

EVALUATION OF INTERNAL AUDIT ACTIVITY EFFECTIVENESS IN RISK ASSESSMENT OF ANTI-MONEY LAUNDERING AREA: A CASE OF “LATVIAN BANK N”

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Abstract. Due to recent AML violation cases occurred in financial institutions within Baltic States (Estonian Danske Bank, ABLV Bank AS and Versobank AS) and expressed concerns on Banks’ Internal Audit activity within AML area, the author sees the necessity for assessment of Internal Audit activity within AML area in order to determine the level of adequacy of AML regulatory changes within the risk assessment and potential gaps in risk assessment of AML area. The research focuses on AML compliance with the constantly evolving and increasingly more complicated regulatory requirements and evaluation of organizational part of IA activity using an example of a Latvian Bank N.

The aim of this research is to investigate completeness of Internal Audit risk assessment in accordance with recent AML regulatory changes. This research also compares the IA organizational process that affects all banking areas between a Latvian Bank N and an Estonian practice.

This research relies on qualitative methods. Qualitative methods include face-to-face interviews with Board Members of Latvian Bank N, AML Internal Auditor of Latvian Bank N and telephone interviews with Estonian IA Experts. Also, involves documentary analysis of Latvian Bank N internal audit risk assessment conducted in 2017 for the implementation in 2018.

The conducted investigation showed that IA activity has certain deficiencies and shortcomings in relation to AML regulatory changes reflection in IA risk assessment for AML area, and for overall IA organizational process organization that is crucial for audits organization and conduction not only in AML area, but for all Latvian Bank N and other Latvian Banks’ activities areas. Elimination of these deficiencies will help to achieve full reflection of AML regulatory changes and thereby mitigate the risks that bank processes which are affected by these regulation changes are not sufficiently assessed within the Internal Audit Risk Assessment. In addition, elimination of the deficiencies identified in relation to IA organizational processes will lead to increase of conformance in accordance with International Standards for the Professional Practice of Internal Auditing (pub. the Institute of Internal Auditors, 2017) and, as a result, will strengthen and improve the IA activity effectiveness that is within Internal Audit department and Bank’s interest.

Many of these results are likely to apply not only in the particular bank on which the research is focused, but also to other banks in Latvia. Thus, the research has practical implications in formulating common risk management tactics and methods that could be applied across the banking sector.

Introduction

Anti-money laundering subject has been always the crucial part of any organization, but much more important for those who are in scope of financial service companies. Increasingly, such firms manage all-around the world operations and activities across multiple continents and countries. As a result, the essential consequences of these international expansions are permanent emergence of new official requirements and its updates that puts financial institutions under scrutiny of regulatory authorities.

The year 2018 have been very stressful for financial sector due to situations arisen within banking area of Baltic States. Situations came up in February 2018 when ABLV Bank AS (Gelzis, 2018), the third largest Latvian Bank, has been incriminated by FinCEN on money laundering schemes and resulted in excluding ABLV Bank AS from U.S. financial sector, sanctions from European Central Bank and shareholder's decision on starting liquidations process. Second one, would be Estonian Versobank AS (Mardiste, 2018) which license has been withdrawn as of March 2018 as a result of money laundering probe, permanent violation of AML law requirements and liquidation process have started. The third case, as of September-December 2018 came up with Estonian branch of Danske Bank (Coppola, 2018) where the ten former employees have been arrested due to AML international investigation. Danish, United States, United Kingdom and Estonian authorities are in progress of investigation of money flow from non-residents accumulated in billions of euros made in period of 2007-2015 through the bank that served as "correspondent bank". On the basis of these situations the authors agree with stated by Mellor, anti-corruption expert, (Mellor, 2018): "Ten years on from the financial crash and there are still bankers behaving with scant regard for the law or the impact of their actions on the rest of the world. Europe has a major money-laundering problem".

Despite of the fact that the financial articles on AML cases stated above are described in relation to involvement of Senior Management the authors want to investigate AML matter from different, but closely related, angle – Internal Audit activity that is serving as independent third line of defense. Chairman of the Institute of Internal Audit's (IIA) Global Board of Directors, Mouri stated (2018): "Stakeholders pressure on internal audit has never been greater", and emphasized that nowadays when business world is very dynamic and permanently developing new possibilities for business conduction, internal audit role becomes much more critical. Despite of its standard adding-value objectives, nowadays, the role and responsibilities of internal audit became more critical due to permanent changes and looking for new ways how to hold the independent opinion and make the impact for the company. Also, internal audit accompanying financial institutions cannot allow being static especially for AML area and the first and crucial step to be undertaken is to ensure that all possible risks are detected and sufficiently evaluated within the independent internal risk assessment.

