

Regulatory Impact Statement

[Anti-Money Laundering and Countering the Financing of Terrorism Regime Reform - 25 June 2009]

EXECUTIVE SUMMARY

The Financial Action Task Force (FATF), of which New Zealand is a member, has developed Recommendations to guide member countries in implementing anti money laundering and counter terrorist financing (AML/CFT) measures.

Member's countries' compliance with these Recommendations is routinely evaluated. New Zealand's compliance with the Recommendations will be evaluated by the FATF in 2009. There are significant deficiencies in New Zealand's AML/CFT regime in respect of the standard established by the FATF Recommendations. The main gaps in New Zealand's AML/CFT regime are as follows:

- financial and non-financial businesses are not required to implement AML/CFT systems, involving for example, customer due diligence and record keeping procedures, to the standard established according to the FATF Recommendations;
- not all businesses included in the scope of FATF Recommendations fall within New Zealand's regime; and
- there is no mandatory supervision and monitoring of reporting entities (businesses determined as having AML/CFT responsibilities) to ensure that they are carrying out their AML/CFT obligations.

The status quo is not preferred as it would see New Zealand continue to have a deficient AML/CFT regime in respect of the internationally accepted standard. *[information deleted in order to maintain the effective conduct of public affairs through the free and frank expression of opinions between officials and Ministers]*

The expected costs of the proposed AML/CFT reform include:

1. costs to reporting entities and their customers of new and extended regulatory requirements related to customer due diligence, transaction monitoring, transaction reporting, record keeping and implementation of AML/CFT compliance programmes.
2. costs to the Crown of monitoring and supervising reporting entities, assessing money laundering risks at national and sector levels, analysing an increased volume and variety of Suspicious Transaction Reports; and ensuring adequate coordination of regulatory functions across multiple supervisors.

Over time, the expected benefits of the proposed AML/CFT reform include:

- supporting and protecting New Zealand's international trade, borrowing, investment and business objectives
- strengthening the ability of law enforcement agencies to detect, investigate, prosecute and recover the proceeds of serious crime
- deterring predicate offending by ensuring that any proceeds of crime are more difficult to launder, therefore reducing the crime incentive
- supporting counter terrorism efforts in New Zealand and the Asia Pacific region.

Officials have consulted on options for compliance with the FATF Recommendations that seek to avoid excessive compliance burdens, are effective in their resolve and appropriate to New Zealand circumstances.

ADEQUACY STATEMENT

The Regulatory Impact Analysis Team has reviewed this Regulatory Impact Statement (RIS) and considers that it contains the required information and accurately reflects the regulatory

impact analysis undertaken in relation to the proposal, which we also consider to be adequate according to the criteria set out in the CabGuide. As a result, we consider that this RIS is adequate.

STATUS QUO AND PROBLEM

Money laundering and the financing of terrorism are global problems.

The FATF, associated with the OECD, was established by the G7 countries in 1989 to develop and promote policies and legislation to combat money laundering and terrorist financing. In April 1990 the FATF issued Forty Recommendations to guide governments in their implementation of laws and regulations to combat money laundering. In response to the attacks in the United States on 11 September 2001, the FATF issued an additional eight special Recommendations to guide governments in their implementation of laws and regulations to combat terrorist financing (with a ninth added in 2004).

New Zealand is a member of the FATF, and while not legally binding, there is a strong impetus for compliance with the Recommendations. There is widespread acceptance of the Recommendations as a robust standard of AML/CFT measures, with FATF membership extending well beyond the OECD membership (32 jurisdictions and 2 regional organisations including the European Commission and the Gulf Cooperation Council).

New Zealand voted in favour of the revised Recommendations in 2004, and the United Nations (UN) Security Council has strongly urged UN member states to comply with FATF standards (Security Council Resolution No. 1617, 29 July 2005). Implementing the FATF recommendations would also enable New Zealand to demonstrate its compliance with the UN Convention Against Trans-national Organized Crime (ratified in 2002) and the International Convention for the Suppression of the Financing of Terrorism (to which New Zealand is a State Party) and progress compliance with the UN Convention Against Corruption (signed in December 2003).

Member's countries' compliance with the FATF Recommendations is routinely evaluated. New Zealand's compliance with the Recommendations will be evaluated by a FATF/Asia Pacific Group (APG) Mutual Evaluation process commencing in April 2009 and later publicised in October 2009.

New Zealand to some degree achieves compliance with the Recommendations via the Financial Transactions Reporting Act 1996 (FTRA), which places obligations on financial institutions to undertake measures, such as verifying the identity of customers, keeping records of transactions and verifications of identity, and reporting suspicious transactions to the Commissioner of Police. Compliance with the nine Special Recommendations relating to terrorist financing is achieved primarily through the Terrorism Suppression Act 2002.

