

2018/2/14



ACAMS-FCI

WHITE PAPER

Defensive SAR Filing: An Unnecessarily Heavy Burden on the AML Field

A Preliminary Study on Defensive SAR Filing | Zhang Teng

(CAMS)

Table of Contents

Table of Contents	2
Executive Summary	2
What is a Defensive SAR?.....	2
Survey Results On Defensive Reporting.....	4
Comprehensive Analysis of Defensive SARs	8
Maintaining a Balance between Regulators and Financial Institutions.....	9
Conclusion	11

Executive Summary

As one of the most critical tools in the anti-money laundering field, Suspicious Activity Reports (hereafter referred to as SAR) have played a significant role in reporting potential money laundering activities conducted in financial institutions to the regulators, especially in the Asia-Pacific region. Regulators also consider SAR to be one of the most efficient approaches to information collection. However, the decisions made to report SARs were sometimes driven by compliance concerns instead of genuine suspicions. Filing a SAR to avoid regulatory criticism is commonly called “defensive filing.”¹There is a generally agreed understanding that no one gets into trouble with regulators for filing a particular SAR, even if it is misplaced, although the opposite is not absolutely true.²This is a result of tightened regulatory requirements and a complicated global financial environment.

To better understand this phenomenon, the author conducted a survey along with an industry study. This paper will discuss the necessity of defensive reports and provide guidance on maintaining a balance between the internal controls of financial institutions and the expectations of regulatory bodies regarding defensive SARs.

What is a Defensive SAR?

A defensive SAR is a common issue in the field of AML. In 2014, a total of 1,726,971 SARs were reported to the FinCEN (the Financial Crimes Enforcement

¹Pinsent, Masons (29 Apr, 2017). “UK government 'committed' to changing suspicious activity reporting regime.” (<https://www.out-law.com/en/articles/2016/april/uk-government-committed-to-changing-suspicious-activity-reporting-regime/>) Retrieved on 11 Oct, 2017

²Peter D., Hardy (19 Oct, 2017). “Suspicious Activity Reports Rarely Provide “Operational Value” to Law Enforcement Investigations”. (<https://www.moneylaunderingwatchblog.com/2017/10/suspicious-activity-reports-rarely-provide-operational-value-to-law-enforcement-investigations/>) Retrieved on 24 Dec, 2017

Network, acting as the SAR receiver in the US). However, only 205,000 SARs were reviewed. This raises concern over how many of these SARs were actually warranted and how many of them could be considered to be “defensive.”³ Defensive SARs exist both in highly regulated and high risk jurisdictions. Australia, with a CPI (Corruption Perceptions Index) score of 79 per Transparency International⁴ in 2017, has always been considered as a jurisdiction with a “strong institutional framework for combating ML (Money Laundering), TF (Terrorist Financing), and proliferation financing” according to the Mutual Evaluation Report issued by FATF⁵ (Financial Action Task Force, an inter-governmental body aiming to develop policies to combat money laundering⁶) in 2015. China, on the other hand, has a CPI score of only 36 per Transparency International⁷ in 2017. These two countries are generally acknowledged as a highly regulated jurisdiction and a less regulated jurisdiction, respectively. A large volume of International Fund Transfer Instructions (hereafter known as IFTIs) have been conducted between Australia and China since Australia offers a big market for Chinese real estate investors.⁸ Recently, Australian financial institutions have identified frequent IFTIs slightly below \$50,000 US dollars, which are an apparent attempt to structure transactions to avoid regulatory controls by the Chinese government. With no other AML related red flag identified, it caused confusion in terms of whether these transactions should be cleared as non-suspicious or filed via potentially defensive reports from both the originating and beneficiary financial institutions of these IFTIs.

Another example of defensive filing is related to a recent regulatory hot topic: virtual currency. Multiple law enforcement actions including fines and prosecutions have been recently reported regarding virtual currency platforms. In 2015, FinCEN fined Ripple Labs Inc., a virtual currency open payment network, \$700,000 US dollars for “a willful violation of the anti-money laundering laws.”⁹ Furthermore, Ross Ulbricht, the founder of Silk Road, was convicted of seven charges including money laundering by the US government within the same year.¹⁰ For many Anti-Money Laundering (hereafter known as AML) analysts in financial institutions, there is concern that the decision not to file a SAR related to virtual currency might lead to heavy regulatory criticism. Consequently, some AML analysts choose to escalate all virtual currency related transactions regardless of the customer background and transaction volume.

