU AML Directive—New challenges for companies and financial institutions," November 2014, [http://www.berlinrisk.com/Media/Downloads/BR\\_8\\_13\\_BRL\\_Whitepaper\\_4\\_13\\_11\\_2014.pdf](http://www.berlinrisk.com/Media/Downloads/BR_8_13_BRL_Whitepaper_4_13_11_2014.pdf)

Figure 1: Combating financial crime—An evolving regulatory landscape<sup>4</sup>



The RBA is not, as the Directive text specifically points out, “an unduly permissive option for member states and obliged entities.”<sup>5</sup> The enhanced RBA involves the use of evidence-based decision-making in order to target the risks of money laundering and terrorist financing facing the EU and those operating within it more effectively.

However, obliged entities are not completely left standing in the cold, since this is the first time the national regulators, the European Supervisory Authority (ESA) and the European Commission are obliged to present guidance and technical standards to assist obliged entities in assessing the risk attached to money laundering and terrorism.

### Politically exposed persons (PEPs)

Apart from PEPs having an a priori high-risk status, the Fourth EU AML Directive has expanded its reach beyond foreign PEPs to include all national PEPs as being high-risk customers due to the risk exposure attached to their positions.

The definition of a PEP, according to the Directive, is a “natural person who is or who has been entrusted with prominent public functions.” The PEP status should be applied for a period of 12 months after they leave office. Middle-ranking or more junior officials are not included in this definition.

PEPs include the following:

- Heads of state, heads of government, ministers and deputy or assistant ministers
- Members of parliament or of similar legislative bodies
- Members of the governing bodies of political parties
- Members of supreme courts, constitutional courts or of other high-level judicial bodies, the decisions of which are not subject to further appeal, except in exceptional circumstances

- Members of courts of auditors or of the boards of central banks
- Ambassadors, chargés d'affaires and high-ranking officers in the armed forces
- Members of the administrative, management or supervisory bodies of state-owned enterprises
- Directors, deputy directors and members of the board or equivalent function of an international organization
- No public function referred to the points above shall be understood as covering middle-ranking or more junior officials

The definition is far reaching and goes beyond the individual himself to include family members and close associates. Family members include:

- The spouse, or a person considered to be equivalent to a spouse of a PEP;

<sup>5</sup> EU Directive of the European Parliament and of the Council, May 20, 2015, [http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=OJ:JOL\\_2015\\_141\\_R\\_0003](http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=OJ:JOL_2015_141_R_0003)

- The children and their spouses, or persons considered to be equivalent to a spouse of a PEP; and
- The parents of a PEP.

Close associates include:

- Natural persons who are known to have joint beneficial ownership of legal entities or legal arrangements, or any other close business relations with a PEP; and
- Natural persons who have sole beneficial ownership of a legal entity or legal arrangement, which is known to have been set up for the de facto benefit of a PEP.

Besides undertaking EDD with respect to transactions or business relationships with PEPs, obliged entities should be required to:

- Have in place appropriate risk management systems, including risk-based procedures, to determine whether the customer or the beneficial owner of the customer is a PEP; and
- Apply the following measures in cases of business relationships with PEPs:
  - Obtain senior management approval for establishing or continuing business relationships with such persons;
  - Take adequate measures to establish the source of wealth and source of funds that are involved in business relationships or transactions with such persons; and
  - Conduct enhanced, ongoing monitoring of those business relationships.

## Beneficial ownership

One of the most groundbreaking requirements made by the Fourth EU AML Directive is that entities incorporated within the EU should hold adequate, accurate and current information on their beneficial ownership, in addition to basic information such as the company name and address and proof of incorporation and legal ownership. In addition, with a view to enhancing transparency in order to combat the misuse of legal entities, member states should also ensure that beneficial ownership information is stored in a central register located outside the company.

Member states can, for that purpose, use a central database, which collects beneficial ownership information, or the business registry, or another central register. The information contained in the central register should be made available to competent authorities and FIUs and is provided to oblige entities when the latter undertake CDD measures. Member states should also ensure that other persons who are able to demonstrate a legitimate interest with respect to money laundering, terrorist financing and the associated predicate offenses, such as corruption, tax crimes and fraud, are granted access to beneficial ownership information, in accordance with data protection rules.

In order to ensure a level playing field among the different types of legal forms, trustees should also be required to obtain, hold and provide beneficial ownership information to obliged entities taking CDD measures and to communicate that information to a central register or a central database and they should disclose their status to obliged entities. Legal entities such as foundations and legal arrangements similar to trusts should be subject to equivalent requirements. It is interesting to note that in Article 31 there is no reference made that access should be granted to those parties who have a legitimate interest, so there might be some exemptions with regard to the register access for trust and foundations.

It will, therefore, be interesting to see how this requirement is implemented in the individual states and what level of access will finally be guaranteed in the individual countries, in particular in those where fund and trust structures are very common and often used to disguise beneficial ownership.

