

Strengthening Capital Markets Intermediaries' Oversight over AML/CFT Outsourcing Arrangements

July 2020



CMIs remain responsible for outsourced AML/CFT functions



Board and Senior Management remain ultimately responsible and accountable

- **The Board and Senior Management need to understand the capital markets intermediaries' ("CMIs") money laundering and terrorism financing ("ML/TF") risks and exercise strong oversight over their anti-money laundering and countering the financing of terrorism ("AML/CFT") controls, even when the CMIs decide to outsource AML/CFT control functions to service providers.**
- In particular, paragraph 4.3 of the MAS Notice SFA04-N02 (Oct 2018) requires CMIs to ensure that they have effective policies, procedures, and controls to deal with ML/TF risks. Paragraph 14.10 of the Notice further highlights the importance for CMIs to have appropriate compliance arrangements in place – this includes AML/CFT outsourcing arrangements where they exist.



Outsourcing of AML/CFT control functions is material outsourcing

- **Based on MAS' Guidelines on Outsourcing (Oct 2018), outsourcing of AML/CFT control functions is considered material outsourcing**, given the criticality of these controls and the access that service providers may have to sensitive customer information. Such material outsourcing arrangements are particularly important as they have significant impact on the CMIs' operations, reputation and/or ability to comply with MAS' laws and regulations.
- Therefore, CMIs need to ensure that they conduct a robust assessment of the service provider, and establish mechanisms to monitor and control the outsourcing arrangement on an ongoing basis.



Adopting best practices to manage risks arising from outsourcing

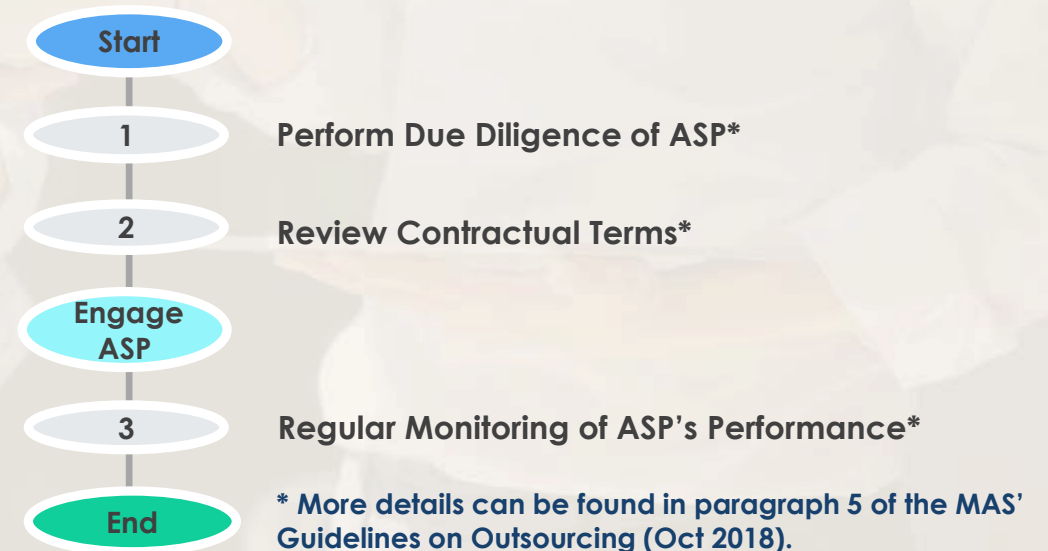
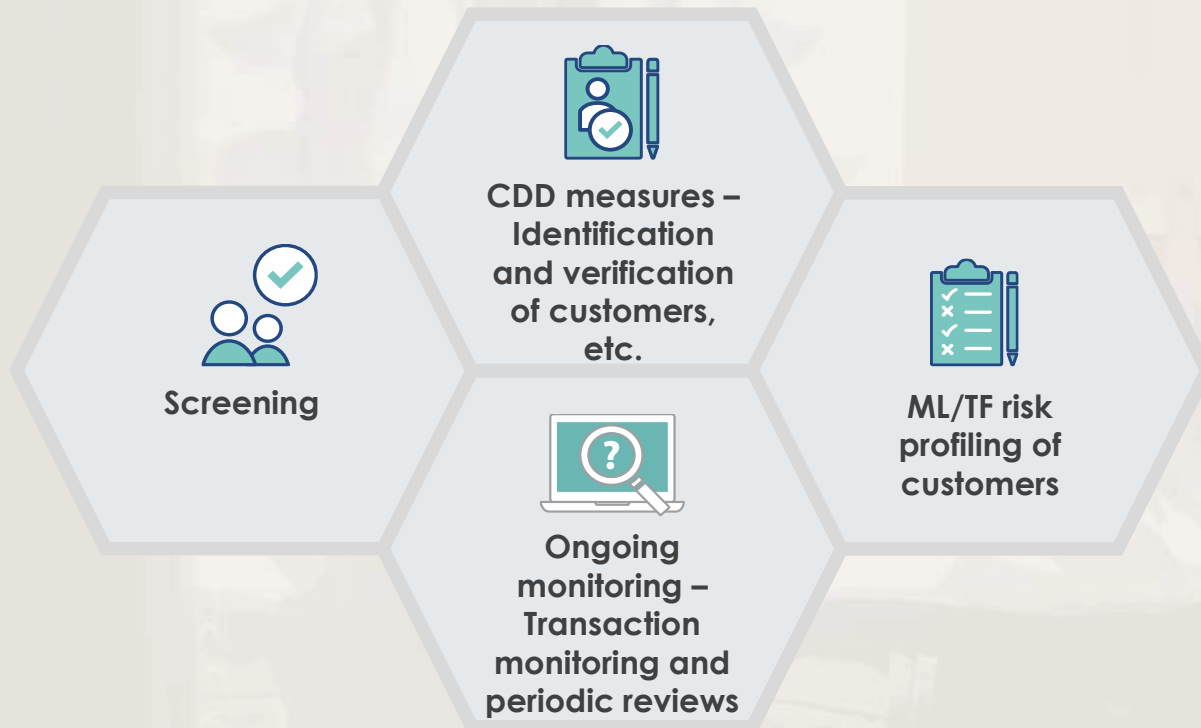
- MAS conducted a series of thematic inspections of CMIs to assess the adequacy of their oversight of AML/CFT service providers ("ASPs"), and their understanding of the key control functions outsourced to these ASPs.
- **This paper summarises the key observations and sound practices that CMIs should reference against to enhance their controls.**