As a result, the authors conclude that in order to mitigate the risk and avoid the circumstances, as happened in outlined AML violation cases, the financial institutions should start from its' inside and promote independent Internal Audit being reliable, strong and trusting tool for protection of financial institution and effective management of AML area.

Background to the Research

AML violation cases happened in the year 2018 (Estonian Danske Bank, ABLV Bank AS and Versobank AS) demonstrate the common problems of the entire banking system within Baltic States and, consequently, the authors will investigate AML area, but performed specifically by Internal Audit activity, serving as independent audit, and which main goal is risk detection and prevention. In order to carry out the research and due to possibility of obtaining information the authors will conduct investigation in a form of case study on the basis of Latvian Bank N. The research focuses on AML compliance with the constantly evolving and increasingly more complicated regulatory requirements and evaluation of organizational part of IA activity that covers all banking areas including AML. For more extensive assessment the authors provide the evaluation of Latvian Bank N IA organizational process and its comparison with the Estonian practice provided by IA Experts.

Aim and Objectives of the Research

Aim of research

To investigate completeness of Internal Audit risk assessment in accordance with recent AML regulatory changes, effectiveness of Internal Audit organizational process and to elaborate recommendations.

Research objectives

- To analyze whether within Internal Audit risk assessment of Latvian Bank N the most recent AML regulatory requirements have been fully applied (Research Question 1);
- To perform evaluation of Internal Audit of the Latvian Bank N organizational process and its comparison with the Estonian practice provided by Internal Audit Experts (Research Question 2);
- To summarize findings, provide the conclusion and develop adding-value recommendations for Latvian Banks' Internal Audit activity within AML area.

Internal Audit Function within AML area

As per Rodriguez (2017): "Money laundering is the criminal process of transforming ill-gotten gains from serious crimes into the appearance that they are indeed legitimate assets".

Banking industry always had a crucial role by establishment of trust between countries, clientele and creating the link between common people and government. Mat Isa, et al. (2015) stated in scientific investigation of money laundering within banking sector: "Assessment of money laundering risk is important, given that any bank would be exposed to considerably high level of such risk due to the inherent nature of banking operation". The authors agree that financial institutions comprise broad range of different services and products, and they are related to various money laundering risks that are needed to be properly managed and mitigated. To decrease the exposure to money-laundering risks the financial institutions analyze, evaluate, weigh intrinsic risks, assign the compliance resources, establish internal structures and controls, internal policies and specific procedures in order to detect and eliminate the aspects of money laundering. In order to evaluate the risks associated with money laundering the financial institutions have to consider wide range of different factors, for example, but not limited to, diversity, scale, business complexity, market targets, nature, jurisdictions, regulatory reports, clientele, transactions' size and volume, etc. As it was noted by Raza, et al. (2017) within their scientific publication: "Adequate internal controls are a prerequisite for the effective implementation of policies and processes to mitigate ML/TF¹ risk". Another argument on importance of internal controls for conduction of AML activities has been expressed by Pinho (2015) in his scientific study: "More specifically, internal control comprises of a plan for organized and coordinated methodologies and procedures which have been adopted by an organization to ensure the safeguarding of assets, the adequacy and reliability of financial report data, the operational efficiency and the adherence, at the various levels of the organization, to the policies set out by the management body".