³FinCEN (October, 2015). “SAR Stats Technical Bulletin”.

(https://www.fincen.gov/sites/default/files/sar_report/SAR_Stats_2_FINAL.pdf) Retrieved on 11 Feb, 2018

⁴From Transparency International, (<https://cpi.transparency.org/>)

⁵From FATF, “Australia Mutual Evaluation Report”, Page 9, April 2015. Retrieved on 17 Dec, 2017

⁶ From FATF, (<http://www.fatf-gafi.org/about/>)

⁷From Transparency International, (<https://cpi.transparency.org/>)

⁸Will, Koulouris (20 Feb, 2017). “News Analysis: Chinese investment in Australian real estate crucial to economy: experts”, Page1. (http://news.xinhuanet.com/english/2017-02/20/c_136070080.htm) Retrieved on 17 Dec, 2017

⁹Franca Harris Gutierrez, Michael E. Gordon, Katrina Carroll, Elijah M. Alper, and Jennifer R. (8 Jun, 2015). “Jacob Wilmer Hale discusses FinCEN’s First Enforcement Action for Virtual Currency Activity”. (<http://clsbluesky.law.columbia.edu/2015/06/08/wilmerhale-discusses-fincens-first-enforcement-action-for-virtual-currency-activity/>) Retrieved on 17 Dec, 2017

¹⁰ Mullin, Joe (4 Feb, 2015). “Ulbricht guilty in Silk Road online drug-trafficking trial”.

(<https://arstechnica.com/tech-policy/2015/02/ulbricht-guilty-in-silk-road-online-drug-trafficking-trial/>) Retrieved on 25 Dec, 2017.

Without any suspicion noted, these SARs can be identified as defensive SARs with the only reason being concern over compliance failure or regulatory criticism.

It is obvious that defensive reporting is not a welcome idea from the regulators' (in US, FinCEN) point of view since many facts prove that regulators have put tremendous effort into diminishing the SAR volume. For example, the decrease in defensive SAR volume has been specifically mentioned in the China Anti-Money Laundering Report issued in 2017, which stated "The volume of SAR had dropped by 51.42% with the quality of SAR significantly improving; the defensive SAR had continuously decreased."¹¹ Similar positions are also being identified in the United Kingdom, a highly developed jurisdiction regarding their AML regime and one of the original founders of the FATF¹², according to the latest Anti-Money Laundering Annual Report issued by the UK Financial Conduct Authority (hereafter known as the FCA). In this report, it states that the purpose of altering the Criminal Finances Bill was to reduce the number of defensive SARs¹³ and the FCA is also proposing communications between financial institutions to "avoid making a 'defensive' SAR."¹⁴ It is clear that reducing the defensive SAR volume has become a significant measurement of regulators' achievement and the maturity level of its AML regime.

A similar issue may also be observed on the other side of SARs, the financial institutions. There are very few financial institutions who will admit to filing a defensive SAR¹⁵ as it could be considered a failure of its AML system and non-compliance.

However, as the first and second line of defense in each financial institution, do the AML officers and analysts agree on this same issue?

Survey Results on Defensive Reporting

To discover the answer to the question above, the author conducted a survey targeting AML officers and analysts in different financial institutions located in the Asian and Pacific regions. Within a month, a total of 51 AML officers and analysts from

¹¹From People's Bank of China (27Nov, 2017). "China Anti-Money Laundering Report 2016", Page 11, Retrieved on 17 Dec, 2017.

¹²From Wikipedia, (https://en.wikipedia.org/wiki/Financial_Action_Task_Force_on_Money_Laundering) retrieved on 17 Dec, 2017

¹³From UK Financial Conduct Authority (5 July, 2017). "Annual Anti-Money Laundering Report 2016/17", Page 15 (<https://www.fca.org.uk/publication/annual-reports/annual-anti-money-laundering-report-2016-17.pdf>), Retrieved on 2 Dec, 2017

¹⁴UK Financial Conduct Authority (5 July, 2017). "Annual Anti-Money Laundering Report 2016/17". Page 16 (<https://www.fca.org.uk/publication/annual-reports/annual-anti-money-laundering-report-2016-17.pdf>) Retrieved on 2 Dec, 2017

