

Independent Verification and Validation (IVV) Survey: Results Summary

Conducted 1st quarter 2015

Introduction:

In the first quarter of 2015, we conducted a survey about an Independent Verification and Validation (IVV) to get a better understanding of what financial institutions are doing about them, if at all. We wanted to know if the institutions we spoke to have had their anti-money laundering (AML) software program, which including BSA, OFAC, CDD/KYC and FinCEN 314(a) software validated; if so, who conducted it; how frequently; who remediated; were the costs associated more or less costly than the validation itself. If not, why haven't they conducted an Independent Verification and Validation (IVV) of their AML software; when were they planning on doing so; what software program would they focus their efforts on. Some of the answers were what we expected, some were not.

Before we asked any questions, we defined what we meant by an Independent Verification and Validation (IVV). We defined Model Validations; Independent Verification and Validation; IVV; or just "Validation" as a system review and written report for your financial institution on your AML compliance software. Further, we define "AML compliance software program" as an anti-money laundering compliance software program, which includes BSA, OFAC, CDD/KYC, and FinCEN 314(a).

Demographic questions:

To demonstrate the type of financial institutions that participated in our survey, we asked a couple of demographic questions. We found that most of our respondents represented a wholesale bank (see figure 1, at 29%) at a foreign bank (see figure 2, at 64%). Further, we found that 73% (see figure 3) of our respondents were compliance officers themselves.

Figure 1: Type of Business

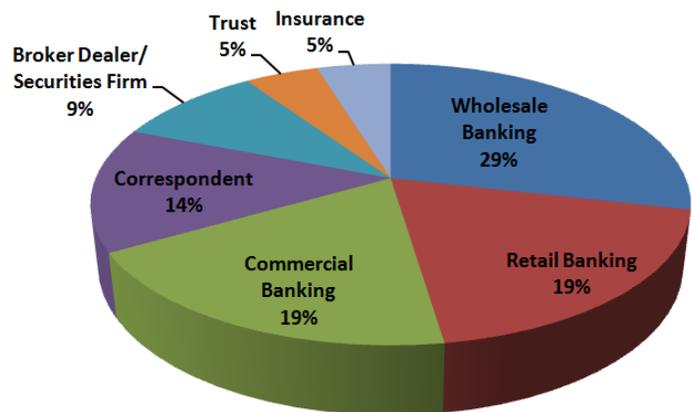


Figure 2: Type of Institution

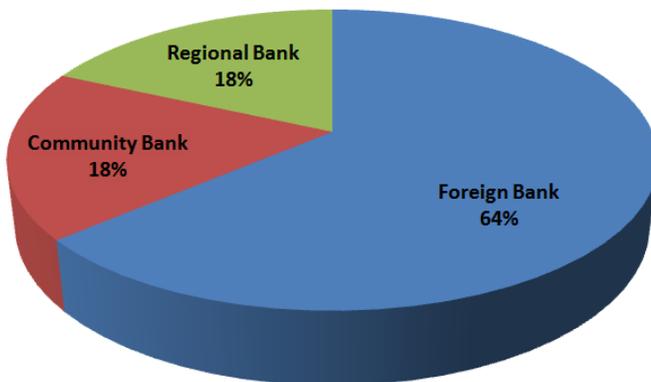
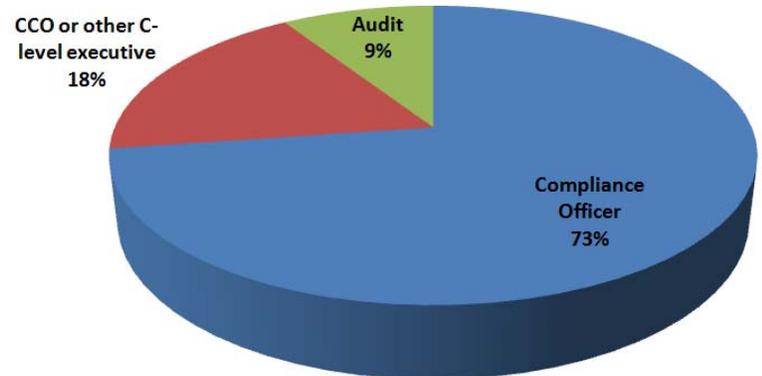