Internal Audit and internal controls are tightly interconnected. Precise purpose of Internal audit for internal controls can be described as concluded within investigation performed by Nie (2017): "Internal audit is the confirmer of internal control, supervises evaluates as well as proposes amendments". However, the nature of these relationships is often discussed and is the subject of disputes within professional publications on whether the internal audit has an opponent role by independently controlling the bank departments or the value adding role, especially for money-laundering issues, if effectively integrated and managed. The role of Internal Audit has been very precisely defined with scientific study carried by Petraşcu and Tîeanu (2014): "The internal audit constitutes a tool at the disposal of the audit committee, the only one able to independently assess fraud risks and anti-fraud measures implemented by the executive board". Therefore, Internal Audit role is independent evaluation of risks, systems, controls and specifically in relation to AML area, where complete, appropriate risk and control effectiveness assessment is a subject of high importance. Moreover, the internal audit assessment of AML internal controls is crucial as these controls have to be designed to comply with the regulatory requirements related to AML and the importance of their quality has been well expressed by pub. Lowers & Associates (2015): "The quality of these outputs will be the basis for enforcement actions if the regulator finds the program deficient or ineffective". Therefore, the role of Internal Audit is significant because the evaluation of AML internal

¹ Money laundering and terrorist financing

controls, risk and overall system, provision of recommendations, deficiencies detection, for which this function is responsible, plays the crucial role for financial institutions when it comes to AML compliance.

Research Question 1: *Whether Internal Audit risk assessment of Latvian Bank N reflects the recent changes in regulatory requirements for AML area?*

During the interview with the 3 Board Members of Latvian Bank N it was determined that AML regulatory changes is one of the most critical matter for IA AML audits to be considered during their risk assessment of business processes. It was argued by the permanent and prompt AML regulatory changes and more stringent and rigid nature of every next requirement. Therefore, the first research question is devoted to investigation on existence and completeness of reflection of recent AML regulatory changes within business processes included in IA risk assessment.

The following periodicity criteria have been applied by the authors for AML regulations changes taken into analysis of their reflection into risk assessment carried in 2017 for the year 2018:

- The changes must have come into force starting from 2017;
- The revisions on changes, if taken place starting from 2017, should be reflected;
- The changes came into force earlier than 2017 will be reflected if the mandatory compliance date is starting from 2018.

By accumulation of all results obtained on each investigated AML regulatory changes in relation to Latvian Bank N processes the following statements have been concluded by the authors in order to present outcomes in precise and effective way:

- *Extent of regulatory changes reflection into Bank N processes for the year 2018*

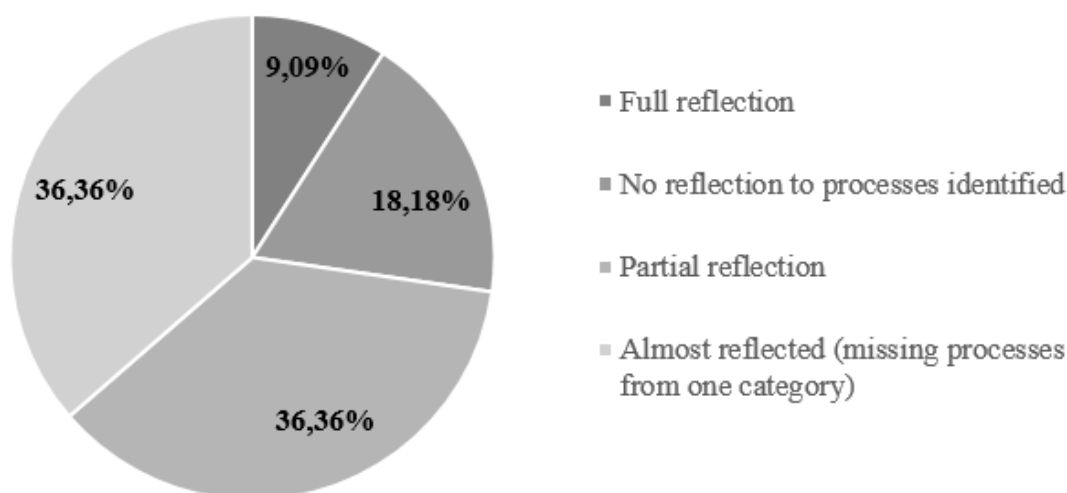


Figure 2.1. Extent of regulatory changes reflection into Bank N processes for the year 2018, developed by the authors (Measure unit: percentage from total 33 regulatory changes)

MiFID II/ MiFIR², AML Directive IV³ (specifically “Requirement on client risk determination”) or 9,09% (3 out of 33 total regulatory changes) has been fully reflected into appropriate business processes by IA of Latvian Bank N, however, Payment Services Directive⁴, Wolfsberg Group Standards and additional revisions of “Call Report” (FFIEC BSA/AML Manual⁵) or 18,18% (6 out of 33 total regulatory changes) have not been reflected to any of banking processes. In relation to remaining regulatory changes: 36,36% (12 out of 33 total regulatory changes) are almost reflected which means that