A 2003 assessment of New Zealand's implementation of FATF's Recommendations found New Zealand to be non-compliant or materially non-compliant with 8 of the 40 Recommendations and 2 of 7 (latterly extended to 9) Special Recommendations, including core requirements of the regime, which are accorded additional scrutiny and weight. Significant deficiencies in New Zealand's AML/CFT regime remain, including:

- financial and non-financial businesses are not required to implement AML/CFT systems, involving for example, customer due diligence and record keeping procedures, to the standards set out in the FATF Recommendations;
- not all businesses included in the scope of FATF Recommendations fall within New Zealand's regime; and
- there is no mandatory supervision and monitoring of reporting entities to ensure that they are carrying out their AML/CFT obligations.

OBJECTIVES

The objectives proposed for New Zealand's AML/CFT regulatory framework are to:

- detect and deter money laundering and terrorist financing;
- maintain and enhance New Zealand's international reputation;
- contribute to public confidence in the financial system; and
- realise these objectives with minimum cost to industry.

ALTERNATIVE OPTIONS

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Status quo

Retaining the status quo is not appropriate given New Zealand's current system (established in 1996) is not equipped to deal with the technological and international regulatory developments along with the greater interconnectedness of jurisdictions and transactional activity, and the associated risk of domestic and cross-jurisdictional money laundering and terrorism financing. Neither would this option satisfy the objective of progressing New Zealand's compliance with our international obligations. There have been a number of extensions to the current legislative and administrative framework in recent years, however, the extent to which the current framework needs to change rules out the option of a simple patch.

Implementation without supervisory system

An alternative approach would be to introduce the AML/CFT obligations for financial institutions and casinos as per the preferred option set out below, without a supervision system to support and enforce the implementation of those obligations. This approach, while providing savings to the Crown in the short term, would not satisfy the FATF's test of having an effective regime. FATF recommends explicitly that countries ensure that reporting entities are adequately supervised for compliance with their AML/CFT obligations (Recommendations 23 and 24), competent authorities (including supervisors) are provided with appropriate financial, human and technical resources (Recommendation 30), and the effectiveness of AML/CFT systems is kept under review (Recommendation 32).

This option is therefore not preferred as it would not satisfy the standard established by the FATF recommendations and, most importantly would impose compliance costs on compliant businesses for little intelligence benefit. This approach would raise fundamental questions about the integrity of New Zealand's AML/CFT measures and its commitment to international AML/CFT efforts, and would therefore fail to satisfy the policy objectives of detecting money laundering and terrorist financing and maintaining New Zealand's international reputation, at minimum cost to industry.

Deferral

An alternative approach would be to defer the proposed legislative AML/CFT reform until 2010, to ensure that business costs are kept to a minimum and allow businesses to attend to managing the most pressing commercial challenges posed by the current financial climate.

This would mean that legislation would not be in force until late 2012 at the earliest.
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Immediate full compliance

A fourth alternative approach is to provide for the proposed reforms to take effect at the enactment of the legislation, and at the same time extend the obligations to other industries that the FATF recommendations indicate should be covered by a country's AML/CFT measures (eg. lawyers, real estate agents, accountants, and other industries considered to be

at risk of abuse by money launderers and terrorist financiers). This option is not preferred as it would significantly exacerbate the cost to businesses during the establishment phase through heightening the competition for AML/CFT systems development expertise.

PREFERRED OPTION

The preferred option is to progress compliance with the FATF Recommendations. The preferred option would see the implementation of a new AML/CFT regime in late 2011 (ie. two years following legislative assent) requiring financial institutions and casinos to undertake to:

- assess their business operating environment (including, for example, product/service offerings and customer base) for money laundering and terrorism financing risks;
- based on the assessment of risks, and legislative obligations, implement AML/CFT policies and procedures to identify, mitigate and report suspicious activity, including:
 - identification and verification of customers identities and beneficial ownership considerations;
 - monitoring transactions for unusual or suspicious transactions;
 - established reporting processes;
 - store records of account files, business correspondence and transactions for five years;
- conduct annual assessments of and two yearly independent audits of their AML/CFT systems.

Other relevant reporting entities would be brought within scope of the regime in a second phase.

The reform would also see the establishment of a new AML/CFT supervisory regime, involving monitoring and enforcement (with recourse to civil and criminal penalties) of reporting entities' compliance with their AML/CFT regulatory obligations by the:

- Securities Commission for issuers of securities, trustee companies, futures dealers, collective investment schemes, brokers, and financial advisers
- Reserve Bank of New Zealand (RBNZ) for banks, life insurers, and non-bank deposit takers
- Department of Internal Affairs (DIA) for casinos, non-deposit taking lenders, and money changers, and other financial institutions not supervised by the Securities Commission or RBNZ.

