A shot across the bows

The Central Bank warns of severe consequences for 'Schedule 2 firms' which are AML non-compliant

In December 2020 the Central Bank of Ireland published its latest 'Dear CEO' letter. The Central Bank wrote to CEOs of 'Schedule 2 firms', such as certain aircraft lessors, which are obliged to register with the Central Bank for anti-money laundering/counter-terrorist financing (**AML/CFT**) purposes (**Schedule 2 Firms**). The Dear CEO letter communicates failings identified by the Central Bank in its recent supervisory engagements with Schedule 2 Firms. It articulates the Central Bank's expectations for the AML/CFT frameworks that such firms should adopt. The message conveyed is simple and powerful: improve your AML compliance or face administrative sanctions.

Schedule 2 Firms should carefully consider the Dear CEO letter and implement changes required to bring their AML/CFT frameworks into conformity with the Central Bank's expectations and their legal obligations. Furthermore, though addressed to Schedule 2 Firms, many aspects of the Dear CEO letter are of more general application for all regulated financial service providers subject to AML/CFT compliance obligations under the Criminal Justice (Money Laundering and Terrorist Financing) Act 2010 (**the 2010 Act**).

The Central Bank's expectations for Schedule 2 Firms are clear. However, identifying precisely which businesses qualify as Schedule 2 Firms is less straightforward.

We examine below which businesses are Schedule 2 Firms and what they need to do/know about their AML obligations.

Is your business a Schedule 2 Firm?

Schedule 2 Firms are '*designated persons*' that are deemed to be 'financial institutions' by virtue of engaging in certain of the activities listed in Schedule 2 of the 2010 Act and which are not otherwise authorised or licenced to carry on business by, or otherwise registered with, the Central Bank. Historically these entities were captured by the obligations under Part 4 of the 2010 Act and, in theory at least, subject to supervision by the Central Bank. However, in practice, the Central Bank had no way of identifying them for the purpose of supervision. The requirement to register as a Schedule 2 Firm was therefore designed to address this issue, and provide the Central Bank with visibility of the Schedule 2 Firms it was responsible for supervising. Registration does not, however, change those entities' AML/CFT obligations under the 2010 Act.

There are 13 Schedule 2 activities, including:[1]

a. Lending;
b. Financial leasing;
c. Payment services;
d. Guarantees and commitments; and
e. Trading for own account or for account of customers in any of money market instruments, foreign exchange, financial futures and options, exchange and interest rate instruments or transferable securities.

Schedule 2 Firms are common in the aviation finance and aviation leasing industry, as many operators in this sector routinely engage in Schedule 2 activities, like lending and financial leasing, but are not otherwise regulated by the Central Bank.

[1] The full list of in-scope activities is available here

Since 26 November 2018 there has been an additional requirement for Schedule 2 Firms to register with the Central Bank and promptly update the Central Bank of any post-registration changes to their Schedule 2 activities. Those who do register can expect significant AML supervisory engagement with the CBI. Non-compliance with the registration requirement is an offence.

However, there are a few carve-outs which complicate the issue of precisely which businesses qualify as Schedule 2 Firms:

A. First, your business will not be a Schedule 2 Firm:

1. **If cumulatively:**

Your firm only carries out trading for own account or for account of customers in certain financial instruments); and

Your firm's customers (if any) are members of the same group as your firm.

Or

2. **If cumulatively:**

- Your firm's annual turnover is less than €70,000, and
- The total of any single transaction, or series of linked transactions, in relation to your firm's Schedule 2 activities does not exceed €1,000, and
- Your firm's Schedule 2 activities do not exceed 5% of your firm's total turnover, and
- Your firm's Schedule 2 activities are directly related to and ancillary to your firm's main business activities, and
- Your firm only provides Schedule 2 activities to customers of its main business activities, rather than to the public in general.

B. Second, only firms *not otherwise registered* with the Central Bank are obliged to register for Schedule 2 purposes. In practice this means that a business which is registered with the Central Bank for other purposes – even purposes that do not trigger AML compliance obligations – and that carries out Schedule 2 activities, may not have to register with the Central Bank for AML purposes. In this scenario, that business would be subject to exactly the same AML obligations as any other 'designated person'. However, in practice Central Bank scrutiny of its AML compliance would be less likely if it has not registered with the Central Bank for Schedule 2 purposes; a curious and perhaps unintended feature of the legislation.