²MiFID II - Markets in Financial Instruments Directive II;

MiFIR - Markets in Financial Instruments and Amending Regulation;

³Directive (EU) 2015/849 of the European Parliament and of the Council

⁴Directive (EU) 2015/2366 of the European Parliament and of the Council

⁵ Federal Financial Institutions Examination Council Bank Secrecy Act / Anti-money Laundering Manual

missing bank processes are related to one category (for example, customer and third party data, and formation of a package of documents are related to “Transactions” process group) and 36.36% (12 out of 33 total regulatory changes) are partially reflected regulatory changes which means that missing bank processes are from different types of process groupings.

- *Level of appropriate Latvian Bank N business processes reflection per each AML regulation for the year 2018*

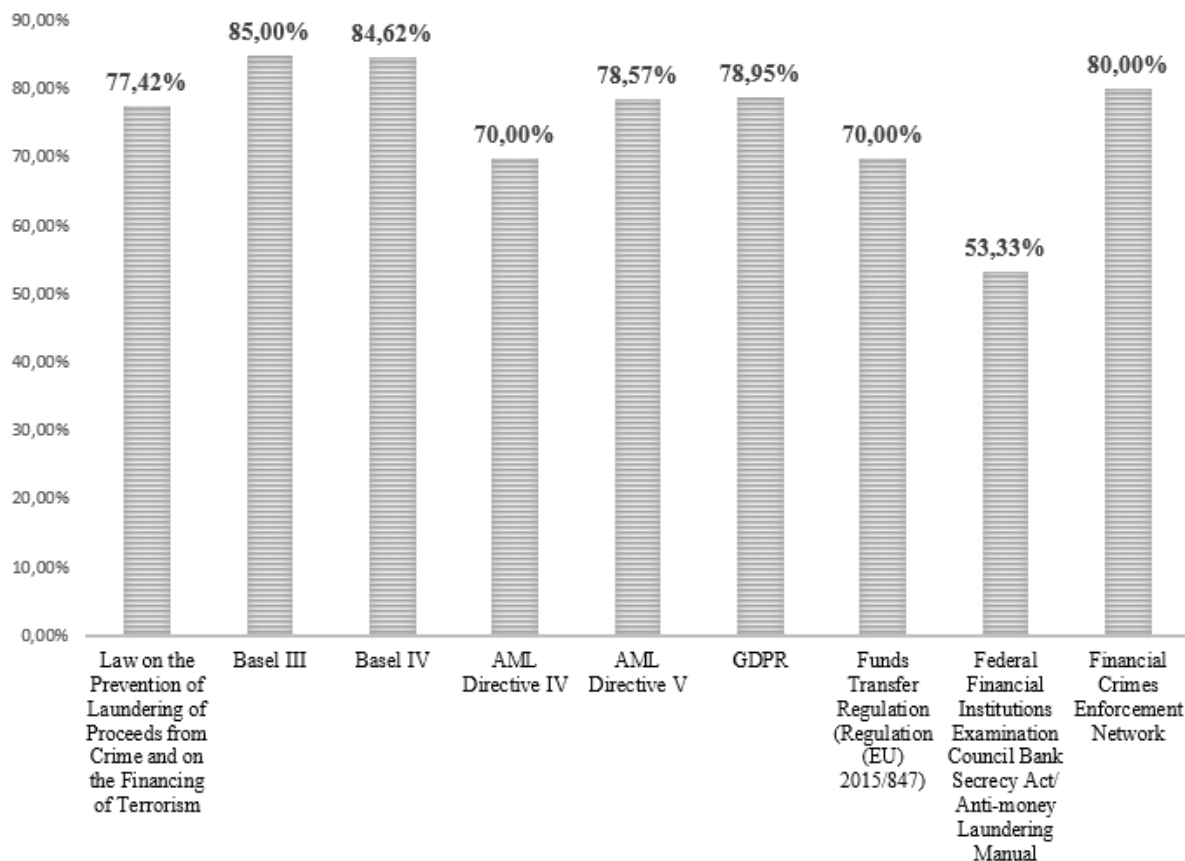


Figure 2.2. Level of appropriate Latvian Bank N business processes reflection per each AML regulation for the year 2018, developed by the authors (Measure unit: percentage from total business processes that have to be reflected to regulatory change)

