NATIONAL BANK OF SERBIA

AML SUPERVISION CENTRE

ANALYSIS OF FINANCIAL LESSORS’ RESPONSES TO THE QUESTIONNAIRE ON ACTIVITIES REGARDING ML/TF RISK MANAGEMENT FOR 2020

April 2021

Introductory note

The Law on Financial Leasing designated the National Bank of Serbia (hereinafter: NBS) as the institution which issues and revokes licences for performing financial leasing transactions, provides consent for the acquisition of shares/stakes in lessors, gives consent to the appointment to managing bodies of lessors; and other types of consents in accordance with the Law on Financial Leasing (RS Official Gazette, Nos 55/200, 61/2005, 31/2011 and 99/2011 – other law).

Pursuant to the Law on the Prevention of Money Laundering and Terrorism Financing (RS Official Gazette, Nos 113/2017, 91/2019 and 153/2020), the NBS is in charge of conducting the supervision of implementation of the law governing the prevention of money laundering and terrorism financing by financial lessors in accordance with the Law on Financial Leasing.

In 2010, the NBS established the practice of off-site supervision of financial lessors' activities regarding money laundering/terrorism financing (hereinafter: ML/TF) risk management. The supervision is carried out twice a year based on the data submitted to the NBS by these financial institutions in the form of a filled out Questionnaire on activities of financial lessors regarding the prevention of ML/TF (hereinafter: Questionnaire).

Questions in the Questionnaire are sorted into ten groups:

Part I: General data on financial lessors

Part II: Clients

Part III: Client composition by the assessed ML/TF risk level

Part IV: V Client composition by CDD actions and measures

Part V: Products, services and transactions

Part VI: Outsourcing CDD actions and measures to third parties

Part VII: Employee training

Part VIII: Organisational structure

Part IX: Reporting to the AML/CFT compliance officer and to the Administration for the Prevention of Money Laundering (hereinafter: Administration)

Part X: Internal audit and internal control

The key objectives of the analysis of data from the Questionnaire are as follows:

– getting insight into the state-of-play in terms of identifying, measuring and managing ML/TF risk in financial leasing activities;

– off-site monitoring of the development of the ML/TF risk management system in financial lessors;

– identifying possible deficiencies and timely alerting financial lessors to potential exposure to the ML/TF risk.

– promoting adequate implementation of established rules and principles of the "Know your client" procedure (KYC);

All financial lessors operating in the financial leasing market of the Republic of Serbia submitted their responses to the Questionnaires for the reporting period 1 January – 31 December 2020, so this analysis is based on their responses.

Contents:

I. Key findings

Based on the analysis of primarily the inherent risk of exposure to the ML/TF, i.e. quantitative and qualitative data and information from the Questionnaire, as well as data and information related to the management and control of this risk, the overall conclusion is that financial lessors have low exposure to the ML/TF risk, as in the previously analysed periods.

Low exposure of financial lessors to the ML/TF risk results from the following:

In terms of the **business network size**, the financial leasing sector poses low risk considering the number of clients, a small number of branches/branch offices and the total number of employees whose job entails direct contact with clients. As at 31 December 2020, 16 financial lessors were licensed to perform financial leasing operations in the Republic of Serbia. There were 344 employees in total, of whom 161 front-office staff applying some of the CDD actions and measures. At the end of the reporting period, clients could establish a business relationship at 115 locations in the country and the total number of financial lessors' branches was 13.

The **composition of clients** is another reason why the exposure of this sector to ML/TF risk is low considering primarily the composition of clients by residence and the fact that non-residents account for the negligible share in the total number of clients (around 0.06%).

Resident legal entities accounted for the dominant share (67%) in the total number of clients as at 31 December 2020. Within the financial leasing sector, clients are divided into three categories, according to the assessed ML/TF risk level: low, medium and high exposure to risk. Namely, the bulk of clients are medium-risk clients, i.e. 15,040 clients with the share of almost 74%, followed by the low-risk category (4,114) with the share of around 20%, while those classified as high-risk (1,253) were in the third place, making up around 6% of the total number of clients. The majority of clients assessed as high risk clients are resident legal entities ant they were classified so in the most number of cases because of the risk of the industry they are in. As for non-residents, only three clients were classified in the high risk group and two of them are natural persons (one being an official and the other classified there because of the risk of the country of origin) and one is a legal entity (assessed as high risk client because of the risk of the country of its founder/beneficial owner). As in previously analysed periods, no significant changes occurred in the composition of clients by residence, with upward trend observed in the total number of clients in the financial leasing sector.

As for **products and services**, in view of the fact that financial lessors are allowed to provide almost only the financial leasing service and considering the number, total and average value of all signed contracts on financial leasing, as well as the data about the number, total and average value of these contracts signed with clients assessed as high risk clients, the conclusion to be drawn is that exposure to ML/TF risk under this factor is low. A lower number of contracts were signed than in the previous reporting period and this is mainly attributed to the spread of the disease caused by the coronavirus pandemic.