Figure 3: Job Title



Independent Validation and Verification (IVV) Survey Questions:

Once we had a better understanding of our respondents, we started asking about the topic at hand. Over 80% (see figure 4) of our respondents have conducted a model validation on one or more of their AML software programs in the last six months (see figure 5). However, just under 20% have not. Given Benjamin Lawsky's recent speech regarding the validation of an AML system, specifically a BSA/Transaction Monitoring system we imagine this will change, but we'll further explain that later (Lawsky, 2015).

Figure 4: Have you ever conducted a model validation?

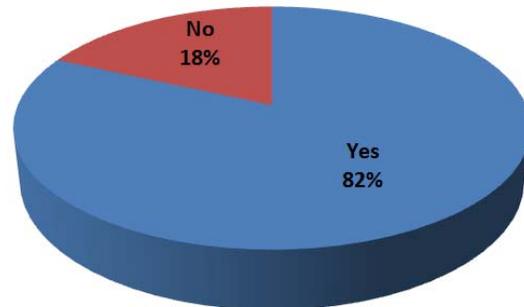
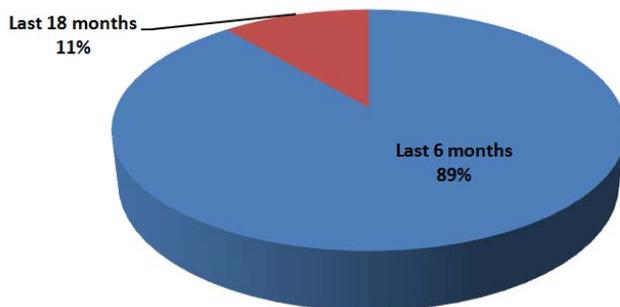


Figure 5: When was the last time you conducted a model validation?



For the 11% that haven't conducted a model validation in the last 18 months (see figure 5), we believe that's its time for them to validate their system according to the guidance by the OCC (Office of the Comptroller of the Currency), which says "Banking organizations should conduct a periodic review-at least annually but more frequently if warranted-of each model to determine it is working as intended and if the existing activities are sufficient" (Board of Governors of the Federal Reserve System (SR 11-7), 2011, p. 3). The same goes for the more than 60% of respondents who only conduct a model validation every 18 months to 2+ or more years (see figure 7).

As expected, the largest focus of model validations of an AML software system has been on a BSA/Transaction Monitoring system at 44%, followed by OFAC at 28%, CDD/KYC at 17% and FinCEN 314(a) at 11% (see figure 6).

Figure 7: How often do you conduct a model validation?

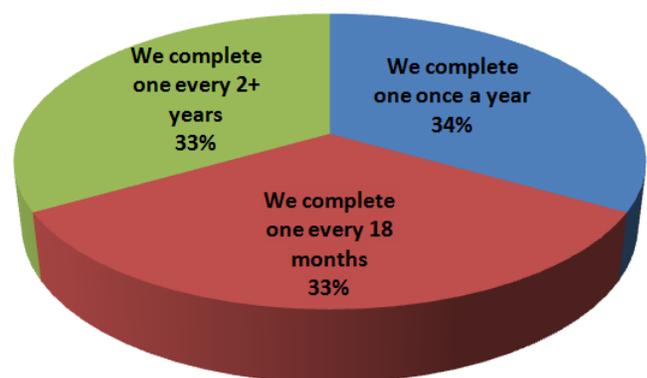
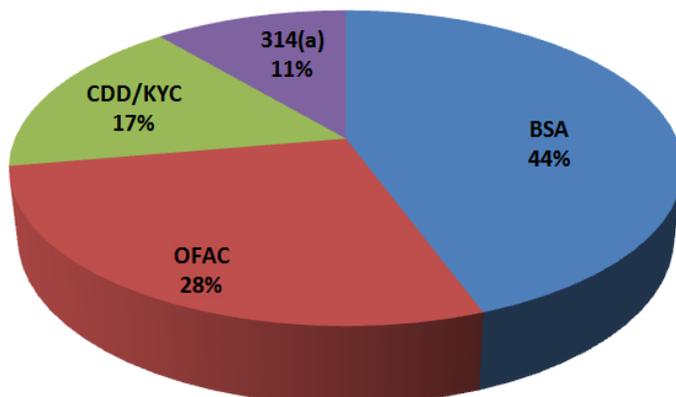


Figure 6: What program(s) have you completed a model validation on? Check all that apply.