The Figure 2.2 represents the percentage of business processes that includes in IA risk assessment certain AML regulatory changes (not taking into account not reflected or totally reflected regulation changes as a group, such as, Wolfsberg Group Standards, MiFID II / MiFIR and Payment Services Directive 2). One of the most reflected regulations are: Basel III⁶ (85%, implementation level: 34 business processes out of total 40 business processes that had to reflect changes in regulation), Basel IV (84.62%, implementation level: 22 business processes out of total 26 business processes that had to reflect changes in regulation) and regulation changes from Financial Crimes Enforcement Network (80%, implementation level: 8 business processes out of total 10 business processes that had to reflect changes in regulation). The last one having the USA origin and, as supposed, by the authors have such level due to AML violation cases occurred in 2018 in relation to ABLV where Financial Crimes Enforcement Network had a critical regulator role. The authors will not express the opinion on importance due to which the Basel III and IV had the highest level of regulatory changes reflection, as according to the authors point of view all AML regulations due to their nature have a significant level of implementation requirements, but AML Manuals, such as Wolfsberg Group Standards and Federal Financial Institutions

⁶ Regulatory standards of the Basel Committee on Banking Supervision

Examination Council Bank Secrecy Act/ Anti-money Laundering Manual, have been set by the ALCB⁷ as mandatory AML/CTF⁸ guidance to be followed.

The least implemented is Federal Financial Institutions Examination Council Bank Secrecy Act/ Anti-money Laundering Manual (53.33%, implementation level: 16 business processes out of total 30 business processes that had to reflect changes in regulation). The authors suppose that this could be due to the nature of regulation, as Manual, but still needs to be considered on reassessment and further implementation as is considered as mandatory AML/CTF guidance required for being followed as set by the ALCB.

- *Extent of not associated (but should be) Latvian Bank N process groupings with AML regulatory changes for the year 2018*

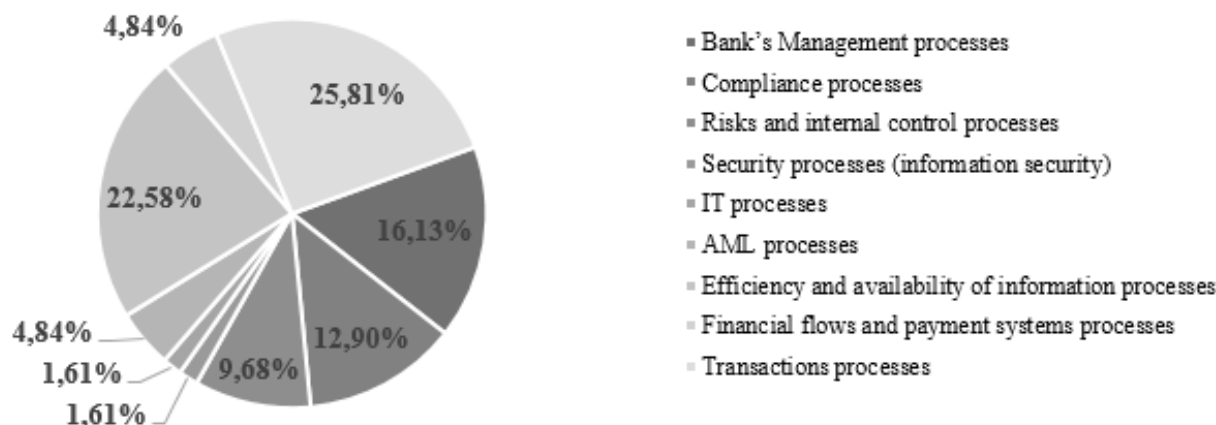


Figure 2.3. Extent of not associated (but should be) Latvian Bank N process groupings with AML regulatory changes for the year 2018, developed by the authors (Measure unit: percentage of non-associated business processes groupings)

