Strengthening the Third Line in the Fight Against Financial Crime

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1. Executive Summary

The cost of compliance is rising; in 2020 the total projected costs across financial institutions globally was US$213.9bn.[1] Organizations are under pressure to respond to these growing costs while increasing effectiveness. Technology is often treated as the panacea to achieve efficiency. In blindly applying these efficiency measures, organizations may be ignoring the hidden gem in strengthening anti-financial crime (AFC) controls – internal audit.

Through this paper and engagement with several subject matter experts in the third line, we explore the challenges and opportunities for organizations to strengthen their internal AFC controls, technology, and processes through the internal audit function.

Our findings resulted in a three-dimensional framework focused on strengthening anti-financial crime audits. The framework is comprised of three aspects: culture, competency, and execution. Achieving the right culture starts with the tone from the top, or tone from above, and appropriate incentivization with sensitivity to unintended consequences. Competency refers to a focus on the skills, knowledge, and responsibility of auditors. As a minimum, auditor's AFC knowledge should be on par with second line experts. Finally, culture and competency will be irrelevant without planning, collaboration, and effective execution. Planning starts with risk assessment, and execution results in appropriate risk coverage for the organization through independent testing involving internal audit, second line and first line monitoring and assurance teams.

Internal audit teams present an excellent channel for organizations to test AFC controls effectively. It would be remiss of organizations to overlook the enormous opportunity presented by their internal audit teams to succeed in supporting implementation of effective AFC measures.

1. https://risk.lexisnexis.com/global/en/insights-resources/research/true-cost-of-financial-crime-compliance-study-global-report

2. Introduction

Effectiveness of AFC controls has been the goal of AFC professionals across the world. Despite strides made in tightening regulations and in the increased use of technology, as an overarching measure, effectiveness remains elusive with less than 1% of laundered funds confiscated. [2]

Bank fines have dominated financial crime news in the last decade. Often the issues that were previously discovered internally by audit are not made public and the role played by internal audit is not always clear during an enforcement action. Yet the ecosystem of anti-financial crime relies heavily on auditors to provide assurance, to test controls with an independent mindset and protect the firm by calling out issues early.

In 2020, Westpac, an Australian bank, was fined AUD1.3bn for significant anti-money laundering (AML) failures. AUSTRAC's CEO, Nicole Rose, shone the spotlight on audit saying:

> **“Such a large number of breaches over several years was unacceptable and could have been avoided with better assurance and oversight processes to identify ongoing reporting failures.[3]”**

In this instance regulators made note of the importance of the third line and of their part in combatting financial crime.

In recent years there has been significant emphasis on the role that internal audit plays in ensuring that firms have robust AFC controls. Financial institutions (FIs) have encountered many challenges in establishing an effective governance model with proper controls in place. In this paper we explore the challenges faced by AFC auditors and discover the potential of internal audit in ensuring that AFC controls remain effective.

2. “Illicit money: how much is out there?” United Nation Office on Drugs and Crime, October 25, 2011, https://www.unodc.org/unodc/en/frontpage/2011/October/illicit-money_-how-much-is-out-there.html
3. https://www.austrac.gov.au/news-and-media/media-release/austrac-and-westpac-agree-penalty

3. The pressures and the pitfalls of AFC audits

We asked several auditors and heads of audit in regulated financial services about the key challenges they faced. Common themes discussed are detailed below.

3.1 Skills and expertise

Auditors in medium and large financial institutions tend to be well trained in the concepts and methodology of conducting audits. The control framework around audits tends to be robust with plans set out annually in many organizations. Audits follow the framework of initial planning, field work, testing, reporting, and monitoring action plans – a well-trodden path. Audits are generally graded on a 4-point scale (e.g. Satisfactory, Needs Improvement, Needs Significant Improvement, Unsatisfactory), which shows the overall performance of a specific audit. This may be comprised of control effectiveness and management awareness (a relatively new concept in some parts of the world).