Note: This paper sets out MAS' supervisory expectations of an effective AML/CFT framework to address risks arising from the material outsourcing of AML/CFT control functions. The paper does not impose any new regulatory obligations, and is based on MAS' inspections of CMIs. The learning points from this paper may also be relevant and applicable to other financial institutions ("FIs"), and FIs should incorporate learning points from this paper in a risk-based and proportionate manner.

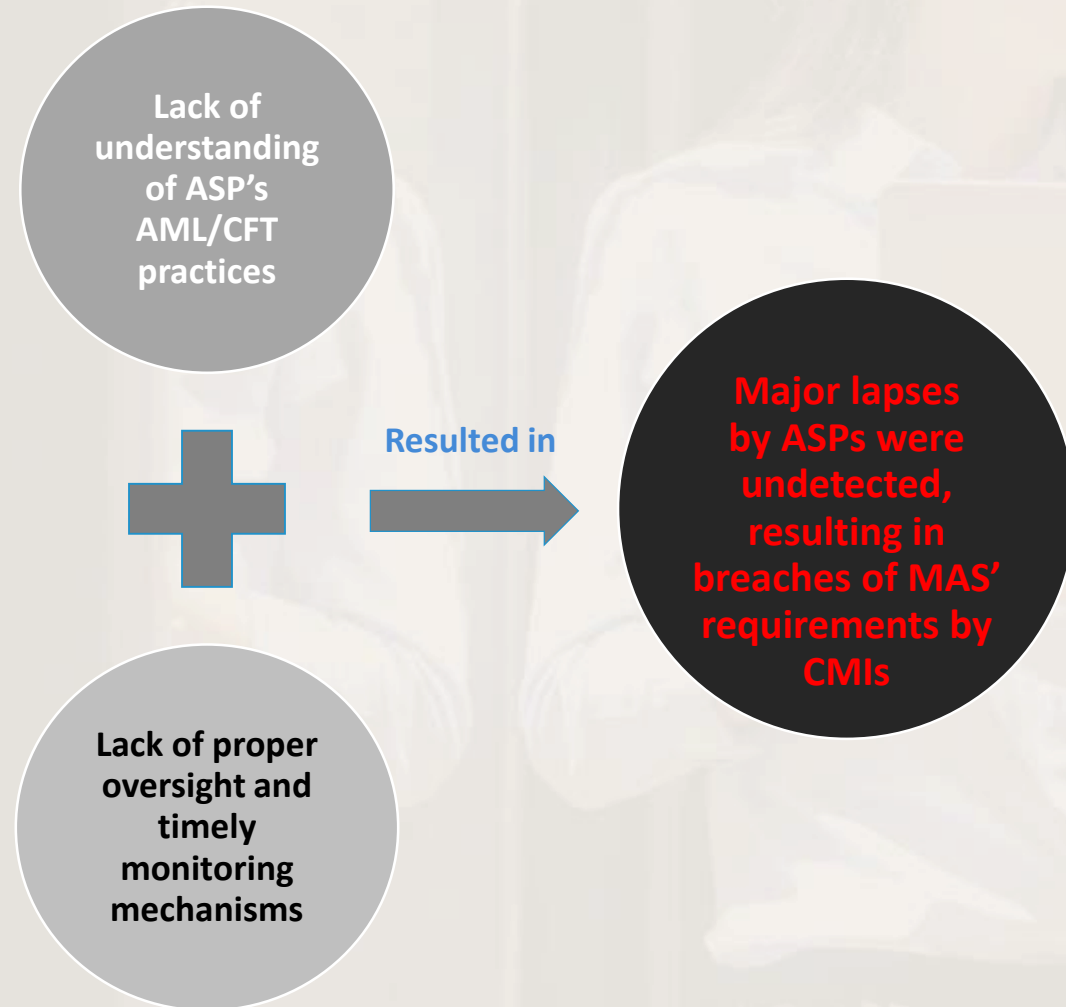
Common AML/CFT control functions outsourced by CMIs

- AML/CFT control functions commonly outsourced include the conduct of customer due diligence (“CDD”) measures, screening, and ML/TF risk profiling of customers.
- Where assets are managed by fund management companies using a fund structure, these AML/CFT control functions are usually outsourced to fund administrators.

- Deficiencies are commonly noted during stages 1 and 3 of the outsourcing process.
- The outsourcing process typically begins with the CMI performing a thorough due diligence of the potential ASPs. This is crucial in ensuring that a suitably competent ASP is engaged to support the CMI's AML/CFT compliance arrangements. Once the CMI decides on an ASP, the scope and terms of the engagement are finalised in an outsourcing contract. Post-engagement, the CMI is expected to regularly monitor and review the performance of the ASP in relation to the outsourced functions.



Major lapses by ASPs went undetected by CMIs

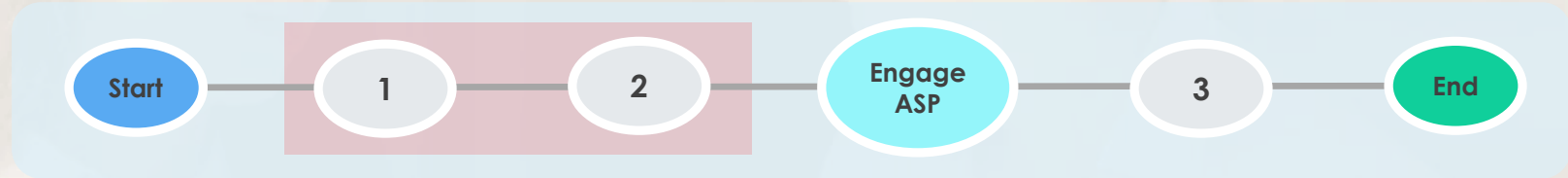


- Several CMIs failed to detect major lapses by ASPs, which resulted in the CMIs breaching MAS' AML/CFT requirements.
- The root causes were mainly a combination of the CMIs' inadequate understanding of the ASPs' practices, and their lack of proper oversight and timely monitoring mechanisms to oversee the ASPs.

Common weak practices by ASPs:

- Protracted delays in conducting periodic reviews of existing customers.
- Enhanced CDD measures were not duly completed; higher risk customers were wrongly rated as "medium risk" by the ASP.
- Screening of existing customers was not conducted.

