Stage 1 Cost Recovery Impact Statement

Levy proposal for the part-funding of the Anti-Money Laundering (AML) and Countering Financing of Terrorism (CFT) system. This CRIS should be read in conjunction with the Regulatory Impact Statement (RIS) for the AML/CFT Funding Model (Funding Model RIS).

Status quo

The purpose of regulating AML/CFT

The purpose of AML/CFT intelligence gathering and supervision is to reduce the occurrence of money laundering and increase the probability of detection where it is still attempted. Where detected, appropriate investigation and enforcement occurs to punish offenders and deter future attempts to money launder.

The outcome sought is an effective and efficient AML/CFT regulatory system, which takes a national risk-based approach and gives effect to our international obligations. Regulatory activity should enhance the ability of reporting entities to comply with AML/CFT obligations and reduce compliance.

S9(2)(d)

here is a related priority of ensuring we have an efficient and effective system that is able to adapt to a changing AML/CFT environment.

Activity necessitating an AML/CFT system

The objective of the AML/CFT system is to detect and deter illegal financial flows whenever:

1. A criminal (or those under their direction) introduces funds earned through criminal activity to the financial system. **Placement**
2. A money launderer (or the criminal themselves) engages in a series of transactions to create layers between the illegal source of the cash they control. **Layering**
3. The criminal moves laundered money back into the financial system. **Integration**

Money laundering can involve layering and integration across different regulated activity types and may include international flows. The risk of a successful initial placement can be assessed and mitigated sector by sector, but organised or complex money laundering can cross various areas of regulation, making detection during the layering process difficult.

As was noted in our last National Risk Assessment[1]:

> the more layers money passes through, the harder it becomes to connect the funds to criminal activity… [i]n New Zealand layering is typically non-cash transactions..., [t]he more countries the money enters and leaves, the harder it is to uncover the 'dirty' source of the money.

For instance, the proceeds of illegal activity overseas might be placed in an offshore bank account, used to purchase real estate in New Zealand, then the proceeds of sale of the real estate are used to invest in the domestic sharemarket. Dividends might then be cashed out for various purposes or returned to the country of origin via a remittance payment.

[1] New Zealand Police Financial Intelligence Unit (2020) *National Risk Assessment of Money Laundering and Terrorism Financing*.

For the financing of terrorism, similar techniques can be used to hide the source and end use (terrorism or weapons proliferation) of the layered funds.

Why does the government need to be involved in AML/CFT?

The government is a monopoly supplier of AML/CFT investigation and enforcement - even where some of that work is contracted to third parties to undertake. Government supply is required both due to the criminal activity at issue and the sanctions available, and for international recognition to enable unhindered participation in international trade and finance.

Surveillance for AML/CFT is undertaken and directed by government, because of the nexus with criminal investigation and enforcement, government ability to operate across different entities and areas of activity, and government interests in meeting international expectations/obligations.[2]

The AML/CFT system is funded from a variety of sources and surveillance is undertaken primarily on a sector-by-sector basis. Any regulatory changes agreed by Government to improve supervisory system effectiveness and efficiency that affect levy calculations will be considered in the Stage 2 CRIS.

Current regulatory roles in the AML/CFT system

Intelligence for the AML/CFT system is gathered both sector-by-sector by supervisors, and across the economy by the New Zealand Police (Police) and its Financial Intelligence Unit.

At present, supervisory activity for sectors incurring AML/CFT obligations is spread across three entities. These supervisors are the Department of Internal Affairs (DIA), Reserve Bank of New Zealand (RBNZ), and the Financial Markets Authority (FMA).

The Ministry of Justice (MoJ) leads regulatory policy development for the AML/CFT system and has overall responsibility for system stewardship.

The FMA is majority levy-funded with supplementary Crown funding, with RBNZ funding set by agreement with the Minister of Finance, and DIA, Police, and MoJ by Crown appropriation.

Analysis in this paper provides a gross estimate of required AML/CFT funding, not a net amount deducting current funding sources. Current funding sources are described in the Funding Model RIS.