> **Challenges emerge for a topic such as financial crime, which requires technical knowledge of AFC regulations, working knowledge of the institutions' products, clients, geographic footprint and associated financial crime risk, an understanding of data lineage and AFC technologies.**

When it comes to financial crime knowledge, organizations' skills and expertise are often mixed. Organizations in the aftermath of fines or remedial actions tend to be better at ensuring specific skills and expertise are available or hired if not available in-house. Ensuring auditors receive technical training at least to the level of the second line is paramount in ensuring successful and meaningful audits. Without specialist financial crime training, demonstrating an effective independent testing program is challenging. However, skills and awareness go beyond technical competency. The knowledge of the organization's products and services play a crucial role in understanding financial crime risks that the organization faces.

Dr. Sam Adam Elnagdy, Head of Internal Audit Department, Mashreq Bank, USA contends management information systems need to be audited often, since information presented to the Board and senior committees is the output of these systems. He also emphasizes the need to have critical skills such as the ability to select appropriate samples for testing, and understanding where risk lies within an organization. In addition, bringing together technology audits and financial crime risk audits is crucial. He said: "In some instances there is a need to bring a technology auditor as part of the audit team along with a risk specialist. However, many instances, e.g. testing logical access controls, do not need a financial crime specialist".

Another challenge for AFC audits is the application of a risk-based approach (RBA). Global standard setters such as Financial Action Task Force (FATF) and regulators across many parts of the world recognize the need for applying a RBA. In its simplest sense, a RBA refers to a firm's ability to apply mitigation measures in proportion to the risk. It enables firms to apply different levels of controls to different levels of risks. A risk assessment would enable a firm to understand its inherent risks, the strength of its controls and any residual risk. A risk appetite statement would clarify to all employees the type of business, products, or geographies the firm is unwilling to engage in. Understanding the organization's risk assessment and risk appetite will be crucial to the success of an AFC audit in drawing conclusions on the level of controls applied to risks.

3.2 Organizational culture

Culture plays a big role in utilizing the strength of the third line. Culture in this context includes tone from the top, incentivization and accountability.

3.2.1 Tone from the top

More successful organizations tend to ensure a healthy tension that does not result in an adversarial relationship between business units, risk and compliance functions and internal audit teams. An organization with a positive culture would also encourage training and education of auditors to the right levels. Less mature organizations may use the existence of the audit function to "tick a box" and meet regulatory compliance at a more superficial level. Such organizations also tend to under-resource audit teams.

Tone from the top plays a very important role with the audit function. If the CEO and their teams stand shoulder to shoulder with their audit functions, explain the reasons for the existence of the function, and how audit can help the organization meet its objectives through value-adding activity, it can make a significant difference to how the role of internal audit teams is perceived. An environment where communication, coordination and alignment are fostered across the lines of business will create a more positive engagement model for conducting audits.

3.2.2 Incentivization

Key performance indicators (KPIs) and key risk indicators (KRIs) are crucial in ensuring that the risks and controls in businesses are treated with the same level of importance as revenue and cost.

> **"When KPIs are misaligned between the business units, compliance functions and internal audit teams, these can create several undesired outcomes."**

In an attempt to build a robust check and challenge process, an organization may sometimes make auditors feel incentivized to find a "major" failing during a financial crime audit. Reporting audits with zero findings can make auditors feel uncomfortable as this situation may imply a waste of effort. Equally, business leaders and compliance leaders whose performance is measured by "successful" audits may be incentivized to argue the findings and talk auditors out of "major" failings on the report. These misaligned incentives can create unintended consequences, animosity across the lines of defense and ultimately result in a lack of effectiveness end-to-end.

3.2.3 Holistic accountability

Incentivizing business leaders and compliance leaders to treat audit actions with due care and importance is key. However, the culture can take a perverse turn when incentives are blindly applied such as attributing too much emphasis to the action without focus on the root causes. This can cause a tick-box approach to completing the actions, e.g. fixing the specific issue only to satisfy a deadline without a "read-across" and failure to apply the solution to other business units where the same problem may apply.

An experienced head of audit from a large U.K. retail bank provided the example of enhanced due diligence (EDD) file reviews. A majority of EDD files sampled had major gaps. Yet the process of 4-eyed checks had been applied consistently. While the finding explained short comings in depth, the recommendation consisted of two parts – remediating files with errors and performing an end-to-end review of the EDD process. Actions such as these need further root cause analysis to understand the scale of the failures. Is the policy lacking detail? Do the procedures have missing steps? Does the problem occur in one business unit only or across the enterprise?