As for **outsourcing CDD actions and measures** to third parties, only two financial lessors outsourced these activities to a third party, that is their parent banks, i.e. founders, which is also an indicator of low exposure to ML/TF risk.

Findings reached through the analysis of data and information regarding measures undertaken by financial lessors to adequately manage and control ML/TF risk in the observed period indicate that the said risk, though low, is adequately managed. Namely, the following indicators were taken into account in the assessment of ML/TF risk management and control.

- Employees in all financial lessors are aware of the consequences of non-compliance with law and the procedures governing the prevention of money laundering and terrorism financing (primarily as a result of trainings).
- Financial lessors pay due attention to staff training in the form of workshops or a combination of workshops and e-learning at least once a year and in some lessors even three or more times per year;
- Eleven lessors had a special AML software, i.e. application for performing the activities regarding the prevention of ML/TF at the end of the reporting period, and in nine of them the software, i.e. application enabled the classification of clients by the degree of risk.
- All lessors use lists of indicators for recognizing suspicious transactions regarding ML/TF published on the website of the Administration as well as lists of designated persons, published by the UN Security Council and other international organisations of which Serbia is a member;
- Financial lessors have set up their own ML/TF risk management systems and regulated the internal controls systems by their internal acts;
- Client composition by CDD actions and measures applied (simplified, general and enhanced) is relatively consistent with the client composition by the assessed ML/TF risk level. Financial lessors do not apply simplified actions and measures to all low-risk clients, but only somewhat more than 67% of them. Enhanced actions and measures are applied to all clients classified as high-risk, while the bulk of clients are subject to general actions and measures. The above highlights a fact that financial lessors understood correctly the significance of proper ML/TF risk assessment, which, coupled with stronger caution, resulted in adequate allocation of human resources, and consequently in high-quality ML/TF risk management.
- In the reporting period, there were no cases of termination of a business relationship due to the impossibility to apply CDD actions and measures referred to in Article 7, paragraph 1, items 1–5 of the Law. Only one lessor refused the offer to establish a business relationship due to the impossibility to apply the said actions and measures.

Although the ML/TF risk is low in this area, by no means should it be ignored. Being obligors under the Law on the Prevention of Money Laundering and Terrorism Financing (hereinafter: Law), financial lessors are obliged to take all actions and measures necessary for detecting and preventing ML/TF.

II. General data on financial lessors

As at 31 December 2020, 16 lessors[1] in Serbia had the financial leasing licence and eight of them (50%) operated through 13 branches.

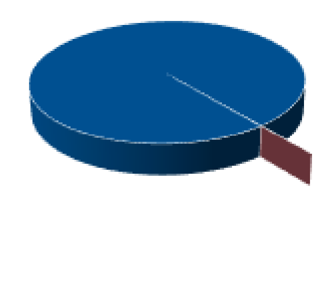
There were 344 employees in total working in the financial leasing sector, of which 161 (almost 47%) front-office staff applying some of the CDD actions and measures. At sector level, the average number of clients per front-office staff member applying CDD actions and measures was 127 at the end of the reporting period, which was an increase from 2019 (122).

In this context, based on the size of the business network, as a factor affecting the ML/TF risk exposure, the exposure of financial lessors to the ML/TF risk is judged to be low as was also estimated in the previous period with balance as at 31/12/2019.

III. Clients

The total number of clients as at 31 December 2020 was 20,407, 99% of them residents (Chart 1). Resident legal entities accounted for the highest share – 67.17% (13,707 in total), followed by resident natural persons – 17.22% (3,514 in total), resident natural persons engaged in a business activity – 15.55% (3,173 in total). There were six non-resident natural persons, and seven a non-resident legal entities, with negligible shares (Chart 2).

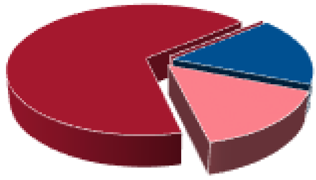
Chart 1 Composition of clients in the financial leasing sector by residence as at 31 December 2020



[1] Three lessors are undergoing voluntary liquidation, approved by the NBS.

Compared to the previous reporting period (as at 31 December 2019) the number of lessors' clients grew by 1,460, or by 7.70%.