[2] Refer Supervisory Model RIS for definitions of supervisors and other regulatory roles under the AML/CFT Act.

Policy Rationale

Why a user charge?

Reporting entities facilitate the system that gives rise to negative spillovers
Law enforcement in the United Kingdom has found that "in nearly all money laundering cases, criminal money passes through the AML-regulated sector at some point to obtain legitimacy". It was considered fair that "those whose business activities are exposed to money laundering risk pay towards the costs associated with responding to and mitigating those risks".[3]

Reporting entities themselves are not the source of the underlying illegal activity, and in almost all cases try to comply with the requirements of the AML/CFT system. However, many of the positive characteristics of regulated activity, which underpin legitimate economic activity, also allow for flows of value that are either illegal in origin or intended use. Reporting entities are risk exacerbators.

The externalities created are negative for society, but where undetected allow additional profit to regulated entities (albeit an involuntary gain). Placement of illegal funds into the real estate sector provides a good example of this, as do fees and service charges for domestic and international money transfer. Advances in the digital economy will accelerate processes used for ML/TF. The negative externalities caused by ML/TF cannot be allocated to individual reporting entities.

Effective and efficient regulatory systems are an industry good
Much of the activity required of our AML/CFT system by FATF does not have direct line of sight to the use or benefit of individual reporting entities. For instance, it would be inefficient to identify the amount of regulatory 'service' an entity or group of regulated entities receives from the National Risk Assessment (NRA) or improvements to the regulatory system.

In comparable regulatory systems in New Zealand, a strong case is made for the operational costs of a well-regulated market to be recovered from the industry that benefits from it. In the AML/CFT context, regulation enables ready access to global capital markets, and for offshore banking accounts to be held by New Zealand trading entities. It is considered reasonable to recover the cost of maintaining that access for those entities (and their customers) who benefit most. Without the AML/CFT system the costs of accessing overseas markets would increase.

In setting and expanding the FMA's levy in 2021, MBIE considered supervision of the conduct of financial institutions was primarily a private rather than public benefit, noting it was a:

> [g]eneral benefit attributable to financial institutions through these entities holding conduct licences and being able to provide products and services to consumers, receiving guidance, support and engagement from the FMA. Increased consumer trust in financial institutions and reduced consumer harm as a result of the FMA's activities will result in benefits to both the industry (from confident consumers being more likely to engage with the industry and use financial products and services) and the general public (confidence in financial markets and well-functioning financial markets generally).

The same can be said of an AML/CFT system.

Why is a levy appropriate?

The AML/CFT regulatory system operates across reporting sectors

[3] HM Treasury (2020) *Economic crime levy: Funding new government action to tackle money laundering. 5.*

Our AML/CFT system will need to pass our next FATF mutual evaluation as a whole. The nature of ML/TF means that the regulatory chain for AML/CFT is only as strong as its weakest link. Identified vulnerabilities in any part of our financial system or broader economy will be taken advantage of.

Publicly stated intentions for the New Zealand financial sector and payments systems are to increase the speed and ease with which transactions can occur – both domestically and internationally – while also supporting a much larger ecosystem of value-adding services and service-providers.[4]

The Government is also focused on reducing the costs of doing business, and the digital economy is expected to play a role in this. Digital Identity and Consumer Product and Data Rights are two related programmes. Without mutual confidence in the AML/CFT system there will be duplication of due diligence and administration costs for participants in digital systems and their consumers. Much of the service provided by the AML/CFT system is therefore akin to a club good rather than being able to be attributed directly to any one type of regulated activity or reporting entity within it.[5]

As technology and regulation come to enable greater levels of domestic and international financial system integration (and a broader ecosystem of related service providers), the levels of inter-dependency will result in AML/CFT becoming even more of a club good across reporting sectors.[6]

An unclear interface between different types of regulated entities in either digital or traditional business systems can result in similar duplication and inefficiency for industry and consumers.