Interestingly enough, nearly half of the respondents at 44% (see figure 8) said that internal audit completed the model validation of one or more of their AML software programs. We believe there are two challenges to overcome when using Internal Audit:

- 1) If they're conducting the annual audit of the compliance program, they cannot also be independent.
- 2) They need a certain level of technical expertise of the software and technology around the model, not just regarding the policies and procedures.

For those that have conducted a model validation of one or more of their AML software systems, 78% said that it has helped with regulatory requirement (see figure 9), and that's not surprising given that 67% conducted a model validation because of regulatory requirement (see figure 10).

For those that said "no" it did not help with regulatory compliance, the reasons given were that it "Never came up" and "Due to the model validation, management has not supported efforts to remediate issues properly (budget, planning or focus)."

Figure 8: Who conducted your model validation?

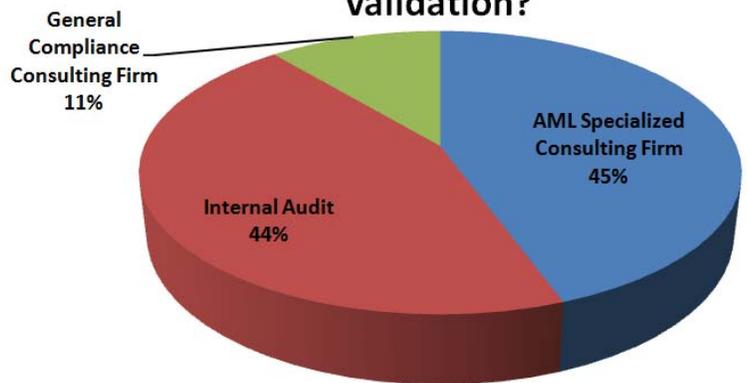
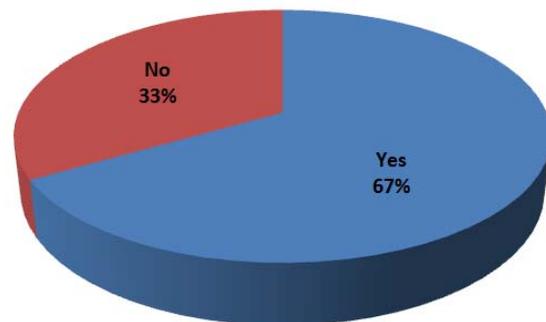
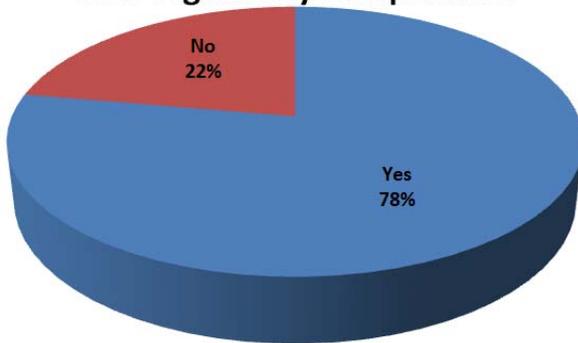


