Know your customer: Unravelling the challenges

Received (in revised form): 15th December, 2023

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Journal of Payments Strategy & Systems
Vol. 18, No. 1 2024, pp. 30–38

1750-1806

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Abstract

Regulated financial institutions must conduct regular know-your-customer (KYC) reviews on corporate clients to prevent money laundering and the financing of terrorism. However, national add-on requirements and regulatory discrepancies challenge the vision of a unified Europe, hindering the creation of an efficient, digital and hence scalable pan-European anti-money laundering (AML) process for all stakeholders who are active beyond their national borders. The current inability of banks to introduce efficient but robust pan-European KYC processes delays customers' access to finance and other banking products, and indirectly impedes the free movement of goods, services and capital. The European Commission plans to introduce the Anti-Money Laundering Regulation (AMLR) to harmonise and strengthen the EU AML framework. This could reduce national divergences, allowing for a level playing field across the internal market and consistent application of provisions throughout the EU. Unfortunately, harmonised regulation alone does not solve the current issues faced by financial institutions. While a harmonised rulebook provides certainty related to 'what' needs to be done, significant pan-European discrepancies remain related to 'how' the requirements can be fulfilled. For example, the EU has directed all member states to establish commercial and beneficial ownership registers, but left the design of such registers under the authority of the member state. Consequently, banks active on a pan-European level have to adjust their processes based on the type and content of the national register. Also, the definition of what constitutes a politically exposed person (PEP) varies significantly across the EU, as do the enhanced due diligence requirements which are triggered upon the identification of such a PEP. This paper provides suggestions on how EU member states can help the financial industry in a joint effort to prevent money laundering and combat the financing of terrorism more effectively. The objective of this discussion is to create a streamlined and unified approach to KYC processes across Europe.

Keywords: know-your-customer, KYC, ultimate beneficial owner, politically exposed person, anti-money laundering, AML, Anti-Money Laundering Regulation, European business registers, financial crime compliance, harmonisation of regulations

BACKGROUND

The United Nations Office on Drugs and Crime estimates that 2–5 per cent of the world's annual gross domestic product (GDP) is related to crime.[1] The proceeds of such illegal activities are laundered through the financial system, where sophisticated techniques are used by criminals to disguise the illegal source of such funds and to hide their beneficiary behind a legitimate facade. Subsequently, to prevent money laundering and the financing of terrorism, European and national regulators have created a framework of regulations which require financial institutions to implement financial crime compliance processes that prevent, for example, the opening of accounts for fictitious persons or for criminals using stolen identities, and to identify and prevent any flow of money that may be linked to criminal activities.

The annual global expenditure on financial crime compliance by financial institutions was estimated to exceed US$213bn (~€200bn) in 2021, with approximately US$150bn (~€140bn) of these costs being incurred in Europe alone.[2] These expenses burden the average Western European financial institution with around €50m per year, and the economic strain these costs place on regulated market participants and their customers is significant. In a recent survey conducted by Fenergo, almost one-third of the banks surveyed spent 30 per cent of their financial crime compliance budget on know-your-customer (KYC) processes, rising to more than 40 per cent for one-fifth of the surveyed institutions.[3] Furthermore, the survey found that the average KYC process on a corporate customer takes between 30–60 days due to the often still manual processes required for KYC. The subsequent operational bottlenecks conflict with the banks' objective to provide exceptional and timely customer experiences while safeguarding the institution from fraud and reputational risks. As a result, the KYC process during customer onboarding, along with the identification of ultimate beneficial owners (UBOs) and politically exposed persons (PEPs), are, along with risk-profiling, often highlighted as the most significant challenges confronting financial institutions in Europe.[4]

At the beginning of 2021, the Euro Banking Association's (EBA) member institutions proposed to address this issue, leading to the establishment of the EBA's Expert Group on KYC-related Topics (KYC Expert Group or KYCEG) which commenced work in May 2021.[5] This group's primary objective is to identify and address pan-European inconsistencies in KYC due diligence practices, and to uncover any obstacles that could hinder or restrict the deployment of cost-efficient, automated and scalable KYC data collection and monitoring processes across the EU/EEA.