Fees and service charges have been looked at but are not supported for AML/CFT
Fees for the provision of individual AML/CFT services have been looked at domestically and in the United Kingdom, and initially used in Australia. An example of a fee would be for individual entities to pay the cost of any on-site activity by a regulator. Another would be a charge for the cost of any review/investigation of activity at a reporting entity by a regulator.

It was found overseas, and we consider it would be the case here, that charging fees for regulatory services unnecessarily disrupts cooperation from reporting entities and adds unnecessary complexity and uncertainty to the ongoing funding of the system. Negative incentives would also arise if there were charges for reviewing suspicious activity or transaction reports or for other regulatory interactions with/by reporting entities. The impact on small and medium enterprises (SMEs) may also outweigh benefits.

What would the levy be used for?

We intend for the levy to be non-discretionary and allow for the funding of both policy and operational activity. Operational activity would cover intelligence and surveillance activity and also include educational initiatives, the issuing of guidance, and similar industry-good activity. Transition and transformation costs would be included within scope of operational activity but may also be funded by Crown appropriation. Policy activity will have both a domestic and an international focus, ensuring the system remains fit for purpose and that we meet our international obligations.

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[4] Refer RBNZ *Future of Money*, 27 July 2023 https://www.rbnz.govt.nz/money-and-cash/future-of-money/payments; Payments NZ *Payments Direction* https://www.paymentsnz.co.nz/our-work/payments-direction/ retrieved September 2024.
[5] An example is the EU. The free movement of goods, services, and capital are nonrival in consumption but other countries are excluded from them. Adding extra countries and types of exchange increase the benefits. [Adapted from https://en.wikipedia.org/wiki/Club_good].
[6] As AML/CFT mitigation becomes increasingly digitized, it can be excludable but is non-rivalrous. People and firms can be excluded from the benefits of an AML/CFT compliant ecosystem (e.g. open banking) but their use of it does not constrain other consumers.

This is consistent with the approach to levy-setting taken for the FMA.[7]

How should the levy be set and apportioned?

Public/private split *of regulatory burden and benefit of the AML/CFT system*
As with the FMA, we expect that those parts of the AML/CFT regulatory system that cannot be attributed to negative externalities that are created or enabled by industry, or that do not confer an industry-specific benefit, will not be cost recovered. This includes prosecution and asset recovery.

We also consider there is a public good component to the national gathering of intelligence and maintaining the fitness for purpose of the AML/CFT system. This is both in terms of reducing criminal offending (and avoiding victimisation) and New Zealand playing its role as a good global citizen. There is widespread economic and public benefit from an efficient and effective system for financial transactions and the trading of goods and services.

Due to the public nature of the benefit of some AML/CFT activity, we are proposing partial cost recovery for the regulatory system rather than full cost recovery. Setting the level of public benefit in the Stage 2 CRIS will only be possible in generalised terms, as noted by MBIE:

> It is not possible to make direct and isolated correlations between the benefit derived by particular participants or the public. Indeed, unlike a fee, a levy can factor in benefits shared between groups or benefits that cannot be specifically assigned to individual groups.
>
> Accordingly, we cannot establish percentages or proportions for the level of private and public benefit. Instead, our allocations and assessment of benefit are constrained to the more general explanations.

A differentiated levy is ***equitable*** *as risks and returns across sectors vary widely*
A risk-based approach initially identifies sectors or activities of interest, then individual entities within that area of interest are assessed in more detail. It is not practical to charge individual entities for this intelligence and surveillance, but the NRA and Sector Risk Assessments (SRA) provide generic levels of risk that can help inform a levy. Both the NRA and SRAs are clear that the level of risk created by different areas of regulated activity (potential for illegal value transfer), and different types of entity within those areas, varies widely.

We therefore consider a higher levy from the sub-sectors that create the greatest negative spillovers to be appropriate. AML/CFT measures support these same entities maintain their social license to operate and benefit from efficiencies in international and domestic transactions. Revisions of the NRA and SRAs can be used to help recalibrate the levy over time.