The most significant matters that more frequently have been observed as “no evidence noted, but should be associated with regulatory changes” and percentage of which is not less than 5% from total not reflected processes were “Transactions” process group (25,81%, 16 out of 62 not reflected business processes) that includes responsibilities for “Customer and third party data”, “Documentation management” and “Formation of a package of documents”, and “Efficiency and availability of information” process group (22,58% or 14 out of 62 not reflected business processes) devoted to timely exchange of information with Management and Regulators, however, as it was discussed with IA Experts, that this can be made due to inattentiveness, but performed in practice, therefore, needs to be discussed with IA of Latvian Bank N. Other process groups that have not been, but should be associated with regulatory changes are “Bank’s Management” process group (16,13%), “Compliance” process group (12,90%) and “Risks and internal control” process group (9,68%). The authors want the IA department of Latvian Bank N to pay attention on all banking business processes reflected in Figure 2.3 as they demonstrate the business processes that have to be reassessed due to potential risk of underestimation within the risk assessment and risk of insufficiency of planned engagements which are decided on the basis of risk assessment.

⁷ Association of Latvian Commercial Banks, 2017

⁸ Anti-money laundering and counter-terrorism financing

Research Question 2: *What are the differences between Internal Audit organizational process of Latvian Bank N in comparison with Internal Audit organizational process of Estonian Banks?*

The second question is dedicated to analyzation and comparison of organizational activity of Internal Audit of Latvian Bank N (risk assessment, audit universe, annual plan) to Estonian Banks' practice based on opinions of 2 Estonian Internal Audit Experts who have more than 10 years' experience of internal auditing and possess CIA⁹ certificates. The interview conduction has taken place in January 2019. The aim of research question is to evaluate and identify the differences that would lead the authors for development for valuable recommendations for IA activity's organizational part that affects all business processes, including AML area, and is applicable for all Banks.

As a result of analysis conducted the authors have identified the following deficiencies as a result of research conducted:

- *“Revision of risk assessment” - Risk of non-compliance with IIA’s International Standards for the Professional Practice of Internal Auditing*

Risk assessment is updated by IA on annual basis, however as in accordance with IIA’s International Standards for the Professional Practice of Internal Auditing the risk assessment should be updated at least annually (each time when any additional concern or update occurs);

- *“Reservation of time for consulting services” - Risk of overload and work quality decrease*

As it was noted by the authors audit plan does not provide the time for consulting engagements, if any. In order to eliminate the risk of overload with engagements, decrease of work quality and lack of resources, the authors would advise to reserve 10% of annual time for consulting projects;

- *“Finalization and approval of audit plan” - Risk of non-compliance with formal banking decision-making process and IIA’s International Standards for the Professional Practice of Internal Auditing*

As it was noted by the authors the IA audit plan in Latvian Bank N should be finished by the end of January, however, in order to eliminate the risk of non-compliance with formal banking decision-making process (conduction of engagements without approval from the Council and Revision Committee) the authors would recommend to state in IA Policy and implement the finalization and approval of audit plan in December. In addition, it should be noted that as per IA Experts experience from Estonian Banks this deficiency often observed within Estonian financial services industry.

In addition, the following considerations for improvement of organizational process effectiveness have been developed by the authors on the basis of opinion and experience of IA Experts:

- *Risk assessment evaluation elements*

The authors would advise to consider additional elements (as in accordance with IA Experts' experience) that would enhance the risk assessment process, such as: written analysis of each risk in regards to business process (risk causes), usage of benchmarking, industry surveys, update of risk factors from discussion with Senior Management, Revision Committee, Head of Departments, as well, from Head of IAD knowledge and concerns;

- *Risk assessment and Audit Universe separation*

As it was noted by the authors the IA of Latvian Bank N prepares Audit Universe (Strategic plan) and risk assessment in one documentation file. Per James Aquino (2010) the Audit Universe is defined as: "An inventory of audit areas that is compiled and maintained to identify areas for audit during the audit planning process". However, due to different purposes of these IA elements and great amount of banking processes, risks, controls, the authors consider that they have to be separated and role of each of them should be clearly understandable by Internal Auditors. Risk assessment purpose has operational character and it serves as working file with, as a result, identified areas to be audited during next year,

⁹ Certified Internal Auditor

however, an Audit Universe has strategic characteristics with different time scope (3-5 years) on projected high risk audit areas and engagements, and overall view on obligatory coverage of all areas during this time scope;

