Generating a dynamic customer risk-rating

Background
Assessing customer risk and assigning risk scores to your customer portfolio are rapidly becoming requirements at most financial institutions. As a result, a key issue has become the practicality of implementing such procedures. Is there a practical and cost-effective way to generate a risk score for each customer — one that changes dynamically with changes in customer characteristics and transaction behavior?

The Federal Financial Institutions Examination Council Bank Secrecy Act Anti-Money Laundering (BSA/AML) Examination Manual, issued in June 2005, contains two separate indices that provide topical guidance on risk-rating customers:

- Appendix I: Risk Assessment Link to the BSA/AML Compliance Program
- Appendix K: Customer Risk Versus Due Diligence and Suspicious Activity Monitoring

An institution’s AML specialist is a pivotal player in originating, maintaining and strategically utilizing risk ratings for compliance and operational purposes.

Current challenges
Current methods of implementing this requirement remain problematic for several reasons:

- New customers are interviewed with a series of questions and answers. A score is produced reflecting potential risks that customer poses, before any transactions have been performed. The sophistication of these processes and systems varies widely between institutions, but certainly integrating risk assessments with customer origination systems can be daunting.
- What happens to existing customers who were not interviewed during the origination process? A large majority of the customer base has no risk scores. Again, it’s a daunting operational task to reach out to existing customers, one that is normally taken only if a customer shows significant risk.
- What happens to this risk score after the customer completes the institution’s original Customer Identification Program /Know Your Customer CIP/KYC process? It may get stale, since the customer’s situation may change with time.
- Perhaps the greatest challenge is seamlessly integrating risk requirements into a customer acquisition process that is focused on selling products and services. An overly aggressive inaugural interview can be a sales deterrent during the origination process at the branch (brick & mortar or Internet) level.

The goal
Most institutions are in search of a “magic bullet,” a process that automatically generates customer risk scores — daily, accurately and without significant impact on operations. This updated fluid risk score is vital that risk rating/scores be used operationally across all organizational silos and in all risk mitigation functions.
becomes a risk mitigation/compliance asset by offering a valid snapshot of each and every customer.

**The holistic customer risk score**

It is vital that risk rating/scores be used operationally across all organizational silos and in all risk mitigation functions. A “holistic cultural approach” can be beneficial, resulting in both compliance and fraud detection enhancements. Simultaneously, the risk score provides a benchmark for service and business functions to use as they move forward on business plan rollouts.

A holistic customer risk score contains two types of risk categories:

**Static risk attributes:** These attributes describe the customer entity Customer Identification Program, Customer Due Diligence, Enhanced Due Diligence, Know Your Customer (CIP/CDD/EDD/KYC) and do not change frequently. More important, they are contained in virtually every core processing system as part of normal customer information, and reflect current changes. By risk-rating specific values of these fields, this data can be valuable. For example:

- Is the customer entity a business or a person?
- NAICS code: What type of business is this entity?
- ZIP code or Census Tract: geographic risk indicators
  - Does the customer exist within a High-Intensity Drug Trafficking Areas (HIDTA) and High Intensity Money Laundering and Related Financial Crime Areas (HIFCA) zones?
  - Distance risk: How far from the bank does the customer live/work?
- Is the customer a foreign national?
- What country does the customer reside/work in?
  - Country risk
  - Customer open date: How long has this entity been a customer at the institution?
    - New customer risk
- What products does this customer use at the institution?
  - Product risk
- Is the customer an employee?
- CIP score
  - The CIP risk assigned at origination
- Is the customer on any lists?
  - Politically Exposed Person (PEP)
  - Your own hot list
- Is the customer part of a Select Employee Group (credit unions)?

**Transaction risk attributes:** These reflect patterns of actual risky transaction behavior. They change on a daily basis and vary according to the risk profile of the financial institution. Transaction-based alerts should be generated by transaction monitoring systems. These systems should be a combination of computer software and employee review. The following are examples of conditions that may be monitored and risk-rated:

- Cash structuring alerts
- Terrorist financing pattern alerts
- Large wire monitor from high-risk countries
- Actual behavior exceeds expected behavior for risky transaction categories
- Risk-rating of alert based on subject sensitivity.
  - For example, an alert that has not been investigated would be of higher risk than one that was investigated and cleared, but lower than an alert being considered for a Suspicious Activity Report (SAR).
- Number and severity of past alerts for a customer
- Number of SARs filed in the past for a customer
- Number of manual SARs filed in the past for a customer

**Dynamic risk rating**

If the static and transaction risk scores are calculated every day the resulting combined scores reflect a valid dynamic risk value. This dynamic customer risk rating accurately reflects the current condition of each customer. When used in combination with other AML analysis tasks and BSA compliance practices this dynamic risk score becomes a valuable asset for the AML specialist or BSA officer.

Dynamic risk scores can be used to:

- Risk-value alerts and the order in which they are investigated
- Segment the customer database to select and analyze the high-risk customer’s transaction activity
- Review and log comments on the highest risk customers: Enhanced Due Diligence
- Support cross functional risk abatement efforts
- Review and update KYC and CIP efforts and data
- Provide a foundation for decision-making on a case-by-case basis for investigative and compliance efforts
- Provide support and analysis data for the institution’s business practices

**Conclusion**

There is tremendous value in a financial institution’s current data, and when leveraged that data can be a key factor in automating the risk assignment process — practically and cost-effectively. Once a financial institution or organization establishes such a process, the challenges of BSA compliance, money laundering detection and fraud mitigation become more manageable.

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