The draft AML/CFT National Risk Assessment 2024 noted "banking is colossal in contrast to other higher-risk sectors and is complex due to its broad range of products and services". An equitable apportionment of costs to the banking sector will be considered in more detail in the Stage 2 CRIS.

The levels of financial and economic benefit also vary widely between and within classes of regulated entity/activity. Profitability and size of reporting entity is not necessarily a proxy for their creation of negative externality, or 'consumption' of regulatory services. However, this is relevant as a starting point both to the efficiency of any levy system and the equity within it. Within a sector it is also likely to be indicative of the volume of activity, and therefore AML/CFT risk, created.

This also reflects the outcome of a wider study of potential AML levy metrics in the United Kingdom:

[7] Sections 68 and 69 of the Financial Markets Authority Act 2011.

> No one metric can satisfy all the levy principles. It is therefore a case of evaluating which metric can best meet the principles while resulting in the fewest drawbacks. Against these criteria, the government currently assesses revenue as the most desirable levy base.
>
> Revenue provides proportionality as it relates to the scale of the activity undertaken and is broadly (although not entirely) approximate to a business' ability to pay. It is a metric business can readily report (for the purposes of calculating the levy), is simple and transparent, and is familiar to nearly all businesses. Using revenue would also lead to fewer unintended consequences than the other options considered, as it should not incentivise businesses to change their behaviours.[8]

*A levy differentiated by type of activity and entity is also **efficient***

We are proposing consultation on splits in the amount of levy charged similar to those set out in Table A. Overseas jurisdictions have found there to be diminishing and then negative benefits to setting very granular bands for levying reporting entities. There is a reasonable degree of overlap in the reported risk of sectors as set out in Table A and the ability of the sector to pay, so differentiation at sub-sector level seems appropriate. Smaller money remittance providers may be an exception to the link between ability to pay and risk.

A minimum size/revenue threshold is also applied in overseas jurisdictions that apply a levy - to offset undue AML/CFT compliance costs for SMEs and administration costs for collection. We consider the same approach would be justified in New Zealand.

Additional considerations will be identified through industry consultation and included in analysis for the Stage 2 CRIS. In particular, we expect that further sub-groups will be delineated based on industry feedback in the accounting, legal, real estate, and payments sectors.

The proposed levy will provide incentives for both the regulator and regulated entities to streamline and integrate AML/CFT activity within and across different sectors. Further, incentives will improve within a sector as the levy set is differentiated by sub-groupings of regulated activity and based on residual risk levels (i.e. the ML/TF risk remaining after mitigations are considered).

Competition and consumer impact of the levy

The Commerce Commission has noted the unintended effects of the AML/CFT system in increasing the costs of retail bank account and financial product searching and switching, and in some instances contributing to financial exclusion, especially for owners of Māori freehold land or where a person is unable to verify their identity.[9]

This is in part due to the system not taking a risk-based approach to different entities with the same legal structure (e.g. Māori land trusts), and deficiencies and duplication that have been identified in respect of the current system. Inadequate identification by customers is more difficult to resolve.

Competition and access issues were similarly identified by a market study in the United Kingdom, the response to which was a regulatory system for open banking. An improved AML/CFT system needs to work hand-in-glove with similar efforts here, such as the Customer and Product Data Bill and Digital

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[8] HM Treasury (2020) Economic crime levy: Funding new government action to tackle money laundering. Page 13. Australia also uses an adjusted business and activity metric to charge their AML levy. Refer https://www.austrac.gov.au/business/core-guidance/industry-contribution-levy Work is still underway in Canada on applying levies to cost-recover regulatory activity. Refer https://www.canada.ca/content/dam/fin/programs-programmes/fsp-psf/rs-sr/rs-sr-eng.pdf

[9] Commerce Commission *Personal banking services,* Final Competition Report 20 August 2024.

Identity Services Trust Framework, that will reduce barriers to competition in retail banking and increase consumer choice. The possible impact of these schemes and efforts to reduce the "bluntness" of the AML/CFT system was noted by the Commerce Commission.