- Transition to IA specialized software

As noted, IA department of Latvian Bank N uses Microsoft Office tools for preparation and secured folders for keeping documentation. In order to enhance efficiency and effectiveness of overall IA activity, the authors would recommend to take into consideration the opportunity for transformation of all documented processes into one, specialized on IA, tool. For example, “E-dok” internal audit software developed by Estonian company and already showed itself on Estonian market as highly trusted tool. The price for the annual licensing of “E-dok” (the IT control will be performed by Estonian company) is negotiable depending on size and complexity of organization. It will enable internal auditors to strengthen the consistent quality of their audits in an efficient manner, in compliance with IIA standards, and enhance teamwork and ensure the confidentiality and retention of data. The software has not been generated to require one single narrow methodological path, but enables a variety of approaches, for example, to prevent mistakes done manually on placing the risk assessment updates to Audit Universe and/or update of Audit Universe before risk assessment. The software would help to decrease the manual interactions into Audit Universe by replacement with automated transfers of any risk assessment changes and/or established settings under which a certain manual changes would be possible. As well, using the software enables the internal auditor to take a step back and analyze the approach used so far, providing an opportunity to spot deficiencies in performing audits what is critical for overall IA activity and as needed by Senior Management.

Recommendations

Research Question 1

In order to eliminate the risks described within conclusion part for Research Question 1 and achieve full reflection of recent changes in regulatory requirements for AML area and needs of Board Members within IA risk assessment, the following recommendations related to research question “*Whether Internal Audit risk assessment of Latvian Bank N reflects the recent changes in regulatory requirements for AML area?*” have been developed by the authors for Internal Audit departments of Latvian Banks:

- To consider permanent review and reflection into IA risk assessment any potential changes in AML regulations, for example, proposed changes stated within AML regulatory reports (post-analysis on regulatory change), AML key considerations expressed during official discussions and AML devoted conferences, etc. in order to be well informed and be ready for prompt reactions to any sudden changes within AML regulatory framework;
- To consider establishment of permanent verifications of IA risk assessment on reflection of AML regulatory changes to the bank processes in order to avoid the risk of insufficient bank processes’ risk assessment that can lead to non-conduction of appropriate AML audit and, further, lack of proper money-laundering risk coverage.

Research Question 2

In order to enhance the effectiveness of overall organizational process that is important for audits conduction for AML area and all Banks areas, and eliminate the risks described within conclusion part for Research Question 2, the following recommendations related to research question “*What are the differences between Internal Audit organizational process of Latvian Bank N in comparison with Internal Audit organizational process of Estonian Banks?*” have been developed by the authors for Internal Audit departments of Latvian Banks:

- To consider the revision for risk assessment at least annually as in accordance with IIA’s International Standards for the Professional Practice of Internal Auditing;
- To consider reservation of 10% of annual time for unexpected consulting engagements to mitigate the risk of engagements overlapping and, as a result, lack of resources and decreased work effectiveness;

- To analyze opportunity for finalization and approval of audit plan in December instead of January to mitigate the non-compliance risk related to formal decision-making process;
- To consider review of risk assessment's evaluation elements in order to improve risk assessment process, such as: written analysis of each risk in regards to business process (risk causes), usage of benchmarking, industry surveys, update of risk factors from discussion with Senior Management, Revision Committee, Head of Departments, as well, from Head of IAD knowledge and concerns;
- To separate risk assessment and Audit Universe documentation due to different aims followed by these IA elements. Risk assessment has an operational character and serves as working file with performed assessment for identification of areas to be audited upcoming year, however, Audit Universe has a strategic nature with different time scope (3-5 years) on future projects and significant audit areas, and view on mandatory coverage of all banking areas within the time scope;
- To analyze possibility of transition to IA specialized software (for example, Estonian tool for Internal Audit – "E-dok") that would strengthen the quality of IA audits in an efficient manner, in compliance with IIA's International Standards for the Professional Practice of Internal Auditing, enhance teamwork, ensure the confidentiality and retention of data. The software enables variety of different approaches. In addition, using this software it will enable internal auditor to analyze the methodology used so far, and will provide opportunity to identify deficiencies and risks within IA activity, for example, prevention of manual mistakes on placing risk assessment updates into Audit Universe or Audit Universe being updated before risk assessment. In such situations the software helps to minimize interactions done manually within Audit Universe by automated transfers of changes in risk assessment and establishing conditions under which manual changes are possible.

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