¹⁵James, DeFrantz (17 Mar, 2016). "WHEN TO HOLD 'EM AND WHEN TO FILE 'EM- A TWO PART SERIES ON SAR FILINGS, SPECIAL CONTRIBUTOR REPORT" (<https://www.acfcs.org/news/300062/When-to-Hold-em-and-When-to-file-em--A-Two-Part-series-on-SAR-filings-special-contributor-report.htm>) Retrieved on 24Dec, 2017.

different financial institutions participated in the survey. Among them, 8 are from payment service providers, 3 work in the forensic advisory industry, 4 are employed by insurance companies, and the rest of the participants come from the banking industry. Regarding the position that the participants hold in their financial institutions, 3 hold the role of compliance officer, 3 hold internal audit roles, 3 are senior managers, and 6 hold management positions while the remaining 36 hold senior analyst/analyst roles. The survey was designed to reflect the real environment in the AML field. A majority of the survey participants are working in the second line of defense as AML senior analyst/analyst. It is therefore reasonable to believe that the survey is able to reflect the actual facts in the AML world.

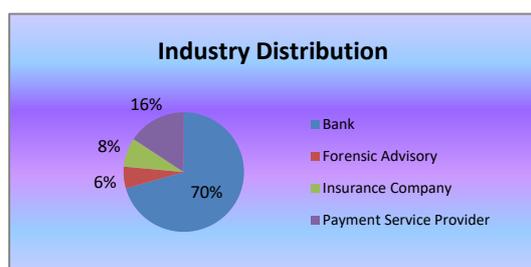


Chart 1

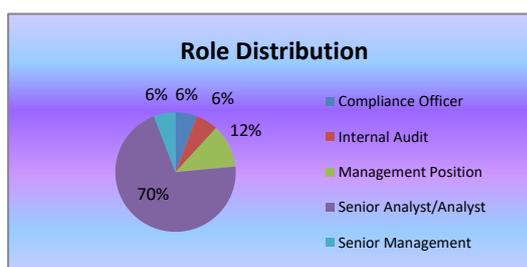


Chart 2

The first question raised regarding defensive filing was whether the participants have ever filed, approved, or reviewed a defensive SAR. Over 70% of the participants admitted that they had encountered a defensive report.

One observation worth mentioning is that all of the participants from payment processors ticked yes for that answer. Given the fact that payment processing is a relatively new industry in the AML field, especially in the Asia and Pacific region, the related supporting AML guidelines and policies are still in development. In comparison, the Chinese banking industry has been regulated since the first AML law was issued in 2006. As a result, 44% of the participants from the banking industry selected the answer, no.

The questionnaire further explored whether the institution/management had ever discussed defensive SAR filing. Only 15.6% of the participants stated that the institution or the institution's management team had never discussed defensive reports. It is a positive sign to note that within the participants who claimed that previously encountered defensive reports, over 84% of the participants admitted that their company/management had ever discussed the defensive filing issue. Although the effectiveness and outcome of these discussions is still unclear, communication is the first step toward resolving the issue.

Among the participants who claimed that they had encountered defensive SARs before, over 30% stated that the percentage of filing, approving, or reviewing defensive reports over the course of their work was below 20%. However, if only the senior analyst/analyst participants' answers are taken into consideration, about 17.4%

of the result is “below 20%” compared with over 26% of the participants who stated “above 80%.” It is not usual to see a significant difference between chart 3 and chart 4. The management level and compliance officers of financial institutions hold the idea that defensive SARs only occupy a small percentage of the AML team’s daily work. In contrast, the results coming from the senior analysts/analysts who are the actual investigators of alerted transactions illustrate a contradictory story. Given the fact that an analyst preparing SARs and senior analysts escalating SARs is the common workflow in an AML team, the author believes chart 4 reflects a more comprehensive picture of reality.

There is another interesting fact revealed by the survey: over half of the participants requested that the survey would be anonymous after they understood what the survey was about. This concern and request for privacy reveals a general fact that communication regarding defensive reports does exist in financial institutions. However, the transparency of this communication is highly questionable.