We have not identified a case for any other potentially negative impacts upon industry or consumers that may result from the imposition of a levy as outlined in Table A. Further analysis is required of any competition impact on remittance providers as costs might be passed on to low-income or otherwise vulnerable consumers.

How would the levy be monitored?

The entity/ies utilising the proceeds of the levy will all have performance measures and report publicly against them. Accountability, implementation review, and ongoing monitoring will be agreed in the Stage 2 CRIS and related Cabinet decisions. This will include giving effect to any requirements of the levy option selected from the Funding Model RIS.

Irrespective, we anticipate that the regulatory work programme for AML/CFT will be developed in close consultation with industry over a 3+ year horizon and reviewed annually, taking into account the need to respond to the 7-year cycle for FATF mutual evaluations.

Source data

Source information for Table A on the following page:

1. Reserve Bank of New Zealand (2017) *Sector Risk Assessment for Registered Banks, Non-Bank Deposit Takers and Life Insurers*
2. Reserve Bank (2024) *Registered banks financial statistics* https://www.rbnz.govt.nz/statistics/series/registered-banks retrieved July 2024
3. Bank profit and asset data derived from Reserve Bank register of disclosure statements, retrieved July 2024
4. Financial Markets Authority (2021) *Anti-Money Laundering and Countering Financing of Terrorism: Sector Risk Assessment 2021*
5. Department of Internal Affairs (2019) *Designated Non-Financial Businesses and Professions (DNFBPs) and Casinos Sector Risk Assessment*
6. Department of Internal Affairs (2019) *Financial Institutions Sector Risk Assessment*
7. Department of Internal Affairs *Gambling expenditure* https://www.dia.govt.nz/gambling-statistics-expenditure retrieved July 2024
8. Commerce Commission (2024) *Retail Payment System Costs to businesses and consumers of card payments in Aotearoa New Zealand: Consultation Paper*
9. TAB NZ (2024) *Annual Report 2023*
10. Australasian Legal Practice Management Association (2024) *FY2023 New Zealand Financial Performance Benchmarking Report* [Law firms]
11. Sunday-Star Times (2020) *NZ's top accounting firms: How they rank*
12. IBISWorld (2023) *Real Estate Services in New Zealand - Market Size, Industry Analysis, Trends and Forecasts (2024-2029)*
13. NBR (2024) *The Accountants 2024: The $2.1b business of complexity.*

Table A: Preliminary analysis of levy cost allocation (indicative only)

S9(2)(f)(iv)

S9(2)(f)(iv)

High level cost recovery model

We do not have a detailed or consistent cost model for the AML/CFT system, in part due to its dispersed nature across a range of entities. Information received by the MoJ indicates a full cost-recovery levy based on current regulatory costs would be in the order of $23 million dollars (refer accompanying Funding Model RIS), with approximately $7 million of that spent on intelligence, $14 million on domestic supervision, and $2 million on policy, regulation, and international coordination. Enforcement, asset recovery, and non-supervisor costs for investigation are not included.

A cost model tailored to Cabinet decisions on supervisory structure, level of expenditure to be cost-recovered, and major components of the work programme will be prepared for the Stage 2 CRIS.

Individual levy amount would be set by revenue/risk band, rather than a fixed percentage of revenue being levied. The levy collected in Table A would exceed S9(2)(f)(iv) if the total amount were to be collected from each reporting/regulated entity identified. However, many entities will fall under an income threshold. If higher levies are set in some sub-sectors this may allow a higher income threshold for smaller reporting entities to be excluded from the levy.

Supervisors take different approaches to rating ML/TF risk and accounting for mitigations in their publicly published SRAs. The RBNZ's 2017 SRA does not take into account the adequacy or effectiveness of any ML/TF controls, whereas these are considered by FMA in their 2021 SRA (residual risk assessment) and in part by DIA in their 2019 SRAs. In the absence of more detailed information, Table A has been prepared based on publicly available information.