Robust assessment of ASPs is a crucial first step



Key weaknesses noted

- Several **CMI**s did not have a formalised approach to assess the suitability and ability of ASPs to perform the required AML/CFT control functions. As a result, there were no clearly defined assessment criteria used in their evaluation process. In many cases, the due diligence undertaken by CMI
- In some instances, CMI
- Many **CMI**s did not have a good understanding of the ASPs' actual AML/CFT practices, and hence failed to ensure they were in line with the CMI
- **Lack of attention to contractual terms**, which resulted in significant differences between the actual scope of AML/CFT control functions outsourced to the ASP and the CMI

Some case examples

Inadequate scope of outsourcing agreement

CMI A intended for its ASP to perform a full suite of AML/CFT controls (including CDD, screening and ongoing monitoring) for both its new and existing customers. However, it only realised during MAS' inspection that the actual scope of its outsourcing agreement with the ASP was narrower than intended, where some controls relating to existing customers were outside the contracted scope. As a result, these key AML/CFT controls were not performed for an extended period of time.

Inadequate understanding of ASP's policies & procedures

CMI B selected an ASP due to favourable commercial terms offered without a thorough review of the ASP's actual AML/CFT practices. It was thus not familiar with the ASP's AML/CFT risk assessment framework and CDD measures. In particular, the customer risk assessment framework used by the ASP differed from CMI B's own framework. This resulted in the ASP assigning lower ML/TF risk ratings than what CMI B had intended for some customers. Required enhanced CDD measures were thus not performed.

Structured assessment process

CMI C had a structured assessment process, with defined criteria (including the ASP's level of staff competency and experience, its track record and ability to comply with regulatory requirements), as part of its outsourcing policy. Appointment of the ASP was approved by the senior management, with formal documentation to support the assessments.

Prior to the engagement of its ASP, CMI D conducted a gap analysis between its AML/CFT policies and procedures and that of the potential ASPs. CMI D also reviewed the potential ASPs' policies and procedures to ensure that they met local regulatory requirements.

Strengthening due diligence framework requires...



Board and Senior Management to set the tone:

- Set out a clear and formalised policy to evaluate the outsourcing of AML/CFT control functions to ASP(s).
- Understand the CMI's potential exposure to ML/TF risks, and evaluate how outsourcing to an ASP can help mitigate such risks as part of its business risk assessments.
- The CMI's AML/CFT compliance officer(s) should be experienced and equipped to support the assessment of ASPs.

Structured assessment process with defined criteria:

- Assessing the reputation, skill, and experience of the ASP, especially in relation to its understanding of MAS' AML/CFT requirements.
- Performing a gap analysis to ensure that the ASP has adequate policies and procedures which meet the CMI's requirements. The ASP should also have processes in place to keep its policies and procedures up-to-date by incorporating changes in regulatory requirements and emerging ML/TF risk trends.
- Evaluating if the ASP is sufficiently resourced to perform the required activities, including assessing the level of relevant AML/CFT experience of the specific teams that are supporting the CMI's outsourced activities.
- Understanding observations from recent audit(s) of the ASP's AML/CFT programme, and ensuring that the ASP has implemented appropriate rectification measures.
- Screening and other due diligence to ensure the probity of the ASP.

Strengthening due diligence framework requires...



A well-defined outsourcing agreement:

- Sets out the scope of the outsourcing and the roles and responsibilities of the ASP.
- Establishes key AML/CFT performance, operational, and control standards, including clearly setting out the specific adverse or higher risk circumstances that should be escalated to the CMI to consider whether prompt mitigating measures are needed.
- Establishes the rights to regularly audit the work performed by the ASP and to promptly access all information, data, or reports maintained by the ASP.
- Ensures that the ASP is required to implement the necessary policies and procedures on information security and safeguards to protect the confidentiality of the CMI's customer data.

Proper documentation of assessments and approvals:

- Sets out clearly the basis for the appointment, and a timeframe for the re-performance of due diligence on the ASP, as part of the CMI's periodic review after the appointment of the ASP.