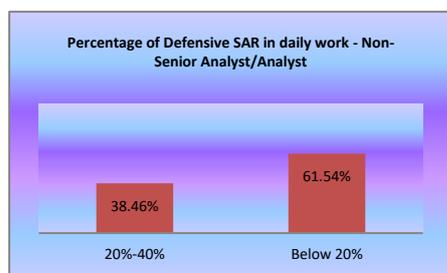


Chart 3

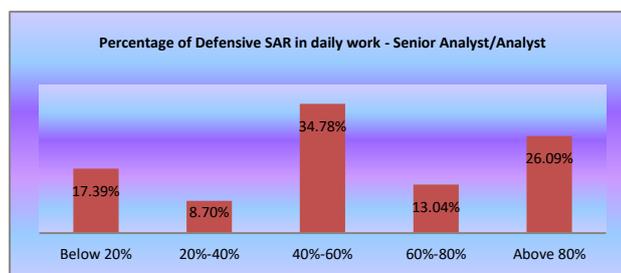


Chart 4

The next question in the survey asked about common red flags leading to defensive SARs. Regulatory hot topics appear on the top of the list with 39.2% of the participants agreeing that it is the major reason for a defensive report. Given that defensive SARs are filed more because of concerns regarding a failure to comply with the regulations than because of genuine suspicion, this result is not surprising. With the example provided earlier in this paper regarding the virtual currency market, the internal control of virtual currency exchange platforms is a momentous topic from both the regulatory and media perspective. Therefore, analysts investigating related transactions would prefer to file a defensive report instead of worrying about being challenged for not filing a SAR on a hot topic.

After learning about the major red flags leading to defensive SARs, the questionnaire further discussed the key reasons for filing defensive SARs. Without any doubt, over 56% of the participants chose quality assurance concerns as the most significant reason for filing defensive reports. The result of this question may lead to another topic worth discussing: what is the role quality assurance teams play in filing SARs and should a quality assurance team be involved in the decision-making process of filing SARs? According to the survey results, the answer is probably no. In the common workflow, the escalated SARs should have already been identified by an

analyst and confirmed by a senior analyst. Involving a third party in such a subjective process may lead to a result wherein a decision maker will make a more “conservative” decision of filing defensive SARs. To reduce the volume of defensive SARs and increase the quality of SARs filed, the quality assurance team’s role should be further clarified. The second key reason for filing a defensive report is the filing deadline. 29.4% of the participants claimed that the deadline significantly affected their decisions regarding defensive filing. Two scenarios might explain this result:

1. The alerted transactions are complicated with more information needed to understand the customer behavior such as open source, historical transactions, and related parties. However, with the deadline approaching, the investigator may not have enough time to further dig into the relevant information and identify the reason behind the customer behavior. Instead, filing defensive SARs is safer and saves time.
2. More information should be collected to support the decision to clear the alerted transactions as non-suspicious such as the branch staff’s feedback or a reply from the related financial institutions (for example, section 314(b) of the USA PATRIOT Act). However, the deadline is approaching without sufficient information having been fully received. Yet, the investigator has to file a defensive report to avoid any breach regarding the deadline even if it is “an act of simply giving up and admitting that there is insufficient information about the customer.”¹⁶

Next, the questionnaire touched on the cycle time for defensive filing. More than 52% of the participants believed that the average cycle time of defensive reports is equal or less than the average cycle time of a normal report and only 6% of the participants thought that the average cycle time of defensive reports is longer. The reasons behind this perception are as follows:

1. If the alerted transaction pattern matches the recent regulatory hot topic, AML analysts will jump to the conclusion that filing defensive SARs are necessary. Further investigation on the customer background and transaction nature is often overlooked. Consequently, the duration of the investigation process can be shortened.
2. Defensive SARs may not involve as many red flags as normal SARs. Otherwise, the analyst would have already reported the suspicious activities based on genuine concerns. As a result, the factor to be analyzed and reporting period might be reduced. A simpler SAR always leads to a shortened processing time.

The last question was on whether the participants believe that defensive reports are necessary in the AML field. The result was surprisingly consistent. Only 1

¹⁶James, DeFrantz (17 Mar, 2016). “WHEN TO HOLD ‘EM AND WHEN TO FILE ‘EM- A TWO PART SERIES ON SAR FILINGS, SPECIAL CONTRIBUTOR REPORT” (<https://www.acfcs.org/news/300062/When-to-Hold-em-and-When-to-file-em--A-Two-Part-series-on-SAR-filings-special-contributor-report.htm>) Retrieved on 24Dec, 2017

participant believed that defensive SARs are unnecessary in the AML field while the other 50 participants all agreed that there is a reason for the existence of defensive filing.