According to the Fourth EU Directive, “beneficial owner” means any natural person(s) who ultimately owns or controls the customer and/or the natural person(s) on whose behalf a transaction or activity is being conducted.

As set out in the Directive, obliged entities should identify the beneficial owner and take reasonable measures to verify that person’s identity, so that the obliged entity is satisfied that it knows who the beneficial owner is, including, legal persons, trusts, companies, foundations and similar legal arrangements.

## Risk assessment and CDD

Apart from the way in which PEPs should be dealt with and the specific requirements attached to identifying beneficial ownership, the Fourth EU Directive moves away from its former approach to defining clearly when simplified due diligence is sufficient and when EDD is required. The Directive focuses on the topic of risk assessment and the requirement to develop risk assessment tools and approaches in order to implement adequate CDD processes and procedures.

Thus, there is no longer a rulebook for filtering low- and high-risk customers. Besides the a priori high-risk customers, including PEPs, correspondent banks and high-risk countries, the Directive merely presents a collection of risk variables and factors. These factors must then be used to develop a risk assessment tool with which low- and high-risk customers can be filtered.

In Annex I, the Directive provides a list of risk variables that obliged entities shall consider when determining to what extent to apply CDD measures. In Annex II and III a list of risk factors attached to customer, product, service transactions or delivery channel risk and geographical risk factors for filtering low- and high-risk customers have been included. These risk variables and risk factors are included in the table on page 78. These factors and variables are not exhaustive and need to be complemented by risk factors specific to any one obliged entity.

## Examples of low-risk factors

### RISK VARIABLES

- Purpose of an account or relationship
- Level of assets to be deposited by a customer
- Size of transactions undertaken
- Regularity or duration of the business relationship

### CUSTOMER RISK FACTORS

- Public companies listed on a stock exchange and subject to disclosure requirements (either by stock exchange rules or through law or enforceable means), which impose requirements to ensure adequate transparency of beneficial ownership
- Public administrations or enterprises
- Customers that are residents in geographical areas of lower risk as set out in the section on geographical risk factors

### PRODUCT, SERVICE, TRANSACTION OR DELIVERY CHANNEL RISK FACTORS

- Life insurance policies for which the premium is low
- Insurance policies for pension schemes if there is no early surrender option and the policy cannot be used as collateral
- A pension, superannuation or similar scheme that provides retirement benefits to employees, where contributions are made by way of deduction from wages, and the scheme rules do not permit the assignment of a member's interest under the scheme
- Financial products or services that provide appropriately defined and limited services to certain types of customers, so as to increase access for financial inclusion purposes
- Products where the risks of money laundering and terrorist financing are managed by other factors such as purse limits or transparency of ownership (e.g., certain types of electronic money)

### GEOGRAPHICAL RISK FACTORS

- EU member states
- Third countries having effective AML/CTF systems
- Third countries identified by credible sources as having a low level of corruption or other criminal activity
- Third countries which, on the basis of credible sources such as mutual evaluations, detailed assessment reports or published follow-up reports, have requirements to combat money laundering and terrorist financing consistent with the revised FATF Recommendations and effectively implement those requirements

## Examples of high-risk factors

### RISK VARIABLES

- Purpose of an account or relationship
- Level of assets to be deposited by a customer
- Size of transactions undertaken
- Regularity or duration of the business relationship

### CUSTOMER RISK FACTORS


- The business relationship is conducted in unusual circumstances
- Customers that are residents in geographical areas of higher risk
- Legal persons or arrangements that are personal asset-holding vehicles
- Companies that have nominee shareholders or shares in bearer form
- Businesses that are cash intensive
- The ownership structure of the company appears unusual or excessively complex given the nature of the company's business

### PRODUCT, SERVICE, TRANSACTION OR DELIVERY CHANNEL RISK FACTORS

- Private banking
- Products or transactions that might favor anonymity
- Non-face-to-face business relationships or transactions, without certain safeguards, such as electronic signatures
- Payment received from unknown or unassociated third parties
- New products and new business practices, including new delivery mechanism, and the use of new or developing technologies for both new and pre-existing products

### GEOGRAPHICAL RISK FACTORS

- Countries that do not have effective AML/CTF systems
- Countries identified as having significant levels of corruption or other criminal activity
- Countries subject to sanctions, embargoes or similar
- Countries providing funding or support for terrorist activities, or countries that have designated terrorist organizations operating within their country

Combining the development of risk factors and variables in addition to reinforcing the risk-based approach, the Fourth EU AML Directive marks a distinct push to develop a holistic approach to combating financial crime. The Directive requires that risk-based methods and monitoring approaches be tailored to the specific requirements of an organization. The future of combating financial crime will, therefore, be driven by a stronger focus on prioritizing risks and managing and mitigating the risks attached to high-risk customers and products in high-risk sectors and geographies. 

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