A National Coordination Committee, comprising the supervisors, FIU, Ministry of Justice and other agencies involved in the operation of the AML/CFT regime, would be established as a central point of operational co-ordination of the regime to ensure gaps and duplication of supervisory activity are minimised, and that supervisory activity is applied consistency and proportionately,

COSTS AND BENEFITS

The costs of the overall proposal are estimated as being:

1. Compliance costs for reporting entities, of complying with additional and strengthened AML/CFT requirements.

An independent cost estimation (undertaken by Deloitte for the Ministry of Justice in 2008) assessed the start-up costs across financial institutions and casinos as \$97 million (to be spread over a two year implementation period), with ongoing costs of \$21 million per year thereafter. These adjusted figures should be treated with some caution. The data indicated an upper end cost estimate of \$249 million for start up costs and \$103 million for ongoing costs. However, Deloitte assessed the probable cost being at the lower end of surveyed

range, bringing the probable cost more into line with actual experience from overseas jurisdictions; particularly that of Australia.

These costs will vary across sectors. Variables include size and nature of business, transaction volumes, customer base, current level of compliance with existing AML/CFT requirements and the ability to share technology and training materials with overseas parent (depending upon the degree of common platforms). The level of start-up cost is also expected to be directly proportionate to the current preparedness of sectors.

Estimate of Business Compliance Costs (adjusted) - \$million					
Totals by sector			Average per entity by sector		
		Start-up Total across years 1 and 2	Ongoing (Year 3 and beyond)	Start-up Total across years 1 and 2	Ongoing (Year 3 and beyond)
Registered Banks	17	\$81.60	\$15.60	\$4.80	\$0.92
Non Bank Deposit Takers	70	\$0.40	\$0.07	\$0.01	\$0.00
Life Insurers	41	\$1.80	\$0.40	\$0.04	\$0.01
Trustee Cos.	3256 "Services to Finance and Investment" companies.	\$2.20	\$0.14	N/A	N/A
Other Financial Institutions		\$9.80	\$4.10	N/A	N/A
Casinos	6	\$1.50	\$0.90	\$0.25	\$0.15
Total		\$97.30	\$21.21		

Of the affected sectors, the banking sector is expected to bear 84% of the start-up cost, and 74% of the ongoing costs, mainly because this sector undertakes the bulk of the transactional activity in the economy. The median estimate of the ongoing cost to the banking sector is 0.12% of gross revenue per year.

The banking sector is expected to have lower per transaction costs than other sectors, given economies of scale considerations, it having existing responsibilities under the Financial Transactions Reporting Act 1996 (which is based on earlier FATF recommendations) and that a number of the banks are headquartered in jurisdictions that have already updated their AML/CFT laws to fully meet FATF requirements. The ability to leverage a fully developed parent AML/CFT programme is often one of the single biggest catalysts to reducing costs and ensuring timeliness of programme completion.

Across most sectors, account and transaction monitoring and AML/CFT compliance programmes are expected to account for around 90% of start-up costs and 80% of ongoing costs. However, again given the varying transactional environments and readiness of existing systems and capabilities, the sectors will bear costs differently across the various elements of the proposed regime, as illustrated in the below table.

Estimate of Compliance burdens across AML/CFT obligations by sector								
	Customer I.D.		Account & Transaction Monitoring		Record Keeping		AML Programmes	
	Start-up Total	Ongoing)	Start-up Total	Ongoing	Start-up Total	Ongoing	Start-up Total	Ongoing
Registered Banks	5%	5%	71%	69%	-	7%	24%	19%
Non Bank Deposit Takers	0%	-	18%	29%	-	-	75%	71%
Life Insurers	0%	-	89%	75%	-	-	9%	25%
Trustee Cos.	-	-	1%	-	-	50%	77%	50%
Other Financial Institutions	-	-	-	1%	16%	4%	84%	71%
Casinos	40%	44%	13%	1%	-	1%	47%	56%

2. Costs to the Crown of new regulatory functions:

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- monitoring and supervising reporting entities, as entities are not currently supervised in New Zealand for compliance with all AML/CFT requirements. The costs of supervision will be spread across the Securities Commission, the Reserve Bank and the Department of Internal Affairs and will include the costs of performing each of the following functions:
 - issuing guidelines to assist reporting entities to meet their obligations;
 - conducting onsite visits, or commissioning expert third parties to do so;
 - providing feedback to reporting entities on their compliance; and
 - taking actions, including enforcement actions, to effect compliance.
- assessing money laundering risks at national and sector levels, because this assessment is necessary for risk based implementation of regulatory requirements and is not currently undertaken;
- analysing an increased volume and variety of Suspicious Transaction Reports (STRs) – because more entities will be required to file suspicious transaction reports, and because all entities will be supervised and monitored in their filing of suspicious transaction reports; and
- ensuring adequate coordination of regulatory functions across multiple supervisors, the FIU and other agencies performing AML/CFT regulatory functions, so as to ensure an effective and efficient approach to regulation.