The KYCEG concentrates its efforts on examining KYC-related issues from a practitioner's perspective. The group conducts a comprehensive analysis of the operational landscape within which obligated financial institutions, such as banks, operate. Its analysis encompasses a range of factors including regulatory frameworks, the availability of standardised digital data in commercial and UBO transparency registers for verification purposes, and any discrepancies that may arise due to the lack of harmonised pan-European definitions for terminologies employed in anti-money laundering directives or national regulations.

This paper provides insights into the problems faced by regulated financial institutions, and in the context of this paper, 'banks', when conducting KYC on their corporate customers, and introduces possible solutions from a practitioner's perspective.

INTRODUCTION

KYC due diligence is a process that regulated financial institutions use to verify and frequently reconfirm the identity and legitimacy of all their customers. KYC is essential to comply with anti-money laundering (AML) and counter-terrorism financing (CTF) regulations, as well as to prevent fraud and reputational risks.

Every customer of a financial institution, whether a private individual or a corporate entity, undergoes the rigorous KYC processes implemented by their bank. In respect to corporates, these processes are designed to understand each corporate customer's business profile, their ownership structure, their anticipated financial activity, and their potential risk related to AML and CTF. However, it is noticeable how these KYC procedures vary significantly not just from one bank to another, but also from one European country to another. This inconsistency places a significant financial and operational strain on all market participants operating within the EU and is also a contributing factor as to why the average financial crime related compliance costs per bank in Western Europe are double those in North America.[6]

The primary challenge for banks conducting KYC due diligence on their corporate customers is the identification of UBOs and of any PEPs who are, either as UBO or senior manager, a stakeholder in the corporate customer. UBOs are the natural persons who ultimately own or control a legal entity, while PEPs are individuals who hold or have held a prominent public function, such as heads of state, senior politicians, judges or military officers, among others. With regards to PEPs, the complexity increases further with the requirement to identify not just the PEPs, but also their family members and close associates who might covertly act on behalf of the PEP. Beyond individuals holding official public functions, PEPs also include individuals who hold senior positions in state-owned enterprises.

As of today, there is no reliable pan-European database available to banks which holds sufficient and up-to-date information about UBOs and PEPs. As a result, the process of identifying UBOs and PEPs can involve a significant amount of manual investigative work, which not only incurs significant cost but also leads to noticeable delays in onboarding new corporate customers or periodically reconfirming KYC data for existing clients.

Despite these challenges, many banks are planning to enhance their customer experience and are actively pursuing the development of efficient, automated solutions that minimise human intervention in low-risk situations. However, the regulatory structure in Europe continues to be fragmented. While some EU member states have not or have only partially implemented the current Anti-Money Laundering Directive (AMLD), others have exceeded the AMLD framework and incorporated additional local requirements. At European Union level, the incomplete implementation of the AMLD prompted the proposal of a regulation. The trilogue negotiations for this new regulation, commonly referred to as the Anti-Money Laundering Regulation (AMLR), are still in progress.[7]

Until the AMLR is in effect, banks have no other option apart from adjusting their KYC procedures to align with diverse national regulations. This not only impedes their ambition to establish scalable and unified pan-European processes for improved operational efficiency, but also poses a significant and expensive obstacle in handling cross-border corporate customer relationships. The impact on the customer side is equally significant. The existing fragmentation, for instance, hinders corporate customers from providing a consistent set of KYC data and supporting documents to their European banking partners. Consequently, pan-European corporations encounter varying KYC data and other information requirements when they expand their business activities across the EU or diversify their European banking relationships.

COMMERCIAL REGISTERS DO NOT PROVIDE STANDARDISED DIGITAL DATA

In 2021, the KYCEG conducted a detailed analysis of pan-European KYC data requirements for bank-to-corporate KYC in low-risk situations and the relative importance of each individual data point used in the KYC risk-assessment process. Upon completion, the KYCEG recommended the publication of the 'Common Baseline Classification Standard' (CBSC) through the EBA in January 2022.[8] According to the experts, the CBCS includes all data points that are relevant to identify and effectively manage AML-low-risk corporate relationships anywhere in Europe. If accepted as a common harmonised market practice, the CBCS would enable low-risk corporate customers to create a single KYC information file — suitable for all its European banking partners, and thus significantly improving the efficiency of the KYC process for corporate customers.