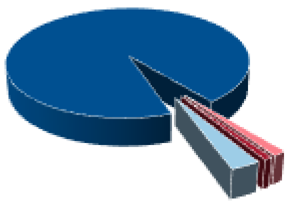
Chart 2 Composition of clients in the financial leasing sector as at 31 December 2020



- Resident natural persons- 3,514; 17.21%
- Entrepreneurs - 3,173, 15.54%
- Resident legal entities - 13,707; 67.16%
- Non-resident natural persons - 6; 0.029%
- Non-resident legal entities - 7; 0.034%

As the bulk of residents are legal entities, the following chart presents their classification: legal entities organised as limited liability companies, legal entities organised as joint-stock companies, legal entities organised in other forms (such as limited and general partnerships) and those that do not belong to any of the said categories, but are e.g. associations, endowments, foundations, sport associations, etc. (categorised as "others") (Chart 3).

Chart 3 Composition of resident legal entities by type of organization as at 31 December 2020



- Legal entities organized as limited liability companies - 13,044; 95.16%
- Legal entities organized as joint stock companies -160;1.17%
- Legal entities organized in other legal forms - 131;0.96%
- Others (associations, endowments, foundations, sports associations, etc.) - 372; 2.71%

Limited liability companies account for the bulk of resident legal entities (13,044 or 95.16%). It is important to stress that the National Risk Assessment determined this form of organisation as risky from the ML/TF perspective. Legal entities organised as joint-stock companies account for 1.17% (160 of them). There were 130 legal entities organised in other legal forms, their share being 0.96%, and "others" make up around 2.71% (372 legal entities).

Non-resident natural persons are from the countries classified as high-, medium- and low-risk category by lessors, one person from each country: Bosnia and Herzegovina (assessed as high-risk country), Croatia (assessed as low-risk country), Israel (assessed as low-risk country), Poland (assessed as low-risk country), USA (assessed as medium-risk country), Romania (assessed as medium-risk country).

Non-resident legal entities are from the countries classified as low-, medium- and high-risk category, one entity from each country: Bulgaria (assessed as medium-risk country), Sweden (assessed as medium-risk country), Italy (assessed as medium-risk country), Belgium (assessed as medium-risk country), Bosnia and Herzegovina (assessed as high-risk country), France (assessed as medium-risk country), and Slovenia (assessed as medium-risk country).

According to the Questionnaire, there is only one non-resident legal entity which has a person from high-risk countries in its ownership structure in the entire financial leasing sector and there are no non-resident legal entities with a trust in their ownership structure.

As in previously analysed periods, no significant changes occurred in the composition of clients by residence, with upward trend observed in the total number of clients.

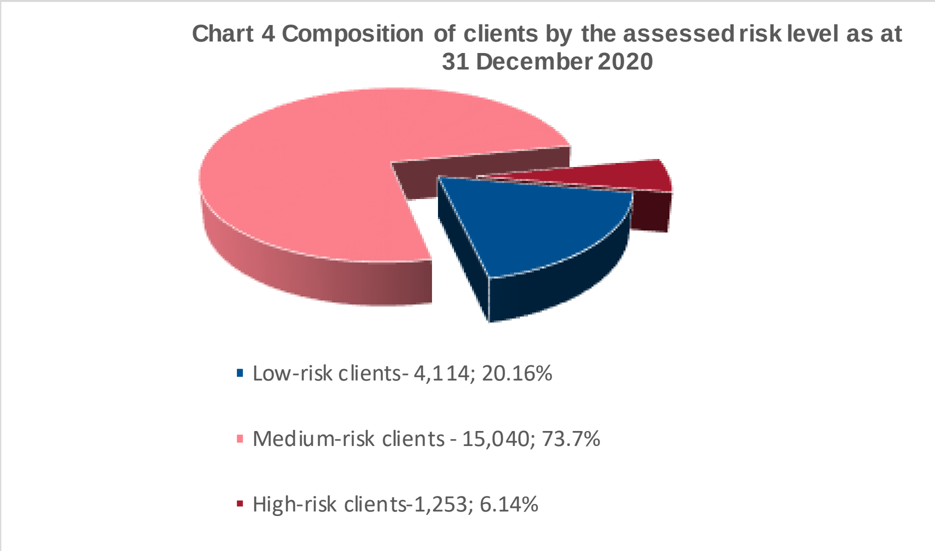
When assessing the structure of clients, as a factor affecting the ML/TF risk exposure, numerous indicators are taken into account, such as the number of high-risk clients, clients who are officials (domestic and foreign), high-risk legal entities: with a complex ownership structure, with persons from off-shore geographical areas or with a trust in their ownership structure, with an official in the governance structure, non-resident natural and legal persons from: high-risk and off-shore geographical areas and countries with strategic deficiencies, the number of clients organised as limited liability companies, entrepreneurs. Looking at the above indicators, it can be concluded that the risk exposure is low, given that the individual share of each of them in the total number of clients in the financial leasing sector is low.