The benefits of implementing the proposed reform are expected to include (once fully implemented):

- i. greater ability of law enforcement agencies to detect, investigate, prosecute and recover the proceeds of serious crime. Through firms having more systematic and robust risk identification and reporting, the reporting of suspicious transaction activity is expected to increase by between 232% (based on UK's experience in enacting similar legislation) and 350% (based on Australia's experience in enacting similar legislation).
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- ii. deterrence of serious crime, tax evasion and the facilitation of terrorism, to the extent that the reform makes the laundering of proceeds of crime and terrorism financing more difficult and costly, and impacts the "returns to crime" and the capacity to reinvest in further criminal activity. This includes transnational organised crime and international tax evasion, which is expected to become more rather than less prevalent overtime given the globalisation of goods, capital and people is anticipated to grow, rather than shrink. Evidence suggests that robust AML/CFT regimes reduce crime through detection and deterrence mechanisms. A value to this particular benefit is difficult to quantify, *[information deleted in order to maintain the effective conduct of public affairs through the free and frank expression of opinions between officials and Ministers]*
- iii. better compliance with our international obligations, which in turn contributes to New Zealand's good name and our trade, foreign direct investment and borrowing interests in the medium term (particularly important goals in the present context of international capital constraints).
- iv. improved efficiency in the economy through improving market integrity, business and industry reputations, reducing costs to law-abiding businesses and citizens from being exploited and defrauded by criminal interests, and the diversion of resources to uses

that would not otherwise be chosen other than for the objective of obscuring criminal offending.

- v. improved risk management in New Zealand businesses and industries, with the result of increased fraud detection and deterrence, better bad debt management, and improved domestic investor confidence (particularly important goals in the present context of revelations of financial fraud). International experience suggests that, despite increased compliance costs, firms regard the regulatory burden as acceptable given the benefits in terms of protecting the integrity of their firms. For example, good risk assessment, customer due diligence and monitoring measures are important from a wider prudential management perspective. Without such measures, financial institutions can become subject to reputation, credit, operational and legal risks, which can result in significant costs;
- vi. improved competitiveness for New Zealand based businesses dealing internationally due to reduced risk premium and transaction costs ascribed to those businesses.

The benefits of the proposed reform are considered to outweigh the costs of its implementation.

The reform is estimated to entail a significant net direct quantifiable cost across industry and government in each of the two establishment years of approximately *[information deleted in order to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials]* per year. However, while difficult to quantify, the benefits of introducing and passing legislation in 2009 are substantial, particularly in terms of protecting New Zealand's international reputation and associated medium term trade and other economic objectives.

In year three when the reform takes effect, while the net quantifiable benefit of the proposed reform could range substantially (between a net cost of \$17 million and a net benefit of \$59 million per year), overall, the benefit of progressing the reform is considered to be substantial to the national interest. The benefits of the reform, particularly in maintaining New Zealand's international reputation and the flow-on benefits associated with this, while at this point are unquantified, are considered substantial and justify progressing the proposed reform.

STEPS TAKEN TO MINIMISE COMPLIANCE COSTS

A number of countries have implemented AML/CFT reforms in recent years to comply with the revised FATF Recommendations, and have incurred costs in doing so as there is limited scope for discretion in the FATF Recommendations. Recognising the limited discretion available in complying with the Recommendations, the proposal will minimise compliance costs by way of an approach that provides for:

- a phased implementation, in which financial institutions and casinos are covered by the reform in the first period, whereas certain non-financial institutions (such as the Racing Board and dealers in precious metals and stones) and designated professions (such as lawyers and real estate agents) would be covered in a second phase of reform. These latter groups will be the subject of subsequent Cabinet approval and amendment to the regime and will therefore have a longer period to prepare for new AML/CFT requirements;
- the establishment of a supervision framework comprising multiple existing regulatory agencies (as opposed to a new dedicated agency), that have existing comparable responsibilities and existing relationships with industry sectors for which they will be responsible for AML/CFT. This benefits industry, by minimising duplication of reporting measures, and ensuring the development of regulation that has benefited from familiarity with sector specific operating environments, and government, by enabling a single agency to undertake multiple functions in relation to a reporting entity or sector.
- following from the above point, to ensure that a coordinated approach to supervision and regulation is taken, a robust governance arrangement is proposed, comprising of a

legislated operational coordination committee, and strategic oversight and monitoring being coordinated by the Ministry of Justice;