However, when a corporate client submits KYC data to their bank, the bank is obligated to cross-verify said data against official commercial registers. This process often encounters numerous obstacles. For instance, some national registers do not offer an English language service. Additionally, the prerequisites for access permissions to commercial registers differ across countries, access restrictions may apply, and paywalls can restrict access to legally mandated data. Despite efforts to standardise the setup, access and content of official registers across Europe, banks are still unable to access some registers located in other EU member states. Until there is harmonisation in language, structure of content, and access to official registers across the European market, the cross-border data verification process will continue to be predominantly manual, making it both costly and inefficient.

Furthermore, there is an absence of a consistent, EU-wide approach to encourage official registers to transition towards digital services. For example, and contrary to equivalent registers in the USA, a significant number of European registers continue to receive the majority of incorporation filings and updates in paper format.[9] There is also a noticeable lack of a unified strategy among register operators to provide open source data files, application programming interfaces (APIs), or other forms of machine-readable data to banks and other parties that require such data for regulatory and compliance purposes. However, such data are crucial for institutions that need to continuously monitor changes in corporate customer data between scheduled KYC review dates. These inconsistencies and constraints not only pose systemic risks but also escalate the cost of regulatory compliance. They obstruct the transition from a static-date-driven (periodic) KYC process to a far more efficient risk-based, trigger-event-driven (perpetual) KYC process.

RELIABLE ULTIMATE BENEFICIAL OWNERSHIP DATA: A KEY REQUIREMENT FOR EFFECTIVE KYC PROCESSES

UBO registers were introduced in the EU's Fourth Anti-Money Laundering Directive (4AMLD, 2015[10]) and are intended to increase transparency and combat money laundering and terrorist financing. These (initially intended to be public) registers are intended to contain information about the ultimate beneficial owners of companies and other legal entities. In theory, banks and other obliged entities can access the UBO registers as part of their due diligence processes. Access to these registers is typically facilitated by the relevant authorities in each member state.

In practice, however, the effectiveness of UBO registers could be enhanced. The directive only describes minimum implementation requirements, and member states are allowed to introduce broader registration obligations — which many did,[11] leading to a lack of harmonised setup. Most importantly, however, the quality of the data procured from the UBO registers is not reliable. Instead, banks are required to identify and report any inconsistencies back to the register, which inadvertently increases their workload and expenses. Furthermore, access to UBO registers cross-border varies considerably, influenced by jurisdiction and specific national regulations. Some jurisdictions may require proof of legitimate and sufficient interest for comprehensive access to the UBO register, sometimes on a case-by-case basis. Countries like Spain, Poland and Romania have private UBO registers, accessible only to authorised entities such as banks, regulators or law enforcement agencies, while some countries including Sweden, Belgium, Croatia and Portugal enable access only to nationals or citizens of the EU and require a national digital identity or a European Digital Identity (eIDAS) of the authorised representative of the bank doing so.

Initially, the UK, Austria, France, Germany and the Netherlands had easy-access open UBO registers. However, a Court of Justice of the European Union ruling on 22nd November, 2022 invalidated the 4AMLD provision for public access to beneficial ownership information due to privacy and data protection rights.[12] This ruling has significantly impacted public access to UBO registers across the EU and altered company information transparency. While banks can assert significant interest in the data, they still may face a lengthy process to access the register, potentially followed by hurdles such as language barriers and inconsistent content or data structures. As a notable exception, Denmark and Latvia are the only two EU countries that provide data via API from their UBO registers.