IV Client composition by the assessed risk level

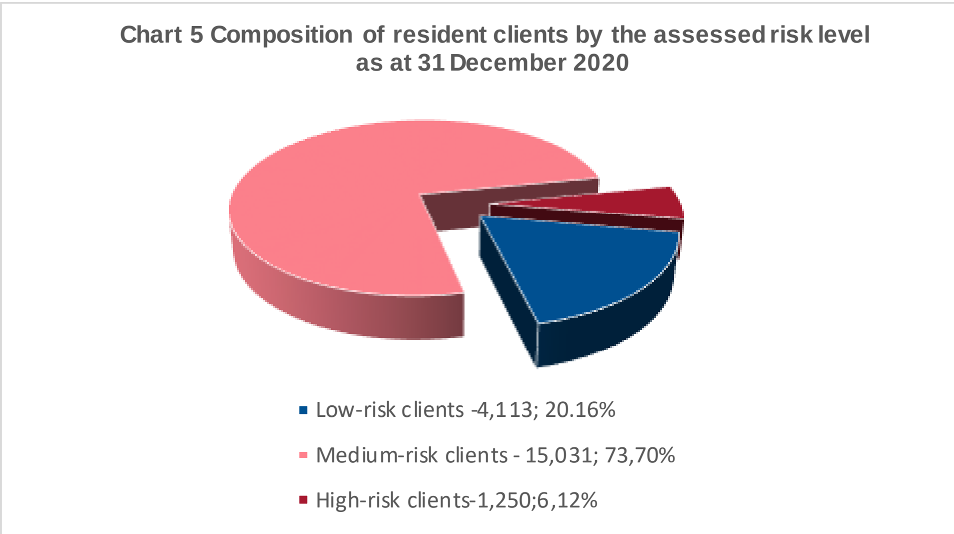
Within the financial leasing sector, clients are divided into three categories, according to the assessed ML/TF risk level: low, medium and high.

The bulk of clients are medium-risk clients, i.e. 15,040 clients with the share of around 73.70%, followed by clients in the low-risk category (4,114) with the share of

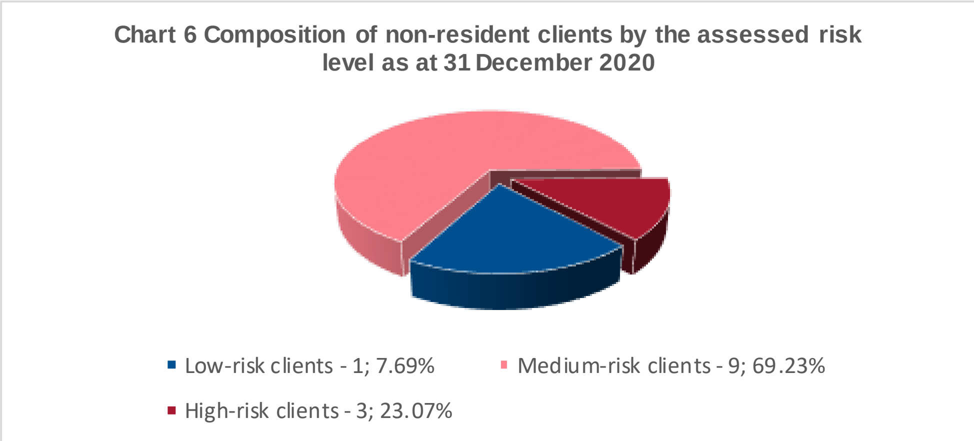
20.16%, while those classified as high-risk (1,253) were in the third place, making up 6.14% of the total number of clients, as shown in Chart 4.



Relative to the previously analysed period, no significant changes occurred in the composition of clients by risk level. Charts 5 and 6 give an overview of the composition of clients in the financial leasing sector by risk level – for residents and non-residents.