- a risk based approach to implementation, so that the resources of reporting entities and supervisors can be concentrated on higher risk situations and saved in lower risk situations;
- based on the proposed risk assessment exercise, identification of areas where it might be justifiable for New Zealand to aim for a lower cost approach to some low risk activities and customer types; and
- collaboration with industry on developing detailed regulatory provisions.

IMPLEMENTATION AND REVIEW

Provided the proposed legislative reform receives assent by October 2009, the new regulatory regime would be brought into force 2 years after legislation is passed. The 2 year lead time is to provide for:

- supervisors and other agencies to increase their capacities and capabilities to undertake additional AML/CFT functions;
- the Ministry of Justice, in consultation with supervisors, the FIU and other agencies to finalise any necessary regulations;
- supervisors and other agencies to develop guidance materials (enforceable and non-enforceable) and to work with reporting entities so that all are aware of their AML/CFT regulatory obligations and of what they must do to achieve compliance; and
- reporting entities to make necessary adjustments and additions to their internal systems and procedures so that they are able to achieve compliance.

A phased approach is also provided for implementation, whereby the regulatory requirements will initially apply to financial institutions and casinos, with a second phase of businesses being brought under the regime at a later date. This will initially mean that New Zealand will not be compliant with FATF Recommendations with respect to these entities.

The Ministry of Justice will monitor and evaluate the overall performance and effectiveness of the new regulatory system, and advise the Minister of Justice on any issues with its performance and options for addressing any such issues.

CONSULTATION

The proposals for a new AML/CFT regulatory system were developed in consultation with the Ministry of Economic Development, the Department of Internal Affairs, the Financial Intelligence Unit of the New Zealand Police, the Customs Service, the Inland Revenue Department, the State Services Commission, the Treasury, the Ministry of Foreign Affairs and Trade, the Reserve Bank of New Zealand and the Securities Commission. The Department of the Prime Minister and Cabinet has been informed of the proposals.

Financial services providers and members of the public were consulted on the proposals as they were developed. Five consultation documents have been issued for public comment:

- “Money Laundering and New Zealand’s Compliance with FATF Recommendations” released in August 2005;
- a second document entitled “Anti Money Laundering and Countering the Financing of Terrorism: New Zealand’s Compliance with FATF Recommendations” released in June 2006
- a third discussion document entitled “Anti Money Laundering and Countering the Financing of Terrorism Supervisory Framework” released in October 2006;

Submissions from around 30 mainly financial institutions and their representatives were received on each of consultations and incorporated into the policy development. Submitters

were also provided with the opportunity to comment on officials' consideration of their submissions and regular meetings were held with businesses and industry associations during the different phases of consultation and policy development.

Key issues raised by submitters included:

- supervisory framework – While some indicated support for a single supervisor on the basis of consistency and effectiveness, the majority favoured the multi supervisor model to minimise compliance associated with duplication of reporting measures. The proposal seeks to manage disadvantages of a multi-supervisory model through the establishment of a National Coordination Committee to manage operational coordination of the regime, and the provision of mechanisms to designate responsibility where multi-supervisory responsibilities become apparent;
- that the framework be appropriate to New Zealand's broader financial framework, and compatible with international AML/CFT frameworks (particularly that of Australia). These objectives have been key criteria guiding the policy development.
- support for a risk based approach, provided the approach is supported by regulators with appropriate expectations and guidance provided, particularly for small and medium enterprises. Regulators would inform and provide feedback to businesses about the risk environment, and regulatory expectations. The proposed legislation also provides for the establishment of codes of practice setting out good practice interpretation of legislative requirements. A key goal for the codes is to provide regulatory certainty to reporting entities in areas where uncertainty exists. Codes would provide a legal defence against prosecution but would not be mandatory; reporting entities would have the flexibility to either follow a relevant code or develop their own AML/CFT programme as per their statutory responsibilities.

In addition, in response to requests from submitters:

- an independent compliance cost estimation was undertaken in 2008 to assess the start-up and ongoing costs across affected sectors (discussed in the cost benefit section above) and
- a draft Bill setting out key elements of the proposal was released in October 2008 for comment.

Feedback on the compliance cost estimation and exposure draft of legislation has been incorporated into the development of the policy proposal.