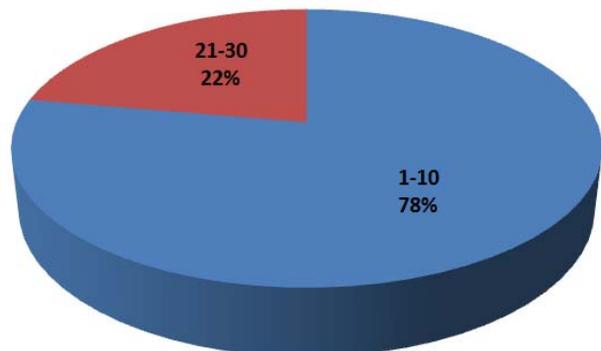
Figure 9: Has a model validation helped with regulatory compliance? **Figure 10: Did you conduct a model validation because of regulatory requirement?**



The majority of our respondents found 1-10 issues because of a model validation of one or more of their AML software systems (see figure 11). Over 20% have found 21-30 issues.

We had expected a greater variance in answers here, so perhaps in the future we need to ask what types of issues were discovered: technical/software related, policy/procedures related, etc. Perhaps a greater understanding of the issues would shed light on a very important topic and could help the AML compliance community as a whole.

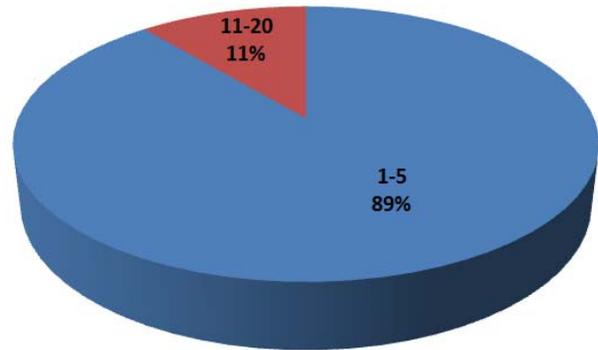
Figure 11: How many issues did you discover through your model validation?



We were surprised with the number of respondents that had critical issues with a majority stating 1-5 (see figure 12). We typically think critical issues could result in an MRA, MRIA, etc. so that might also indicate that a large number of financial institutions are challenged by the AML, BSA, OFAC, CDD/KYC and FinCEN 314(a) regulations.

Even more surprising was the the 11% with 11-20 critical issues. Again, perhaps there is more room for clarification in a future survey surrounding the types of issues that derived from a model validation.

Figure 12: How many were listed as critical issues?



A majority of our respondents were able to remediate the issues derived from a model validation with a combination of their IT and Compliance departments (see figure 13). With that said, it was not surprising then that 67% said that subsequent remediation was less costly than the model validation itself (see figure 14). We're glad to see that because that means that the model validation report gave clear guidelines of what issues needed to be addressed providing the most cost effective solution.

However, for the 33% (see figure 14) who said that it was more costly than the model validation that could be because of the number of issues and/or critical issues that were discovered, internal or external resources chosen for remediation lacked the appropriate level of AML experience, or the model validation report did not clearly define the issues allowing them to address them appropriately.

Figure 13: Did you remediate internally, externally or a combination?

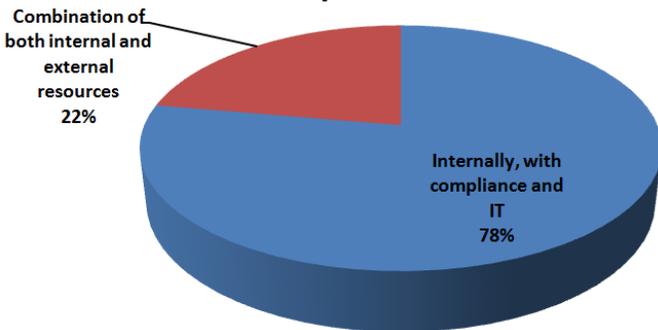
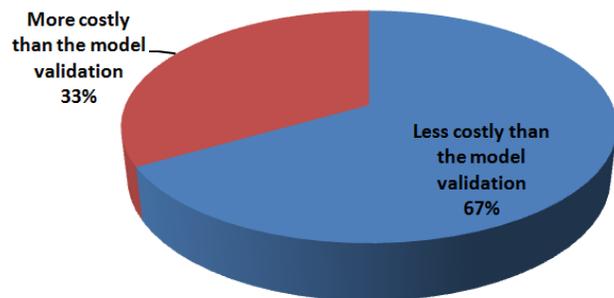
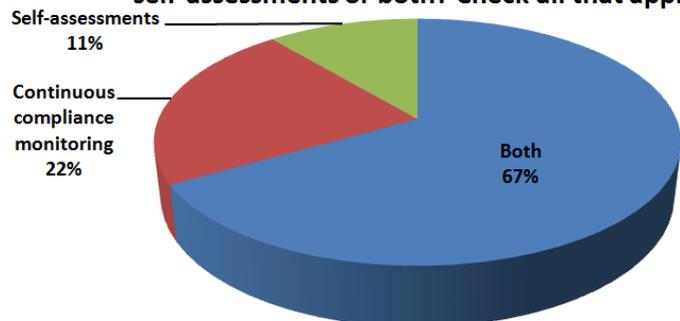