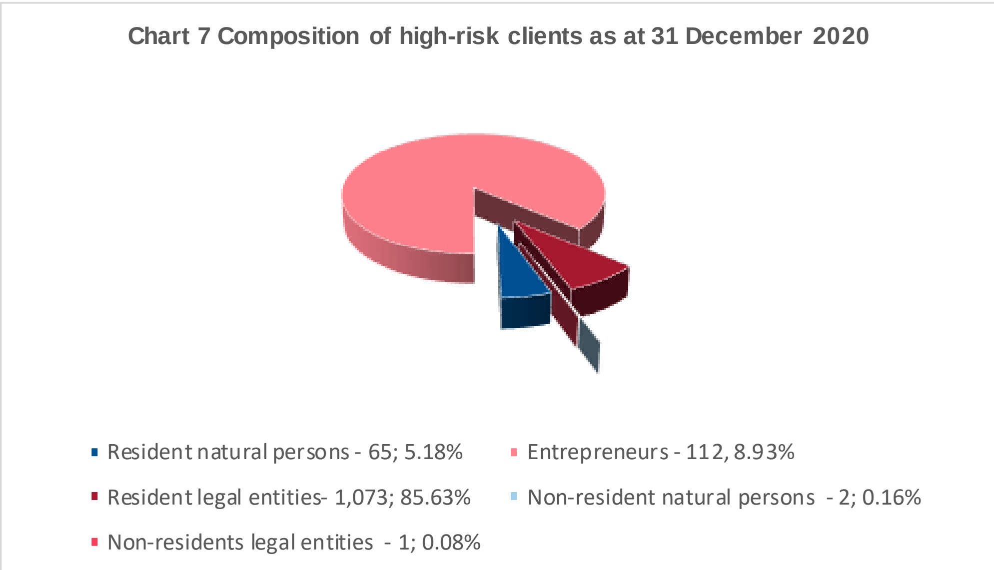


The bulk of residents were classified as medium-risk clients (15,031 of them, or 73.70%), 4,113, or 20.16% of them as low-risk clients and the minority of them as the high risk category (1,250 or 6.12%).



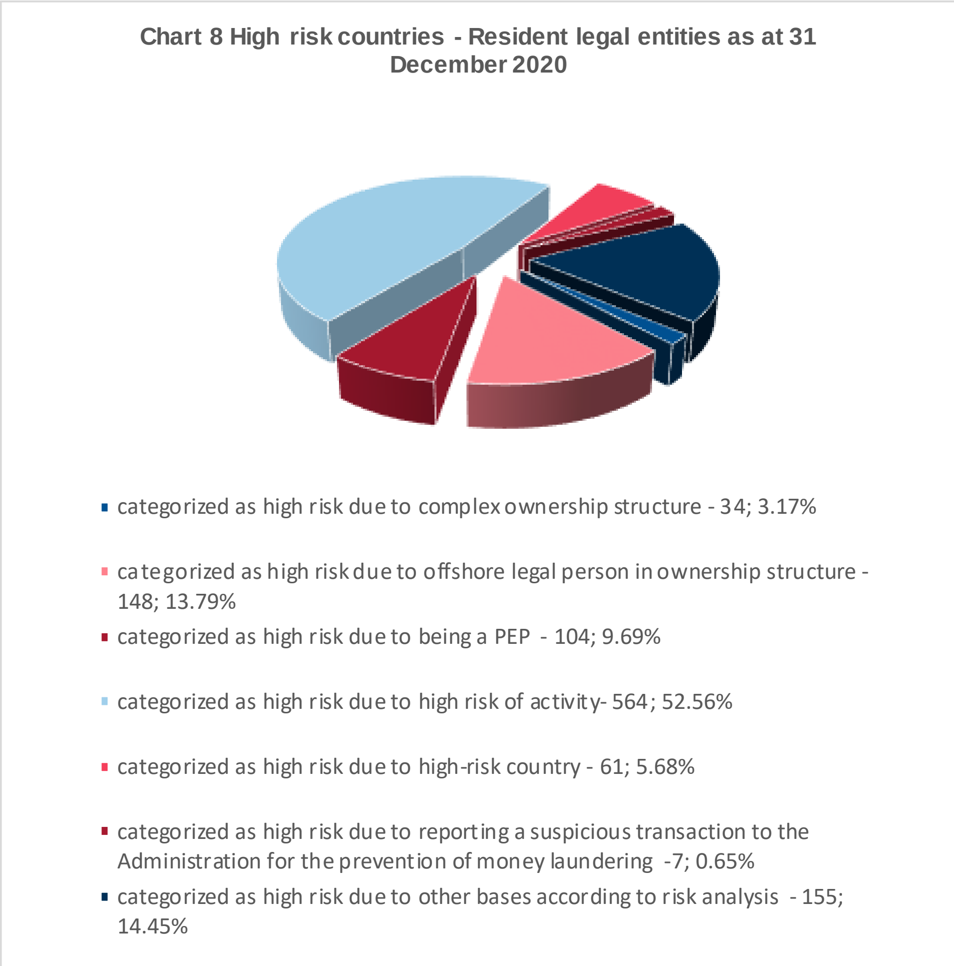
As for non-residents, the highest number of them (nine clients – 69.23%) belong to the medium risk category, three non-residents are classified as high-risk clients, and one as medium-risk client.

Chart 7 gives an overview of the composition of high-risk clients.