Comprehensive Analysis of Defensive SARs

Regulators continuously aim to reduce the number of defensive reports. The following negative aspects of filing defensive reports might explain the reasons for this:

- 1. Increases the regulatory workload and creates a delusion about the value of SARs.** Regulators or law enforcement will need to arrange for the resources to review the SARs reported, not only those filed on suspicious activities but also those of the defensive SARs filed. However, defensive SARs are not valuable to law enforcement when the reported activities are indeed not suspicious.¹⁷ This misallocation of resource will heavily impact the efficiency of the government agencies' work.
- 2. Affects the accuracy of the company's risk assessment model.** A customer's previous SAR volume is one of the key factors in the risk assessment model of financial institutions. If some SARs were filed defensively rather than based on genuine suspicions, the result of the customer's risk assessment might be inaccurate. For example, customer A with a zero SAR filing history may be categorized at a different risk level compared with customer B who has had multiple SARs previously filed. However, the reason why customer B had been reported might only be due to a small volume (less than \$500) virtual currency investment through well known exchange platforms. With customer B categorized as a higher risk level, the bank has to allocate more resources to tighten its ongoing due diligence review process for the customer, which in fact may be unnecessary.

With these negative aspects, defensive SARs are commonly being considered as a heavy burden of the current AML field. However, it is impossible to eliminate defensive filing entirely due to the following reasons:

- 1. Defensive reports decrease the possibility of misreporting.** Money laundering typologies are continuously evolving. Neither regulators nor financial institutions have complete confidence they understand all money laundering typologies as of date, especially the ones related to regulatory hot topics. Through defensive reports, the possibility of misreporting transactions related to newly evolved money laundering typologies will be decreased. In addition, with more data available, it is more efficient and effective for regulators and law enforcement to identify newly developed

¹⁷From Bankers' Hotline (11 Jan, 2014). "FinCEN Director Bemoans "Defensive Filing" Wants Banks/Examiners to Separate "Unusual" from "Suspicious"". (<https://www.bankersonline.com/articles/109653>) Retrieved on 24 Dec, 2017

typologies. Furthermore, when defensive SARs are filed, the law enforcement unit can save much time by collecting the information held by financial institutions (the cycle time of a 314(a) request in the US is 14 days¹⁸). Instead, the law enforcement unit can simply search the SAR database and directly gather first-hand information with the related analysis. It is a way to increase the efficiency of government agencies by giving them access to suspicious customers' information when conducting investigations targeting newly evolved trends.

2. Defensive reports reduce the possibility of being challenged by regulators.

Most financial institutions have branches and subsidiaries in multiple jurisdictions. With different levels of anti-money laundering standards between different jurisdictions and the trend toward centralized AML investigation, it is difficult for the AML unit in financial institutions to smoothly shift between different standards. Defensive filing can assure the AML unit that they are meeting the toughest standard and helping the bank to avoid any challenges or fines from regulators.

Maintaining a Balance between Regulators and Financial Institutions

There are several reasons for the existence of defensive filing, yet the shortcomings still raise concerns. Even though it is difficult to eliminate defensive filing, with effective communication between regulators and financial institutions, it is possible to control the defensive SARs volume at a reasonable level.

1. Developing the AML regime. Per the survey results, more defensive SARs are filed in immature industries. One motive for filing defensive SARs is fear of heavy regulatory criticism. An immature AML regime causes more confusion about regulatory expectations. Consequently, it is critical for regulators to communicate its AML regime by providing clear guidance and criteria for effective SAR escalation processes. As already discussed previously in this paper, the UK FCA has already applied this method and modified their regulations with the aim of reducing the defensive SARs volume.¹⁹

2. Promote active and frequent feedback from regulators and law enforcement to financial institutions. Government agencies hold the perfect position of providing feedback to financial institutions because they are the actual reviewers and users of SARs. They obtain first-hand information regarding the effectiveness of SAR filing such as:

¹⁸Federal Financial Institutions Examination Council, "Information Sharing—Overview".

(https://www.ffiec.gov/bsa_aml_infobase/pages_manual/OLM_021.htm). Retrieved on 24 Dec, 2017.

¹⁹From UK Financial Conduct Authority (5 July, 2017). "Annual Anti-Money Laundering Report 2016/17", Page 15

(<https://www.fca.org.uk/publication/annual-reports/annual-anti-money-laundering-report-2016-17.pdf>),

Retrieved on 2 Dec, 2017

-
- Which SARs have been parts of a criminal investigation?
 - Which SARs have been directly filtered out from the regulators' database?
 - Which SARs have been eventually cleared as non-suspicious?
 - Which institution has the best SAR quality?
 - What kind of red flag has the poorest/highest performance regarding SAR efficiency?