C. Third, AML/CFT obligations only attach to designated persons, whether Schedule 2 Firms or otherwise, where a business conducts its in-scope activities "*in the course of business carried on… in the State*".[2] In the absence of any official guidance on the point, "*in the course of business*" could be interpreted as meaning 'for commercial purposes' and may therefore exempt entities that engage in Schedule 2 activities in certain purely intra-group, non-commercial contexts. It is doubtful that the Oireachtas intended every subsidiary engaging in intra-group lending, even on non-commercial terms, to be caught by the AML compliance net. What would be the point in such subsidiaries conducting identification and verification checks on each other or monitoring each other's behaviour?

Nonetheless, it should be remembered that the obligation on Schedule 2 Firms to comply with the 2010 Act is not new. Furthermore, the requirement to register with the Central Bank has not fundamentally changed the application of the 2010 Act in terms of who is captured as a designated person. Accordingly, if an entity was not considered to be a designated person before the requirement to register (e.g. for intra-group lending) this analysis is not changed simply by virtue of the requirement to register.

It should also be borne in mind that if an entity registers as a Schedule 2 Firm, this is effectively an acknowledgement that the entity is a designated person under the 2010 Act and should be complying with all of the requirements under Part 4 of the Act in respect of AML/CFT. Defensive registration, for the avoidance of doubt, therefore should not be carried out without also putting in place the full suite of internal policies, procedures, corporate governance arrangements and personnel required to comply with the 2010 Act, which will have significant consequences for the firm from an operational and financial perspective.

[2] Section 25(1) of the 2010 Act

The Central Bank's warning shot

As noted, while Schedule 2 Firms' AML/CFT obligations have been in force in various guises since 2010, the new registration requirement now allows the Central Bank to monitor Schedule 2 Firms' compliance with their obligations. The Central Bank has commenced supervising businesses that, until-recently, had in practice gone largely unsupervised for AML purposes.

What emerges clearly from this activity by the Central Bank, as articulated in the Dear CEO letter, is that overall compliance among Schedule 2 Firms is poor. Indeed, the Central Bank noted that many firms were unaware that the 2010 Act applied to them prior to registering and that AML/CFT was only discussed at Board level after notification of the Central Bank's intended engagement for the majority of firms subject to supervisory engagement.

Against this backdrop, the Dear CEO letter is an important statement of intent to Schedule 2 Firms. In it the Central Bank warns that it is prepared to deploy the full range of powers available to it, including enforcement action, when faced with non-compliance. Further the Central Bank plainly states that it is "imperative" that the implications of non-compliance, namely significant criminal or administrative sanctions, are understood by the Board and senior management of Schedule 2 Firms. The Dear CEO letter also signals the Central Bank's intention to continue to conduct supervisory engagements with Schedule 2 Firms throughout 2021 and its expectation that Firms will be able to evidence having considered the contents of the Dear CEO letter.

It appears that the Central Bank's engagement with Schedule 2 Firms has to date been supervisory in nature only and has not yet been escalated to enforcement action. However, Schedule 2 Firms would be well advised to heed the Central Bank's warning.

In addition, in her statement accompanying the release of the Dear CEO letter, the Central Bank's Director of Enforcement and Anti-Money Laundering, Seána Cunningham commented that Schedule 2 Firms which fail to register are "*at risk of significant criminal and/or administrative sanctions*" and that in 2021 the Central Bank "will use all means available to identify" such firms. This indicates that the Central Bank's focus is to assess levels of AML compliance not only by Schedule 2 Firms that have registered but also by those who have not complied with their registration requirements.

Key findings and regulatory expectation

The Dear CEO letter outlines findings and expectations across seven key areas, many of which echo previous guidance and communications issued by the Central Bank. Though emphasising that it expects Schedule 2 Firms to assess their performance against all of the areas dealt with in the Dear CEO letter, the Central Bank has recommended that Schedule 2 Firms prioritise the three areas outlined below. As the findings in these areas are "the most serious in nature", the Central Bank considers that they should be considered and addressed immediately.

1. Governance and oversight

i. Board oversight: Firms could not demonstrate that AML/CFT and financial sanctions were a regular agenda item at Board meetings, as expected by the Central Bank. Many firms failed to provide any detailed reporting to their Boards in order to allow robust discussion and challenge of these matters. The Central Bank requires that a firm's Money Laundering Reporting Officer (**MLRO**) must have a direct reporting line and access to the Board to provide sufficiently detailed reports on a frequent basis.