The recent EBA publication, 'Data Verification for Corporate-to-Bank KYC in Low-Risk Situations',[13] encapsulates the KYCEG's analysis of the public register landscape and its subsequent findings and recommendations. The KYCEG recommends the harmonisation of content, data structures and access mechanisms across Europe's official registers. It specifically suggests the creation of a unified EU-wide access mechanism, ideally enabling financial institutions to access any official register via an interconnected portal, thereby bypassing the need for additional registration at a national level. Furthermore, the KYCEG recommends that all registries should offer data through APIs and open source data files.

EMBRACING CHANGE: THE ROLE OF FUNCTIONAL PEP LISTS

Identifying PEPs, and their family members and close associates, is another top challenge faced by financial institutions during their corporate customer KYC process. The complexity of PEP identification stems from the broad range of individuals encompassed by this term as it extends beyond elected politicians to also include individuals serving in legislative, executive, judicial, administrative and military roles, as well as those employed in public bodies and state-owned enterprises (see Table 1).

Recognising the gravity of this issue, the European Union introduced functional PEP lists as a key component of the compliance obligations under the Fifth Anti-Money Laundering Directive (5AMLD[14]) in 2018.

In early 2023, the Euro Banking Association, upon recommendation of the KYC Expert Group, launched a new initiative in the realm of KYC practices with a specific focus on PEPs. The primary objective of this initiative is to critically examine the current procedures and due diligence processes related to the identification of PEPs, as well as their family members and close associates. This initiative also delves into sub-topics such as evaluating

Table 1: Overview of different types of PEP

Type of PEP	*Description*	*Example*
Politicians	An individual who holds or has held a prominent public function in their own or a foreign country	Mayors, governors, members of parliament, etc.
Leaders of government or state	An individual who holds or has held a high-level position in the executive, legislative, administrative, military, or judicial branches of a foreign or domestic government	Presidents, prime ministers, ministers, etc.
Judges and members of the court	An individual who holds or has held a senior judicial position in a foreign or domestic country	Supreme court judges, constitutional court judges, etc
High-ranking members of the Central Bank	An individual who holds or has held a senior position in a foreign or domestic monetary authority	Governors, deputy governors, etc.
Ambassadors	An individual who holds or has held a diplomatic position in a foreign or domestic country	Ambassadors, consuls, etc.
High-ranking officers in the defence forces	An individual who holds or has held a senior military position in a foreign or domestic country	Generals, admirals, etc.
International organisation PEP	An individual who holds or has held a prominent function by an international organisation	Directors, deputy directors, board members, etc.
Senior managers of state-owned enterprises	An individual who holds or has held a senior management position in a state-owned enterprise	CEOs, CFOs, board members, etc.
Family member of a PEP	An individual who is related to a PEP through blood, marriage, or similar relationship	Spouses, children, parents, siblings, etc.
Close associate of a PEP	An individual who has a close business or personal relationship with a PEP	Business partners, advisors, friends, etc.

the potential implications of utilising functional PEP Lists, and examining the status of state-owned enterprises where senior managers are classified as PEPs due to the public ownership of their employers.

In November 2023, the EU published a consolidated functional PEP list[15] which includes relevant positions at member state level, at accredited international organisations and EU institutions and bodies. The industry has generally welcomed the establishment of functional PEP lists by member states, and the consolidated list published by the EU is set to offer further insights into PEP-relevant positions at the member-state level. However, the publication of the consolidated list also highlights significant pan-European disparities — not only in respect to the format and content of the list, but also in respect to the government levels which have been included as a 'prominent public function'.

The understanding of what constitutes a 'list' varies significantly. Countries like Austria and Italy, among others, adopted a descriptive approach and provide only examples of prominent functions, meaning that banks must decide whether or not the holder of a particular public position qualifies as a PEP. In contrast, Poland provides a comprehensive list of more than 200 positions in local and English language, while Bulgaria offers an alternative approach and associates every relevant position with an internal reference number as a unique identifier to aid obligated institutions. Hungary includes interactive web links to relevant administrative departments, enabling banks to manually identify the current holder of the prominent position.

Furthermore, a comparison of the functional PEP lists at the member state level confirms the still existing lack of consensus on who exactly qualifies as a PEP in the context of AMLD. The interpretations continue to vary widely, with some countries, such as Germany, focusing solely on the highest government and federal state level. On the other hand, member states like Lithuania provide a comprehensive list of PEP positions extending to municipal level, encompassing city mayors and their respective directors of administration.