> **"In a desire to get the audit action completed within deadlines, there is a temptation to superficially fix the issue."**

It is this short-sighted approach that can bring greater refraction (and fines) to a company when the regulators come on site, as it shows a lack of understanding of systemic issues across the organization and the desire to fix them.

The reverse could also pose problems in organizations where audit action plan deadlines are continually extended, with some being carried on for years without agreed gaps being addressed. Such issues are typical symptoms of a poor risk culture, one that can severely affect outcomes of AFC measures. Accountability also extends to how audit action plans are governed. If a collective decision is made at the Board level to delay fixes, then the rationale needs to be documented and risk acknowledged rather than continually extending deadlines.

Other extremes include organizations giving audit a higher level of importance to the detriment of other units. When organizations do not create adequate avenues for business units and compliance teams to self-identify issues and invest in solutions for these issues, these teams may well look to their internal audit counterparts in finding "major" issues so as to seek investment in them. While this may seem innocent, the situation represents an undercurrent of undue influence and lack of independence. Instead, organizations need to find avenues to prioritize issues so that self-identified issues are treated with equal seriousness as issues raised by audit teams.

3.3 Planning, quantity, and timing

There are several traps that organizations may inadvertently fall into when it comes to financial crime audits: lack of planning is one. Planning entails two components – deep understanding of the organization's risks and coordination across functions that are "audit-like". Lack of coordination with business monitoring and testing teams and second line assurance teams on their respective plans can result in duplication for organizations. Practitioners have encountered instances when multiple parties in large organizations were attempting to test the same high-risk area. Operational teams suffered testing fatigue and often felt they could fix issues faster if they did not spend so much time supporting audits and assurance plans.

Quantity refers to performing audits repeatedly and rediscovering the same issues identified in previous audits. With repeated audits, outstanding management action plans end up creating the objectives and business plans for both the first line and second line functions. With a large number of organizations going through transformation programs that run the course of multiple years, there seems little value in audits repeatedly testing the same areas that are under transformation. Auditing the changes on significant delivery milestones to ensure compliance is reviewed incrementally will add more value.

Timing of audits is key too, especially as strategic projects ongoing in financial crime prevention functions can span multiple years. Experienced auditors recommend "business as usual" operations for 3-6 cycles (these could be weeks or months based on the type of control being tested e.g. auditing a daily control compared to a control that operates on a monthly cycle) prior to auditing. However, as change projects get delayed, there is often pressure on the audit function to demonstrate assurance.

3.4 Independence versus arm's length

One of the key reasons for auditors needing to remain independent is so they can review business processes and controls without prejudice. Often this independence translates to an arm's length approach causing audit teams to become quite removed from the challenges faced by the businesses. Isolating audit teams can lead auditors to catastrophize and miscategorize the importance or risk of issues identified. Auditors can become out of sync with the organization's risk appetite and application of a RBA.

> **"Independence should not mean isolation,"**
> – says Neil Jarman, Head of Audit at Rakbank.

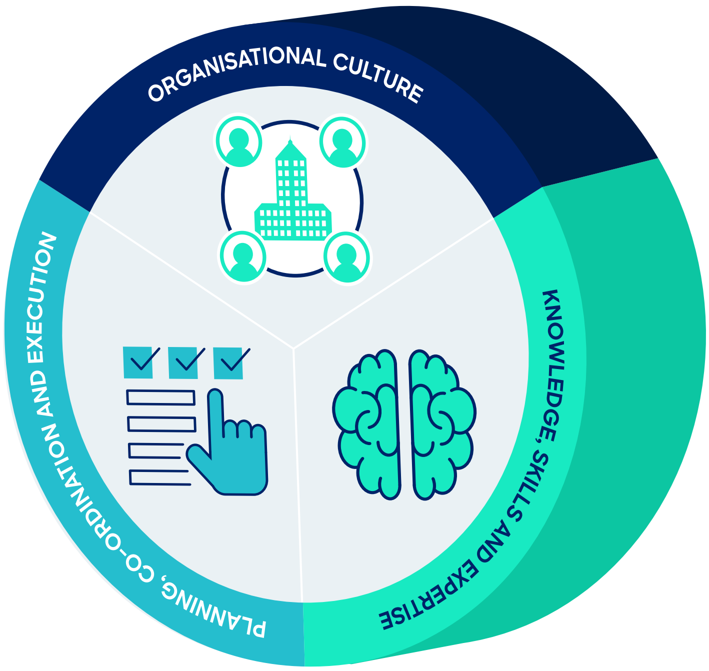
Independence can be maintained while being aware and involved in challenges faced by the organizations. There are multiple ways to avoid isolation. One method is for audit representatives to participate in management meetings and committees, even if as observers. As the Institute of Internal Auditors have stated: "There must be regular interaction between internal audit and management to ensure the work of internal audit is relevant and aligned with the strategic and operational needs of the organization."[4] This enables the audit team to work as a 'trusted partner' to the business. Another method is to encourage secondments from businesses and risk and control functions into audit teams, and vice versa. Secondments provide knowledge exchange for the organization while helping individuals grow professionally.

