

August 2022

Practical regulatory steps for challenger banks

Introduction

Earlier this year, the FCA published its findings of a review it conducted in 2021 of the financial crime controls of six challenger banks, constituting a sample of firms that are relatively new to the market and offer a quick and easy application process for opening an account.¹ While not focused on challenger banks, a recent FCA Final Notice also addressed financial crime issues.²

As observed by the FCA, while there is no universally agreed definition of challenger banks, they "*aim to reduce the market concentration of traditional high street banks through the use of technology and more up to date IT systems*".³ Their increasing popularity and use has been a clear trend in the banking sector in recent years.

The FCA's review was prompted by the UK's 2020 National Risk Assessment of money laundering and terrorist financing (the "**NRA**"), which raised the concern that criminals may be attracted to the fast onboarding process that challenger banks advertise, and that opening accounts quickly could result in insufficient information being gathered to identify high risk customers.

However, while this marks challenger banks as different from other banks, the FCA's review found that there are "*limited differences in the inherent financial crime risks faced by challenger banks, compared with traditional retail banks*", such that the expected levels of controls should be comparable.⁴ The FCA acknowledged that the NRA had previously highlighted that many challenger banks depend on rapid customer growth for survival but stressed that this must not come at the detriment to such banks meeting their regulatory obligations.

In short, while increased competition in the market can be a force for good and customers may welcome a more streamlined onboarding process, the FCA is clearly concerned with the risk of challenger banks cutting corners in their quest for increased market share and will not hesitate to use the range of regulatory tools available to it to mitigate such risk.



¹ [Financial crime controls at challenger banks | FCA](#)

² Final Notice – JLT Specialty Limited (16 June 2022), addressing anti-bribery and corruption systems and controls failings - [Final Notice 2022: JLT Specialty Limited \(fca.org.uk\)](#)

³ National Risk Assessment of money laundering and terrorist financing 2020 – page 55, footnote 1 - [NRA 2020 v1.2 FOR PUBLICATION.pdf \(publishing.service.gov.uk\)](#)

⁴ Indeed, the FCA recently fined Ghana International Bank £5,829,900 for poor anti-money laundering controls over its correspondent banking services to overseas banks - [Decision Notice 2022: Ghana International Bank Plc \(fca.org.uk\)](#)

The FCA's ongoing focus on this area serves as a warning to challenger banks to assess and, where appropriate, improve their financial crime controls on an ongoing basis to ensure they remain fit for purpose as their businesses develop and grow.

The FCA's key findings

The FCA's review covered the following areas: governance and management information; policies and procedures; risk assessments; identification of high risk / sanctioned individuals or entities; due diligence and ongoing monitoring; and communication, training and awareness. The FCA identified seven core areas which require improvement:

1

Customer risk assessment (CRA)

Certain challenger banks' CRA frameworks were not well developed and lacked sufficient detail. Others *"did not even have a customer risk assessment in place"*. In the absence of adequate (or indeed any) CRAs, the FCA commented that it is not possible to ensure that due diligence measures and ongoing monitoring are effective and proportionate to the risks posed by customers.

2

Customer due diligence (CDD)

Most challenger banks did not obtain full customer information (e.g. income and occupation details) to determine their customer's risk, meaning they were unable sufficiently to assess the purpose and intended nature of the customer's relationship with them. Further, some banks failed to have the required CDD procedures at the customer on-boarding stage, instead relying on their transaction monitoring systems to identify high risk customers.

3

Enhanced due diligence (EDD)

Certain challenger banks did not consistently apply EDD nor document it as a formal procedure to apply in higher risk circumstances, for example when managing politically exposed persons (PEPs), meaning they did not have the capability to identify customers that may present a high risk of money laundering.

4

Financial crime change programmes

Certain challenger banks had weaknesses in the management of financial crime change programmes, which included inadequate oversight and a lack of pace in implementation, meaning their control frameworks were not able to keep up with the changes to their business models (brought about, in part, by substantial growth in recent years).