In conclusion, the publication of a consolidated functional PEP list at the EU level will offer additional guidance related to the identification of PEPs to banks, depending on the level of detail at individual member-state level. In their current form, however, it is highly unlikely that they will offer any additional assistance to financial institutions regarding the automation of their KYC or monitoring processes.

The KYCEG highly recommends for the disclosure of both the full name and date of birth of individuals holding prominent positions in the national functional PEP lists. Consistent with the KYCEG's recommendations for commercial and UBO registers, this information should be centrally available to banks in open source data files and via API. However, this recommendation does not apply to family members and close associates, as their right to privacy potentially takes precedence over the financial institutions' need for access to harmonised digital data.

ASCENDING THE RANKS: BECOMING A PEP THROUGH EMPLOYMENT IN STATE-OWNED ENTERPRISES

In the context of state-owned enterprises (SOEs), an individual does not become a PEP through electoral victories or political appointment, but simply by being accepted or promoted into a senior executive position at a legal entity which is under the jurisdiction (eg ownership or control) of a public body or public institution. Unsurprisingly, the particulars of SOEs can vary widely within the EU, not only across different enterprises but also across different countries. Factors such as the operational sector of the SOE, the level and extent of state control, historical backdrop and country-specific regulations contribute to this variation. Subsequently, there is no standardised definition that encapsulates all SOEs in Europe.

This poses several challenges for banks in their efforts to identify individuals who are PEPs due to their senior manager role in a SOE, all of which make the due diligence process more complex and resource-intensive. Unless this issue is addressed centrally at EU level and executed in a harmonised manner by all member states, banks will need to invest continuously in their KYC processes to accurately identify PEPs associated with SOEs.

A potential solution to this issue could be the enhancement of data recorded in UBO registers. Given that the responsibility to update UBO registers rests with the respective company, it serves as the principal source for disclosing its ownership and control structure. The incorporation of a distinct field or marker in the European UBO registers could then signify an entity as being governed, controlled or owned by public bodies. Concurrently, detailed role descriptions could aid in pinpointing individuals who occupy senior roles within these entities, potentially leading to their classification as PEPs. Alternatively, all member states could follow the example set by five of their members and publish a list of all enterprises under their control, including a defined list of roles which are deemed politically exposed.

CONCLUSION

This paper discusses the major challenges of corporate customer KYC due diligence, such as fragmented regulation, inconsistent definitions, limited access to public records and lack of digital data for automation. However, it also highlights the recent EU efforts to tackle these issues, such as the introduction of UBO registers in 4AMLD and the functional PEP lists in 5AMLD, and the proposed transition from a directive-driven regulatory environment towards a directly applicable anti-money laundering regulation.

Today, and despite their good intentions, the directive-driven initiatives place additional burdens on regulated institutions without delivering all potential benefits. This is evident in the case of UBO registries, which not only fail to provide reliable UBO data, but instead escalate costs due to the obligation of reporting data discrepancies back to the register.

To enhance the effectiveness of AML and CTF controls, and to reduce the KYC burden on banks and their corporate clients, it is crucial for European and national regulators, public operators of commercial and UBO registers, and affected banks not only to create and operate in a harmonised regulatory environment, but also to leverage technological solutions. These solutions should enable banks and other obliged entities to automate the data collection and verification process, streamline operations, and promote data sharing and collaboration among stakeholders.

Obliged entities such as banks should advocate for more consistency across Europe regarding the definition, identification, and reporting of UBOs and PEPs. Moreover, all data necessary to counteract money laundering, terrorist financing and fraud should be easily accessible and in a digital format. It is also vital, although not covered in this analysis, that banks are enabled to adopt a uniform risk-based approach to KYC, adjusting the due diligence level to align with each corporate client's specific risk profile. This includes that PEPs, their family members and close associates who pose a lower risk should be subject to less stringent scrutiny compared with higher-risk individuals, instead of labelling all PEPs as inherently high-risk.

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