It is a balancing act for the third line teams, and one for leaders to constantly watch out for.

4. https://na.theiia.org/about-ia/PublicDocuments/Three-Lines-Model-Updated.pdf

4. A three-dimensional framework for strengthening AFC audits

As organizations look to achieve efficiencies and effectiveness together in their AFC measures, internal audit, the hidden gem in strengthening AFC controls, is often overlooked. When structured well AFC audits have the potential to identify issues early and avoid expensive mistakes. How can an organization construct an effective framework for AFC audits?



4.1 Start with organizational culture

Organizational culture can feel like a complex nebulous concept. Two critical aspects of culture with respect to successful AFC audits are "tone from above" and incentivizing the right behaviors.

The concept of tone from the top has been well known and understood in the world of AFC controls. The same concept needs to be applied to AFC audits. The importance of auditing needs to be clarified and communicated consistently. Business leaders and compliance leaders need to direct their teams to plan upcoming audits and encourage teams to work together. Collaboration and action taken in identifying and fixing issues needs to be celebrated. There is a need to live and breathe the behaviors expected of others at each level in the organization consistently.

Incentivizing the right behaviors requires a continuous model of monitoring the right KRIs and KPIs and ensuring that these are aligned to the behaviors that are in line with the values the organization wants to promote. It is not sufficient for leaders to apply KPIs without watching out for their undesired outcomes. A healthy tension needs to be built into the three lines model. Blindly applying performance metrics is likely to create an unhealthy tension and ineffective outcomes for AFC measures.

How should success be measured? One school of thought is that success of business units audited should be measured based on response to findings, not on the findings themselves. Setting performance objectives such as having zero major audit findings would not be advisable, instead these objectives should focus on collaborating with audit to allow independent testing, and agree to fixing issues found at the earliest opportunity that is effectively possible. These KPIs are harder to measure than "zero findings" KPIs, but despite the complexity it is likely to yield better results for the organization. Another school of thought is that KPIs related to audit findings may have a purpose e.g. if a function has an effective QC/QA program and is also subject to second line monitoring and testing, then issues should be identified through these teams. Yet, if an internal audit finds major issues, it is indicative of failings overall and accountability for such failures are necessary for an appropriate risk culture. A balance needs to be sought between inadvertently encouraging a culture of hiding or arguing failings, to one in which there is accountability for such failings.

The next question is how to reward auditors for their efforts. Should auditors be rewarded for "major" findings and penalized for not finding issues? Doing so would again encourage undesired outcomes.

> **"The key here is not to reward auditors on their findings but on the overarching risk coverage model; the processes used to demonstrate the thoroughness of checks, the depth of investigations and their approach."**

If an audit presents no findings and provides assurance to a function, that should present a satisfactory outcome and encourage plans to test other parts of the landscape. The audit function has the potential to create value through identifying what is wrong in the business, while providing assurance on what is working well, thus contributing to the overarching strategic objectives.

4.2 Focus on the skills, knowledge, and responsibilities

AFC audits require a unique set of skills and knowledge. Auditors can be put in an unfavorable position if asked to carry out audits without being equipped with the appropriate skills and knowledge to be successful. These comprise specifically of:

- Deep knowledge of the business unit, processes, and risks.
- Good knowledge of the AFC regulation that applies.
- Good knowledge of technology systems and data lineage that provide AFC controls.
- Strong core understanding and experience of audit principles.
- Application of a risk-based approach.