5

Ineffective transaction monitoring alert management

The FCA identified inadequate handling of transaction monitoring alerts, which included inconsistent and inadequate rationale for discounting alerts by alert handlers and a lack of basic information recording in their investigation notes. Further, and as a result of inadequate resourcing, transaction monitoring alerts were not always reviewed in a timely manner, affecting banks' ability to submit Suspicious Activity Reports ("**SAR**") on a timely basis.

6

SAR submissions

In addition to its concerns regarding delays in the submission of SARs, the FCA stressed the need for improvement in the quality of those submitted. Further, the FCA observed that the NCA had noted a substantial increase in the volume of SARs reported by challenger banks when exiting customers that did not fit their documented risk appetite, raising concerns about the adequacy of the banks' CDD and EDD checks when onboarding these customers.

7

Principle 11 Notifications

There were found to be instances where challenger banks failed to notify the FCA of significant financial crime control failures. In one example, the internal audit team in one of the banks had identified that several areas of the bank's financial control framework were not fully compliant with the MLRs.

Lastly, the FCA pointedly noted that its review predated the significant expansion of sanctions in Russia. With this in mind, the FCA urged challenger banks to ensure that their "*customer risk assessment and EDD measures adapt to the heightened risk of sanctions evasion, including but not limited to the identification of ultimate beneficial ownership in higher risk corporate structures.*"

While the FCA commented in its review that the main controls it assessed equally apply to firms' management of sanctions, we would caution challenger banks not to proceed on the assumption that compliance with anti-money laundering obligations would necessarily meet their requirements to identify their sanctions exposure. They are similar but not coterminous. Indeed, the FCA itself has commented elsewhere that "*standard anti-money laundering checks do not screen clients against the OFSI's Consolidated List. Firms should not confuse the Government's financial sanctions regime with anti-money laundering procedure.*"⁵

Meeting the FCA's expectations

The FCA stressed the need for challenger banks to monitor continuously and to develop their defences and controls in a manner commensurate with their own growth. With this warning shot fired, both the FCA and PRA can be expected to take an increasingly hawkish approach to firms with a disproportionate focus on growth, to the detriment of their systems and controls.

It is trite to observe that there is no ready-made, instant solution to bringing controls up to standard; much will depend on the risk profile of the particular bank. That said, the FCA clearly set out its expectations of challenger banks in respect of each of the core areas referred to above:

- They must have in place **systems and controls to identify, assess, monitor and manage money laundering risk**, and these must be proportionate to the nature, scale and complexity of their activities. These systems must be able to create an audit trail to evidence their existence, including a risk assessment on which the systems and controls are built (with a clear route from each risk to each relevant control).
- They must **keep their customer risk assessment framework updated** so it reflects any changes to their business model and products. This framework needs to be mapped to the overall risk profile of the bank and have clear criteria for the allocation of risk profiles.
- They are expected to ensure that they **identify and collect the relevant information needed to have a complete picture of all the financial crime risks associated with individual customer relationships**, thereby managing potential risk indicators and providing a meaningful basis for subsequent monitoring. Of all the requirements, this is likely to require significant resource allocation.
- While managing financial crime change programmes, they should **have clear project plans for control enhancement outlining key milestones, accountable executives and delivery dates**. Importantly, the FCA stressed the need for senior management to take responsibility for tracking projects and ensuring deadlines are met. The CEO, risk committee and audit committee are also expected to be involved in overseeing material developments to these programmes, helping to ensure that appropriate governance and challenge takes place.
- They must have **adequate resources in place to consider customers' activities holistically** as part of their review of transaction monitoring alerts, and this should include reviewing previous alerts and existing information collected about the customer such as their income and the reasons for the account being opened.
- Firms should **refer to the appropriate UK Financial Intelligence Unit (part of the NCA) publications when making a SAR** in conjunction with guidance issued by the JMSLG and the FCA's Financial Crime Guide. They should also consider their obligations for customer safeguarding through more appropriate channels, such as Action Fraud.