Figure 14: Was the remediation more or less costly than the model validation?



Finally, for the group that said that they did conduct a model validation on one or more of their AML software systems, we asked them if they had an on-going continuous monitoring program, conducted self-assessments or both, and the majority said they did both (see figure 15). This is inline with the thinking that if they are conducting an on-going continuous monitoring program and conduct self-assessments, then it makes sense that the majority had less than five critical issues (see figure 12) and less than 10 issues (see figure 11). It does beg the question that if the 11% who only conduct self-assessments (see figure 15), perhaps they would have found their issues before a model validation and subsequent remediation.

Figure 15: Of those that conducted a model validation, do you conduct continuous monitoring, self-assessments or both? Check all that apply.



Of the 18% of our respondents who said that they have not conducted a model validation on one or more of their AML software systems, which includes BSA, OFAC, CDD/KYC and FinCEN 314(a) (see figure 4), a resounding 100% said that they hadn't for budgetary reasons (see figure 16), but they planned on conducting one in the next 12 months (see figure 17 and 18). This tells us that despite guidance issued by the OCC in 2011 saying that an AML system should be validated annually, if not more often, sometimes compliance officers are faced with a lack of support by management to the AML compliance budget.

Figure 16: Why haven't you conducted a model validation?

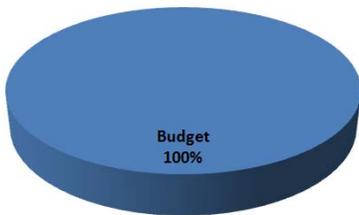


Figure 17: Are you planning on conducting a model validation?



Figure 18: When are you planning on conducting a model validation?



They plan to focus on a BSA/Transaction Monitoring system, but are equally split from there on OFAC, CDD/KYC and FinCEN 314(a) (see figure 19). These numbers are slightly off from the group that has conducted a model validation, but is inline with the priority we're seeing.

Figure 19: What program(s) are you considering to complete a model validation on?

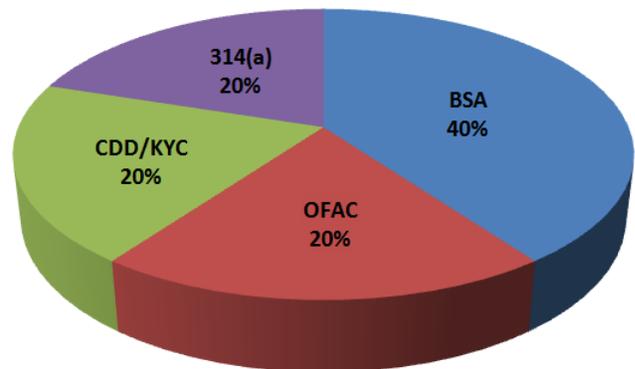
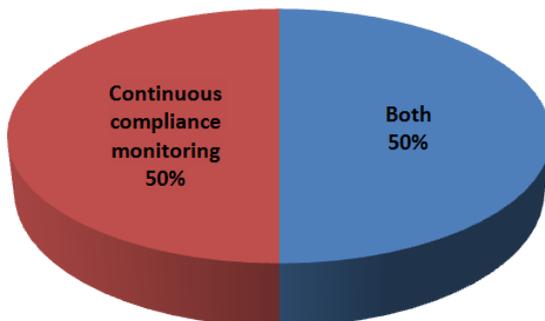


Figure 20: Of those who have not conducted a model validation, do you conduct continuous monitoring, self-assessments, or both?