It is unlikely that one individual possesses all of these skills. Most auditors have an inclination either towards regulatory and policy risks, or technology. Audits are generally organized with a small set of individuals coming together. It is not sufficient to put together a business expert, compliance expert and a technology expert and hope for the best. Roles and responsibilities need to be clarified. If the purpose of this team is to educate each other of their specific expertise areas then that should be clarified and outcomes documented, alongside the main purpose of conducting an independent audit.

Both AFC policy and regulatory knowledge, and AFC technology skills, seem to be in short supply in organizations. Often organizations who have emerged from being under observation of a monitor or a remediation action have addressed the AFC skills shortage. However, data analytics, modelling skills and the need to think outside the box remain deficient. For example, in testing a transaction monitoring system, all of these skills will be highly applicable, and the success of such audits will depend on the skills, knowledge and clarity of teams.

Organizations can be innovative on how they structure and collaborate internally. The audit function should have access to a range of specialist skills across the team to ensure that they have balanced and complementary skill sets that allows for a more intelligent tech and data enabled assessment of risk. This will be of benefit in conducting audits for some AFC areas that have a greater technology dependency such as sanctions screening and transaction monitoring. In such audits, auditors must not only review the outputs and subsequent management of these alerts but look at the data inputs, calibrations, and thresholds.

Education, upskilling, training, secondments, hiring temporary resources (where a specific skill is needed short term) are some of the ways in which the skills and knowledge shortage can be effectively addressed.

4.3 Plan collaboratively and follow through

An organization’s risk assessment and the audit function’s own assessment of financial crime risks should be the starting point of audit plans. Once these are understood, it is imperative to consult with all other teams performing independent testing to identify any overlaps and lack of coverage. Audit teams can begin the collaborative journey by discussing plans in advance with business units and compliance functions and seek their inputs on areas that they would want to see audited. The need to be agile, allowing fluidity and flexibility in the delivery of AFC audits, means moving away from traditional cyclical approaches to working together with other functions to identify and tackle new risks within the business. For the organization, the risk coverage model is key to ensure that controls are being effectively tested independently.

Businesses experience audit fatigue with repetitive testing of the same area. In such instances, rather than repeating audits, internal audit team's efforts would be better spent following through actions from previous audits. Performing specific tests to confirm actions are completed enable audit teams to add value while meeting regulatory requirements. In auditing transformation programs and to avoid the pitfall of testing to meet agreed audit plans, rushing an audit on early pilot phases is not recommended. It is better to perform design effectiveness testing rather than operational effectiveness testing to ensure independent testing of new changes being implemented. Auditors can add value by focusing on testing remediation outcomes and ensure business-as-usual does not suffer. Performing this type of control testing needs different skills that focus on immediate transactional outcomes.

Once planned, the audit type needs to be determined as does the resourcing and timing. Once the scope is agreed, it is good practice for the teams to work collaboratively and for the audit team to share interim findings. The audit reports are not the end of the journey but in a way the start of the journey of fixing issues identified. At this stage, management committees, executive committees and relevant governance needs to step in to ensure that action plans are developed and executed promptly. Audit teams and business leaders need to address issues in suitable depth with a read-across to other business units that may have similar issues.

Action plans then need close monitoring through relevant governance forums, ensuring prompt solutions. There may be competing issues such as self-identified items or issues discovered by second line and first line quality and assurance teams. Prioritization needs to be applied holistically to ensure a consistent application of a risk-based approach.

5. Conclusion

Internal audit teams present an organization with excellent potential to test AFC controls effectively. However, effectiveness of the third line is a direct result of the strength of the third line.

> **"With appropriate training, upskilling, and planning, coupled with the right culture and tone from the top, audit teams can significantly enhance effectiveness at a fraction of the cost of conducting large remediation programs."**

It would be remiss of organizations to overlook the enormous opportunity presented by its internal audit teams to succeed in supporting implementation of effective AFC measures. Audit teams when embedded effectively in an organization can become proactive trusted advisors for the business. Auditors can evolve in their role by adapting and embracing change, allowing the function to become more responsive and agile.

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