⁵ [Financial Sanctions | FCA](#)

In addition to existing guidance in the FCA's Financial Crime Guide, notably on anti-money laundering issues, lessons can be learned from what the FCA identified as examples of good practice during the review:

Tailored financial crime policies and procedures	Innovative use of technology	Mitigation fraud risk
<p>Examples of certain banks adopting stand-alone financial crime policies and procedures which were regularly updated and tailored to the financial crime risks to which that business could give rise. It is therefore key for banks first to identify and measure the challenges and risks facing the business in order to understand what proportionate steps need to be taken to protect the bank and, more importantly, its customers.</p>	<p>As observed in the NRA, given the growing use of online banking, banks are increasingly reliant on technology to detect criminal activity as face-to-face contact with trained staff declines. Technological investment is therefore increasingly relevant, and the FCA's findings make reference to the effective and innovative uses of data and information which challenger banks collected to mitigate risks. There included non-traditional approaches to identify, verify and monitor customers, including video selfies, mobile phone geolocation data and photo images of customers' passports.</p>	<p>Some banks mitigated such risk by incorporating additional monitoring for known fraud typologies at onboarding and as part of account monitoring. This included checks on customers using multiple devices to manage their accounts.</p>

Concluding remarks

The FCA's words of warning to challenger banks have not come out the blue. It is a consistent message across the industry and one to which it is crucial for challenger banks to pay close attention, reviewing the FCA's findings and evaluating their systems and controls on an ongoing basis so as to ensure they remain fit for purpose as their businesses develop and grow.

Regulatory intervention is a likely outcome of failure to address such matters. Monzo Bank Limited, for example, disclosed in its 2021 annual report that the FCA had commenced an investigation in May 2021 into the bank's *"compliance with the Money Laundering Regulations 2017, potential breaches of some of the FCA Principles for Businesses and related FCA rules for anti-money laundering and financial crime systems and controls between 1 October 2018 to 30 April 2021."*⁶

Further, while the FCA's review was concerned with challenger banks' financial crime controls, it goes without saying that both it and the PRA will take a dim view of any systems and controls deficiencies brought about by an expansive strategy (or otherwise). This proved to be the case with Metro Bank plc in December 2021, which received a fine of £7,680,000 from the PRA after failing to ensure the commensurate development of, and investment in, governance arrangements and systems and controls relating to its COREP reporting, which it failed to design, implement or operate effectively in a number of ways.⁷

Our regulatory and financial crime team has extensive experience of advising clients on regulatory compliance challenges (and the investigations which can flow from them) and would be happy to answer any questions you may have in respect of the FCA's review or indeed any aspects of AML systems and controls.

⁶ Note 25, page 142 - [monzo-annual-report-2021.pdf](#)

⁷ [Final notice - Metro Bank plc \(bankofengland.co.uk\)](#)

Contact us



Justin McClelland

Partner

T: +44 20 7809 2127

E: justin.mcclelland@shlegal.com



Alex Logier

Managing associate

T: +44 20 7809 2652

E: alex.logier@shlegal.com

Stephenson Harwood is a law firm with over 1100 people worldwide, including more than 190 partners. Our people are committed to achieving the goals of our clients - listed and private companies, institutions and individuals.

We assemble teams of bright thinkers to match our clients' needs and give the right advice from the right person at the right time. Dedicating the highest calibre of legal talent to overcome the most complex issues, we deliver pragmatic, expert advice that is set squarely in the real world.

Our headquarters are in London, with eight offices across Asia, Europe and the Middle East. In addition we have forged close ties with other high quality law firms and an integrated local law capability in Singapore and the PRC. This diverse mix of expertise and culture results in a combination of deep local insight and the capability to provide a seamless international service.