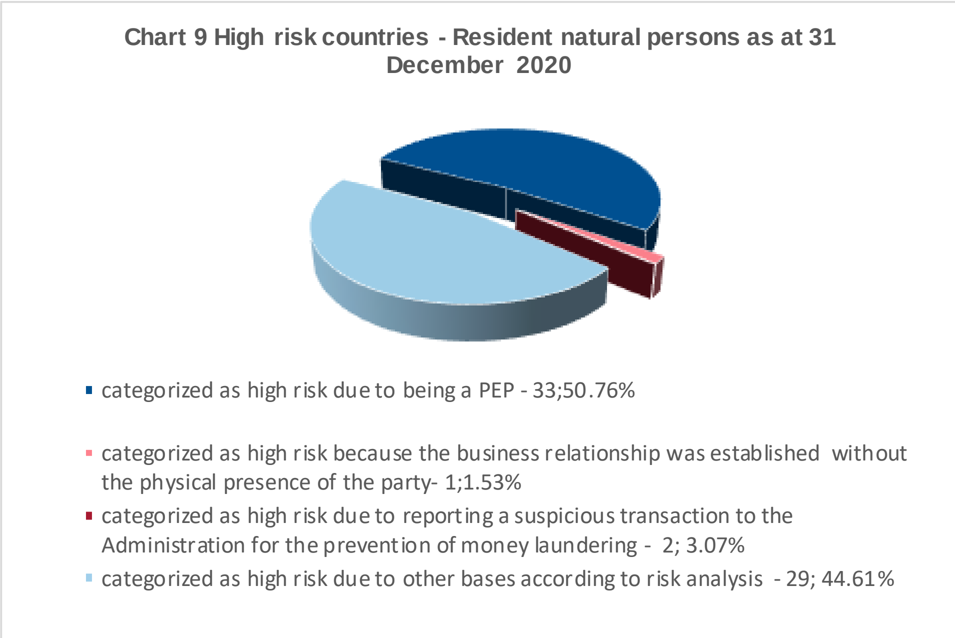
The majority of high-risk clients are resident legal entities (1,073 of 1,253), making up 85.63% of clients in the high-risk category.

As the majority of high-risk clients are resident legal-entities, Chart 8 gives an overview by various indicators for this classification.

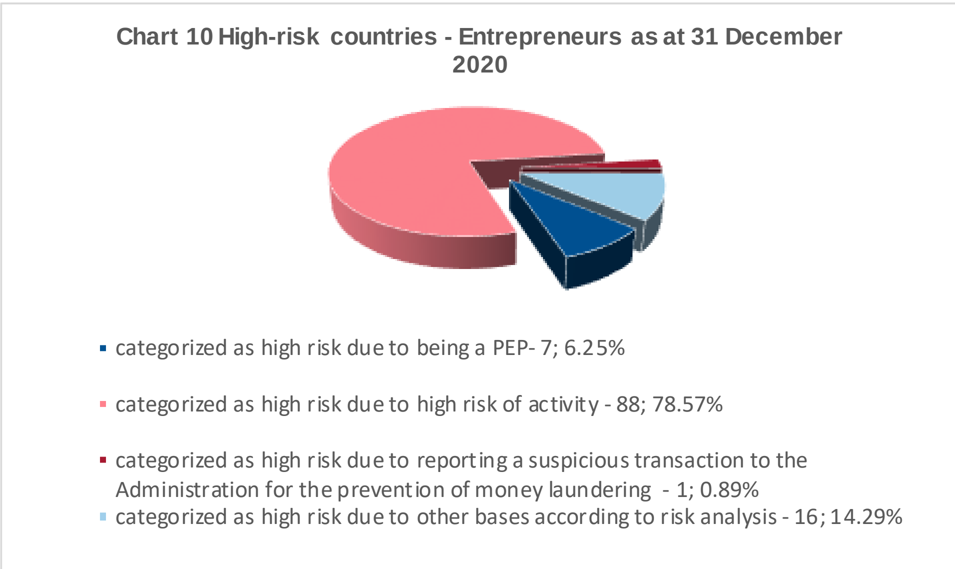


The highest percentage of resident legal entities are classified as high-risk clients due to the risk of the activity they are dealing with (more than half of them, around 52.56%). The remaining resident legal entities are classified into high risk category on account of: officials in their ownership/management structure (9.69%), high risk of the country of its founder/beneficial owner (5.68%), complex ownership structure (3.17%), reported suspicious transactions to the Administration (0.65%), or some other account in accordance with risk analysis. Total of four suspicious transactions were reported at the end of the reporting period.

Resident natural persons mostly belong to the high-risk category as they are officials (around 50.77%%) while around 44.62% belong to this risk category on some other grounds in accordance with risk analysis, as presented in Chart 9.



The majority of entrepreneurs (natural persons engaged in a business activity) were also classified as high-risk clients due to their high-risk activities (Chart 10).



V. Client composition by CDD actions and measures

Simplified CDD actions and measures were applied to 2,762 clients, general CDD to 16,307 clients and enhanced to 1,338 clients. In percentage terms, general CDD was applied to 79.91% of clients, simplified to 13.53% and enhanced to 6.56% of clients (Chart 11).