ii. Outsourcing: Where firms had engaged in outsourcing of their day-to-day AML/CFT and financial sanctions activities to third party service providers, they were unable to demonstrate appropriate oversight of the outsourced functions. Where functions are outsourced, the Central Bank expects that firms will have written contracts/service level agreements in place clearly setting out each party's obligations, that the Board is able to demonstrate full oversight of the outsourced functions through assurance testing and that firms can evidence that they are actively monitoring the progress of any management action points arising from reviews conducted. Whilst not directly legally applicable, the European Banking Authority's Guidelines on Outsourcing provide some guidance on the matters which the Central Bank will expect to be considered and/or included in outsourcing arrangements in this regard.

iii. Clearly defined roles: Firms had not clearly defined and documented the roles and responsibilities of the Board, senior management and MLRO in respect of key elements of firms' AML/CFT and financial sanctions framework, as required by the Central Bank. In some cases, the MLRO could not demonstrate sufficient knowledge of AML/CFT and applicable legislation, resulting in non-compliance.

2. Risk assessment

i. Failure to adequately risk-assess: The majority of the firms inspected could not demonstrate that they had assessed and documented their ML/TF risks as they pertain to the firms' customers and business activities. The Central Bank expects firms to complete and document a holistic, business-wide risk assessment tailored to a firm's particular services/products, customers, jurisdictions and distribution channels, mindful of the nature, scale and complexity of the firm's business model.

ii. Outsourcing/parent entities: Firms often placed reliance on the risk assessment of an outsourced service provider without ensuring this was reflective of the risks to which the firm was exposed or relied on a risk assessment completed at parent entity level rather than considering the risk and controls at firm level. Where a firm relies on a third party or parent entity to conduct a risk assessment on its behalf, it must relate to the risk and controls associated with the firm.

iii. Approval & review: The Board's consideration and approval of a business-wide risk assessment should be formally evidenced. The risk assessment must be reviewed at least annually.

3. Customer due diligence (CDD)

i. Poor understanding: Firms displayed varying levels on understanding of CDD and in some instances applied simplified due diligence to customers deemed high risk or without ensuring the customer was low risk. Firms must ensure their CDD policies and procedures are appropriate, up-to-date and in-line with their legislative obligations.

ii. Lending: A large proportion of firms who engaged in lending where the entity was structured as a Special Purpose Entity were inconsistent in determining who was the customer of the firm for CDD purposes. The Central Bank expects firms to consider the risk relating to both the borrower and the loan noteholders funding the Special Purpose Entity and to conduct appropriate due diligence in accordance with the level of risk.

The other four areas addressed in the Dear CEO letter are PEPs & financial sanctions, suspicious transaction reporting, policies & procedures and training. According to the Central Bank, the findings in these areas should be considered and an action plan should be put in place to fully address any deficiencies identified in a timely manner.

Full details are available here.

What should you do?

Schedule 2 Firms should:

- Ensure that you are registered with the Central Bank if you are a designated person conducting any Schedule 2 activities outside of the stated exemptions and that your registration information remains accurate and up-to-date;
- Review your AML/CFT framework to assess if any of the weaknesses identified by the Central Bank apply to you;
- Put in place an action plan to address any shortcomings identified or enhancements required;
- Follow the Central Bank's lead by ensuring that you address any shortcomings you identify in relation to governance and oversight, risk assessment and CDD as the matters of greatest priority;
- Ensure that your assessment of the findings in the Dear CEO letter is considered at Board level and that any remedial action required is brought to the attention of the Board. This should be a standing agenda item until all action points are completed; and
- Ensure that this Board oversight is appropriately documented in order that it can be evidenced if your firm becomes subject to Central Bank scrutiny.

Legal basis for administrative sanctions

The Central Bank Act 1942 authorises the Central Bank to apply its administrative sanctions procedure to "*regulated financial service providers*". This includes those whose business is regulated by the Central Bank under certain prescribed legislation, such as the 2010 Act. However, Schedule 2 Firms are – by definition – neither authorised nor licenced by the Central Bank. So are they '*regulated financial service providers*'?

Plans are afoot to address this issue going forward in the Criminal Justice (Money Laundering and Terrorist Financing) (Amendment) Bill 2020, which could become law in the coming weeks. In the meantime, and even though this amendment will not be retrospective, the prudent course for Schedule 2 Firms is to assume that they may currently be or, in any event, soon will be amenable to administrative sanctions.

Key contacts

Kenan Furlong
Partner
+353 1 649 2260
kfurlong@algoodbody.com

Dario Dagostino
Partner
+353 1 649 2308
ddagostino@algoodbody.com

Chris Martin
Associate
+353 1 649 62604
cdmartin@algoodbody.com

Eva Morris
Associate
+353 1 649 2247
emorris@algoodbody.com

Clara Gleeson
Solicitor
+353 1 649 2746
cgleeson@algoodbody.com