Further analysis is therefore needed by MoJ on the relativity of the risk-adjusted amount allocated to each levy grouping in Table A, and in the further disaggregation of each group in terms of equity of payment given financial and economic considerations. In the United Kingdom, residual risk was identified as the basis for levy apportionment. We expect this analysis will need to draw on the risk-assessment used internally by the supervisors in undertaking their work in each sub-sector.

Although there are many similarities across sectors of regulated activity on the basis of firm size, ability to pay, and consumption of regulatory services (reflected by sector risk), we expect consultation on the levy will confirm some differences. For instance, the level of profitability amongst law firms can vary widely irrespective of firm size and areas of practice. Small or medium sized firms can be very profitable and operating in areas of particular complexity that are inherently linked with activity at risk of ML/TF (for instance trust and property services).

If community distributions were not considered, gambling entities would face a higher levy on the basis of their risk profile and financial returns. More consideration needs to be given in the Stage 2 CRIS to how the economic/wellbeing impacts of any levy is taken into account.

Consultation

Key AML/CFT agencies such as the FMA, RBNZ, DIA and Police were consulted in the development of this CRIS. Industry has not been consulted specifically on this levy proposal. The concept of introducing a levy has been discussed with industry in the past, with a varied response that was generally negative. Industry was more open to a levy where/when they are involved in setting the regulatory work programme. Refer to Funding Model RIS for more detail on industry consultation.

Agency feedback on the CRIS:

- **Police** consider the risks posed by Virtual Asset Service Providers (VASPs) are significantly understated and that a higher levy apportionment would better reflect their risk level and likely consumption of regulatory services.
- **RBNZ** has pointed out the range of other compliance costs faced by financial and non-financial reporting entities, including Conduct of Financial Institutions, Credit Contracts and Consumer Finance Act amendments, Deposit Takers Act implementation, Insurance (Prudential Supervision) Act review, S9(2)(f)(iv)

MoJ response to feedback - Police

The issue of relativity between different reporting sectors will be worked through for the Stage 2 CRIS as MoJ does not have sufficient information to undertake this analysis at present.

Further input on the proposed levy will be requested from sector supervisors and Police. Targeted consultation will then be undertaken with industry prior to the development of the Stage 2 CRIS. Subsequent consultation prior to implementation will be dependent upon timeframes available.

This consultation will be used to inform our advice on the split between Crown funding (public good) and the partial cost-recovery levy, and apportionment of the levy.

MoJ response to feedback - RBNZ

Table A indicates financial service provision under current levels of compliance cost remains profitable. S9(2)(f)(iv) One or more levies may also be enabled through the Customer and Product Data Bill, but details on potential size and scope are yet to be developed by officials.

Analysis of impact of the proposed AML/CFT levy on the banking sector in this RIS is consistent with that undertaken for the Depositor Compensation Scheme (DCS). Refer Annex 1.

Annex 1: Depositor Compensation Scheme Levy

The DCS levy will be charged to a deposit taker or group of deposit takers according to the risk they pose to the insured deposits. See the Reserve Bank's consultation document, *Levy framework for the Depositor Compensation Scheme* for further information.[10]

The impact of the proposed $1 billion insurance fund was considered by RBNZ analysis of registered banks in July 2023 and found to be "generally not significant even if the cost is fully absorbed by firms' profits". [11] The proposed levy in Table A of this CRIS is unlikely to have a material impact, either compared to the $1 billion fund to be established for the DCS, or in absolute terms given the level of profit currently being made by registered banks in the sector (also shown in Table A).

For 60% of NBDTs it was found that the level would be less than 10% of annual profits. However the RBNZ also found that "a number of other firms have low profits or recent losses, so levies will be more material to their profitability outlook".[12] This is consistent with the approach in this CRIS, its caveats, and the recommended approach to the Stage 2 CRIS. The proposed levy is lower for the smaller deposit-taking entities we are yet to see profitability data on.

[10] https://www.rbnz.govt.nz/-/media/project/sites/rbnz/files/consultations/deposit-takers-act/levy-framework-for-depositor-compensation-scheme-consultation-paper.pdf
[11] Ibid.
[12] Ibid.