Chart 11 Composition of clients by CDD actions and measures applied as at 31 December 2020

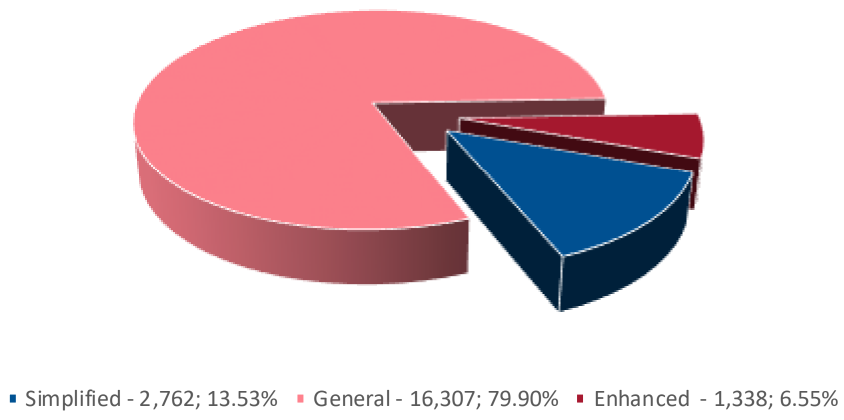


Table 1 gives an overview of applied CDD actions and measures by residence.

Table 1 Overview of applied CDD actions and measures by residence as at 31 December 2020

Clients	Simplified CDD actions and measures	General CDD actions and measures	Enhanced CDD actions and measures
Resident natural persons	757	2,692	65
Resident legal persons	1609	10,971	1127
Natural persons engaged in a business activity	395	2,635	143
Non-resident natural persons	0	4	2
Non-resident legal entities	1	5	1
Total	**2762**	**16,307**	**1338**

Table 2 shows a comparative overview of the number of clients by risk level and CDD actions and measures as at 31 December 2020.

Table 2 **Structure of financial leasing sector clients by risk level and actions and measures applied**

Level of risk	No of clients	Share	Customer due diligence actions and measures	No of clients	Share
Low	4,114	20.16%	Simplified	2,762	13.53%
Medium	15,040	73.70%	General	16,307	80.55%
High	1,253	6.14%	Enhanced	1,338	6.56%
	20,407	100.00%		**20,407**	**100%**

Based on the analysis of the data from the Questionnaire, it can be concluded that lessors do not apply simplified actions and measures to all low-risk clients but to 67.13% of them. Enhanced actions and measures are applied to all clients classified as high-risk, while the bulk of clients are subject to general actions and measures. Accordingly, client composition by CDD actions and measures applied mostly corresponds to client composition by the assessed ML/TF risk level, given that enhanced CDD actions and measures are applied to more clients than are those classified as high-risk, and general to more clients than those classified as medium-risk, meaning that these actions and measures are also applied to a part of low-risk clients.

In the reporting period, there were no cases of termination of a business relationship due to the impossibility to apply CDD actions and measures referred to in Article 7, paragraph 1, items 1–5 of the Law. Only one financial lessor refused the offer to establish a business relationship due to the impossibility to apply CDD actions and measures referred to in Article 7, paragraph 1, items 1–5 of the Law. Data were not submitted to the Administration at its request for any client.

VI Products and services

The total number of signed lease contracts amounted to 13,567 in the reporting period, down by 3,682 from 2019 (17,249 contracts), and 1,876 of those, or 13.82% were signed with high-risk clients. The reduced number of signed financial leasing contracts may be attributed to the spread of the COVID-19 disease.

The number of lease agreements in which the amount of the lease fee exceeds EUR 1,000 for natural persons is 121, (it went down from 187 on 31 December 2019), while those in which the fee exceeds EUR 5,000 is 444 (it went up from 299 on 31 December 2019).

In the reporting period, 10 financial lessors had cases in which third parties provided a guarantee for the lessee, whereby the relationship between the lessee and the guarantor was clear.

Taking into account all the above and the fact that the scope of financial lessors' activities is rather limited and includes financial intermediation between financial lessors and lessees, the risk based on the products and services offered by the financial leasing sector is judged to be low.

VII Outsourcing CDD actions and measures to third parties

Only two financial lessors outsource CDD actions and measures to a third party, that is, their parent banks, i.e. their parent banks/founders which is also an indicator of low exposure to ML/TF risk. A third party obtained data and documents for two clients at the level of the entire financial leasing sector.

Given that only a small number of financial lessors entrusted CDD actions and measures to third parties, it is estimated that the ML/TF risk exposure on this account is low as well.

VIII Employee training

Based on the responses to the Questionnaire, it can be concluded that all employees from the financial leasing sector are aware of the consequences of non-compliance with law and procedures regulating AML/CFT.