Regular monitoring of ASP ensures effective controls



Key weaknesses noted

- Several **CMI**s did not have monitoring mechanisms to oversee their ASPs' implementation of key AML/CFT control functions. In particular, ASPs were not expected to provide regular management reports on their execution of key AML/CFT control functions and ML/TF risk issues, such as status reports on outstanding CDD and periodic reviews.
- In some cases, **CMI**s merely relied on the ad-hoc escalation of issues by ASPs of their own accord. There was no defined escalation process for ASPs to surface specific pertinent ML/TF issues, such as potential sanction hits and material changes to the ASPs' processes. This exposed these CMI
- **Quality assurance reviews by CMI**s were lacking – specifically, some CMI
- Several **CMI**s did not have a formalised approach to conduct regular post-appointment reviews of their ASPs. Hence, there were often no clearly defined assessment criteria used to re-assess the ASPs' suitability.

Some case examples

Inadequate regular monitoring mechanisms in place

CMI E did not have defined metrics to assess the ASP's performance of AML/CFT control functions, nor did it require the ASP to provide any regular status reports. CMI E assumed that the ASP was effectively executing required control functions unless otherwise alerted. During the inspection, MAS discovered that, unbeknownst to the CMI, the ASP had not conducted periodic reviews on the CMI's higher risk customers. CMI E also did not realise that the ASP had adopted an AML/CFT policy which was different from the CMI's expectations and was misaligned with certain MAS' requirements. This resulted in breaches.

No established escalation process

CMIs F and G relied on their ASPs to escalate pertinent AML/CFT issues of their own accord, without clearly-defined circumstances.

As a result, CMI F's ASP had dismissed potential positive screening matches, without first escalating to the CMI for its consideration.

CMI G was not informed by its ASP of the changes in beneficial owners of its customers. This resulted in required CDD documents being outstanding for over two years and CMI G did not complete its CDD measures on a timely basis.



Proper oversight of ASPs' processes

A combination of measures should be implemented, where appropriate. For example, CMI H conducted annual site visits of its ASP, and performed sample reviews of accounts. It also reviewed all screening results and any changes to the ASP's processes.

CMI I implemented quarterly reports to track the progress of periodic reviews conducted by its ASP and engaged auditors to conduct sample reviews of its customer accounts.

CMI J reviewed the performance of its ASP annually, via a questionnaire. This ensured consistency in assessing the effectiveness of its ASP's AML/CFT controls and framework.

Strengthening regular oversight over ASPs requires...

Board and Senior Management's involvement:

- The Board and Senior Management need to ensure effective oversight over outsourcing arrangements and to manage outsourcing risks.
- In particular, the CMI's AML/CFT compliance officer(s) should play an active role to ensure outsourced control functions are being performed as intended, and regularly report key control issues noted for the Board and Senior Management's deliberation.

Regular monitoring and defined escalation mechanisms to include:

- Defining clear roles and responsibilities for regular reporting and escalations.
- Status reports on the implementation of AML/CFT control functions, including status on periodic reviews due to be completed, remediation of any gaps identified, etc.
- Establishing escalation procedures on significant ML/TF issues, including persistent delays in obtaining required CDD documents, changes in the ASP's AML/CFT policies and procedures, and screening hits.

Regular reviews to include:

- Defined metrics to guide the review – some of which could be included in a self-assessment questionnaire for the ASP to complete.
- Quality assurance reviews and/or periodic on-site visits to assess the effectiveness of AML/CFT control functions implemented.
- Timely follow-up with the ASP on any agreed remediation actions.
- Periodic review assessments should be performed and duly approved, with proper documentation.

In summary



- CMLs remain responsible for complying with AML/CFT requirements under the MAS Notice SFA04-N02 (Oct 2018), even when they outsource AML/CFT control functions. The Board and Senior Management play a pivotal role when their firm's functions are outsourced. The Board and Senior Management need to set a strong tone from the top and should ensure that the firm's AML/CFT controls remain effective, including under any outsourcing arrangement.



- MAS observed gaps in CMLs' oversight of AML/CFT outsourcing arrangements, particularly in the evaluation of potential ASPs and the ongoing monitoring of ASPs post-appointment. These deficiencies exposed CMLs to potential regulatory and reputational risks.
- In more severe cases, material lapses in AML/CFT controls were noted, which led to breaches of AML/CFT requirements. This often arose due to a combination of the CMLs' lack of understanding of the ASPs' practices, and an absence of proper oversight and timely monitoring.



- CMLs should conduct a gap analysis against the best practices outlined in this guidance as well as MAS' Guidelines on Outsourcing (Oct 2018), and take appropriate measures to enhance their practices.