By analyzing the above information provided by law enforcement, financial institutions will be able to further understand regulators' expectations about SARs and improve their internal processes accordingly.

3. Group-wide supervision and cooperation mechanisms should be developed.²⁰

From the example provided earlier in this paper regarding virtual currency, the reason why AML analysts decided to conservatively report all transactions related to virtual currency might be due to the knowledge gap between regulators and financial institutions. Regulators and law enforcements receive and study the most up to date AML information. They also have the most knowledge and experience about emerging financial markets and products. More timely training and knowledge sharing from regulators would help financial institutions understand the criteria affecting regulatory hot topics. It would also eliminate the unnecessary concerns of analysts regarding being challenged by regulators.

4. Enhance the communications between the analyst and management levels within financial institutions. According to the findings from the survey results, there is an apparent gap in understanding between the analysts and management level regarding the percentage of defensive SARs. These misunderstandings on the part of management cause a misconception of the institution's current SAR quality. A transparent and more complete communication process regarding defensive SARs would synchronize the knowledge of all staff on this issue. This is the first step toward improving the quality of SARs within a financial institution.

5. Develop internal actions tracking and consolidation methodologies within financial institutions. Filing a SAR is not the final step in the process of dealing with suspicious activities. Further liaison with the staff of the front office is required to determine the control measure to take regarding the customer account such as setting up a transaction limit on the account, forcing an account closure, and/or adding the customer to the internal watch list. For defensive SARs filed, when the customer is indeed not suspicious, it is highly possible the above-mentioned actions will be rejected by the front line staff. By tracking the final outcomes of filed accounts, defensive SARs can be identified and studied in order to reduce the volume.

6. Release AML analysts from deadline pressure. According to the survey result

²⁰International Monetary Fund, "People's Republic of China, Financial System Stability Assessment", Page50 (<http://imgcdn.yicai.com/uppics/files/2017/12/636482651510560703.pdf>). Retrieved on 1 Jan 2018.

discussed previously, a deadline was considered to be one of the top two non-investigative factors leading to defensive SARs. Two detailed solutions aiming to reduce deadline pressure for the analysts are as follows:

a) **Fine-tune the alerting methodology with a risk-based approach.** A risk-based approach to the transaction monitoring process should be taken into consideration to help AML analysts focus on transactions with higher risk levels.²¹ Furthermore, timely detection scenario review and performance tracking is essential to ensure the effectiveness of the alert system and to reduce the volume of false positive alerts. With more efforts and resources available for actual warranted investigations, AML analysts would be freed from deadlines.

b) **Enhance the communications between and within financial institutions.** RFIs (requests for information) that are issued between or within financial institutions occupy a large proportion of the alert investigation life cycle. Creating an enhanced system on RFIs between and within financial institutions (such as reaching a specific agreement to shorten the RFI cycle time similar to section 314(a) of the USA Patriot Act and designing an internal RFI procedure to be applied to the whole institution) would ensure analysts have more time for their further investigations.

Conclusion

Defensive SAR filing has drawn attention from both regulators and financial institutions for a long time. Regulators view defensive SARs as unnecessary and have continuously tried to reduce the volume of defensive SARs.

However, the challenges are still out there. Due to the insufficient level of communication between regulators and financial institutions, insufficient communications between the analyst level and management level, and other factors, defensive SARs still occupy a large proportion of AML resources. The efficiency and effectiveness of SARs are currently way below the expectation of AML society, as much of the effort is wasted on filing and investigating SARs merely for compliance concerns.

As a result, the entire AML field should start taking actions to reduce the volume of defensive SARs as regulatory pressure may not be the best and only solution to this issue. A mature AML regime is the prerequisite while more frequent and effective feedbacks as well as knowledge sharing sessions between regulators and financial institutions are also critical. Financial institutions should also promote a transparent

²¹From ACAMS White Paper, Umberto Lucchetti Junior, "AML Rule Tuning: Applying Statistical and Risk-Based Approach to Achieve Higher Alert Efficiency". (<http://www.acams.org/aml-white-paper-aml-rule-tuning/>) Retrieved on 24 Dec, 2017

and adequate communication channel between analysts and management as well as develop a more efficient system and regime to reasonably allocate the capacities of AML analysts.

It is believed that with the full effort of the AML field, the volume of defensive SARs will be significantly reduced and more resources can be allocated to identify actual money laundering activities. This is to prevent the financial system from being taken advantage of by the ever growing sophistication of money launderers.