Training in financial lessors is usually carried out by compliance officers and their deputies. According to the AML Law, a compliance officer means a person employed with an obligor in a position with the powers allowing for effective, prompt and quality execution of tasks prescribed by this Law, who has not been convicted by a final judgement or has not been prosecuted, and who is professionally trained for AML/CFT operations and familiar with the obligor's operations in areas that are vulnerable to ML/TF risks. These conditions must also be met by the compliance officer deputy. Financial leasing training is conducted in the form of workshops, or a combination of workshops and e-learning, at least once a year. Training of compliance officers/their deputies is conducted in the form of presentations, direct trainings, seminars, conferences and lectures. All lessors test their employees who have completed training, except for those currently undergoing liquidation.

Eleven lessors had a special AML software, i.e. application for performing the activities regarding the prevention of ML/TF at the end of the reporting period, and in nine of them the software, i.e. application enables the classification of clients by the degree of risk. Clients are classified after verification of data used for identification, particularly taking into account geographical risk, client, product and transaction risk, with special attention to clients who are officials and legal entities with complex ownership structure.

All financial lessors use the lists of indicators for detecting suspicious ML/FT-related transactions, published on the website of the Administration. Apart from the mentioned indicators, six financial lessors included their own indicators in the mentioned lists. In the reporting period, most (13) financial lessors prepared official notes on the performed transactions analyses. The total of 504 notes on the performed transactions analyses were prepared in the reporting period.

All financial lessors use the lists of designated persons, published by the UN Security Council and other international organisations of which Serbia is a member. Twelve of the financial lessors use some of the commercial databases for filtering designated persons, including the software of the Administration, as an additional element of client verification.

In the reporting period, there were no cases that clients or persons who tried to establish a business relationship or any other person with whom a financial lessor has or had a business or other similar relationship were designated persons. A designated person is a natural person, a legal person and a group or association, registered or unregistered, which is marked and placed on the list of terrorists, terrorist organisations or terrorist financiers, as well as on the list of persons associated with the proliferation of weapons of mass destruction and special lists based on UN Security Council resolutions or acts of international organisations of which the State is a member, competent bodies' proposals or based on justified request of a country. Special lists are lists based on UN Security Council resolutions or acts of international organisations of which the State is a member and which do not relate to natural or legal persons, groups or associations, but to movable and immovable assets related to the proliferation of weapons of mass destruction, such as ships, planes, etc.

The financial leasing sector established efficient ML/TF risk exposure identification and assessment processes, as well as adequate employee training programmes on the aforementioned risk. The sector has adequate information systems with regular reporting on ML/TF risk to appropriate management levels and relevant employees responsible for managing the said risk.

IX Organisational structure

The majority of compliance officers and their deputies, who should exclusively perform activities in detecting and preventing ML/TF, as defined by the Law, also perform other activities on a daily basis.

Staff numbers changed in eight financial lessors. However, these were insignificant changes.

The financial leasing sector has defined clear lines of responsibilities in identifying, measuring, monitoring and reporting on ML/TF risk, and the risk management system is based on adequate human and technical resources, the ML/TF risk exposure is estimated as low.

X Reporting to the AML/CFT compliance officer and to the Administration

The total number of reports on suspected money laundering that the employees submitted was 93. The total of four suspicious client transactions were reported the Administration. Besides, no internal reports on suspected terrorism financing were submitted to compliance officers in the reporting period.

XI Internal audit and internal control

During the past year, four financial lessors carried out internal audit, while the remaining 12 carried it out two or three years ago. These audits identified irregularities in ten financial lessors and half of them had them removed while in the other half of them the deadline for removing them has not yet expired.

Irregularities mainly relate to the following: inadequate client assessments, irregularities made while opening accounts for natural and legal entities, incomplete KUS forms, minor irregularities made in identification of public officials, deficient implementation of AML policies in case of identification of clients and completeness of a file, deficient reports (form of reports), entry of data on ML risk classification in the application, etc.

Fifteen of sixteen financial lessors declared that their compliance officers and their deputies participate in internal audit and all 15 report internal audit results to the management. In the past two years, all financial lessors performed internal audit, and in eight of them irregularities have been established. Most often these irregularities relate to the following: unsatisfactory quality level of documents, incomplete documents for establishment of ownership structure and beneficial owner, inadequate classification of clients by risk degree, AML assessment not in line with internal acts, outdated KUS forms, etc. Deadlines for eliminating these irregularities were set and seven financial lessors eliminated them.

The board of directors was informed about AML/CFT-related audit findings in all lessors, while the findings of the external auditor regulated this area in seven lessors. Only one financial lessor i.e. its employees is being prosecuted for ML/FT-related matters, and no disciplinary proceedings are conducted due to problems with employee integrity (participation in fraud, theft, corruption, etc.) which has changed from the past period.

Given the above, it can be concluded therefore that an adequate and comprehensive internal controls system is in place in the financial leasing sector with mechanisms to ensure that appropriate levels of management are timely informed about any deviations from the application of procedures so that they can take the necessary measures. Financial lessors also periodically carry out internal audits covering the key elements of ML/TF risk management and control.

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