Finally, for the group that said that they did not conduct a model validation on one or more of their AML software systems, we asked them if they had an on-going continuous monitoring program, conducted self-assessments or both, and they were equally split between only conducting a continuous compliance monitoring program and conducting both (see figure 20).

It would be interesting to see the number of issues that this group finds when they do conduct a model validation, the number that are critical, and if having a continuous compliance monitoring program and/or self-assessments affects the outcome of the model validation. If not, then we should consider what changes can be made there to assist the compliance department maintain compliance better.

Conclusion:

Based on these results, a majority of financial institutions are conducting a model validation of one or more of their AML software systems, and they're focusing their efforts on a BSA/Transaction Monitoring system. This especially makes sense given Benjamin Lawsky's speech in February 2015 and he asked "But...what if those monitoring and filtering systems are flawed or ineffective?" (Lawsky, 2015). He went on to say:

"Problems with transaction monitoring and filtering systems can be the result of one of two situations:

- First: Through inadequate or defective design, or programming of the monitoring and filtering systems, faulty data input, or a failure to regularly update these detection scenarios, which may be attributed to lack of sophistication, knowledge, expertise, or attention by the management and/or employees.
- Or two, perhaps more disturbingly, willful blindness or intentional malfeasance by bank management, or employees - who, for example, turn down the sensitivity of the filters so the systems do not generate enough alerts and therefore suspicious transactions go undetected." (Lawsky, 2015)

With that said, we are surprised that a majority of the respondents would utilize internal audit for conducting the model validation since they often lack the technical expertise to test the technology/software, which is what Benjamin Lawsky is referring to above. Further, for the 66% of respondents who say they conduct a model validation only every 18 months to 2+ years, we're concerned that they aren't validating the system frequently enough, which the OCC says that "Banking organizations should conduct a periodic review-at least annually but more frequently if warranted-of each model to determine it is working as intended and if the existing activities are sufficient" (Board of Governors of the Federal Reserve System (SR 11-7), 2011, p. 3).

Since a majority of respondents said that they conducted a model validation because of regulatory requirement, we're not surprised that they also said that the model validation helped with regulatory requirement. However, we were surprised with the number of issues found - both 1-10 and 21-30. We would challenge that if a large number of a financial institution's model validation report points to policy and/or procedure changes, than they should challenge the report's findings and consider more technical based internal or external resources. Technology changes frequently, along with a bank's products and services, so there is a possibility that the software system is no longer doing what it was intended to do.

Further, we're pleased to see that in a majority of respondents the model validation report clearly defined the changes necessary giving the financial institution freedom to choose the most cost effective remediation plan.

We believe that a model validation of an AML software system is a very proactive approach to AML compliance, along with a continuous compliance monitoring program, so we're not surprised that of this group of respondents a majority of them are doing both. However, it would be interesting to see if they believe the continuous compliance monitoring program limited the issues in their model validation report, and if not, what changes could be done to their monitoring program to fix that.

We provide this value-add service to the compliance community to better the anti-money laundering community as a whole. Thank you to everyone who participated. We hope you will participate in future surveys as well.

For the detailed report of our Independent Verification and Validation (IVV) survey, please email newsletter@arcriskandcompliance.com to request a copy.

References:

Board of Governors of the Federal Reserve System Office of the Comptroller of the Currency. (2011, April 4). Supervision and Regulation Letters (SR 11-7a1). Retrieved May 1, 2014, from Board of Governors of the Federal Reserve System: <http://www.federalreserve.gov/bankinfo/srletters/sr1107a1.pdf>

Lawsky, B. (Director) (2015, February 25). "Financial Federalism: The Catalytic Role of State Regulators in a Post-Financial Crisis World. Speech conducted from Columbia Law School, New York City, NY.