

Lesson 7.1 Quiz: Why Regulation Exists — AML, KYC, and Financial Crime  
Module 7: The Compliance Problem

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Digital Finance — BSc Course

## Question 1

**A financial institution must verify who its customers are, understand the purpose of each relationship, and monitor transactions on an ongoing basis. Which term best describes this obligation?**

- A. Know Your Customer (KYC)
- B. Transaction monitoring
- C. Suspicious Activity Reporting
- D. Sanctions screening

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*[Answer hidden – compile with \solutionstrue to reveal]*

KYC encompasses the full cycle: identify, verify, understand the relationship, and monitor ongoing activity. Transaction monitoring and SAR filing are components within the broader KYC obligation.

## Question 2

The three stages of money laundering are placement, layering, and integration. Which stage involves moving funds through multiple accounts and jurisdictions to obscure their origin?

- A. Placement
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- C. Integration
- D. Layering

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Layering is the stage where criminals create complex layers of transactions — wire transfers, shell companies, currency conversions — to distance the money from its criminal source. Placement puts cash in; integration takes “clean” money out.

## Question 3

**FATF is best described as:**

- A. A central bank that regulates cross-border payments
- B. An intergovernmental body that sets AML/CFT standards through non-binding recommendations
- C. A law enforcement agency that prosecutes money launderers
- D. A private company that provides sanctions screening software

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FATF issues 40 Recommendations that serve as global AML/CFT standards. These are not legally binding, but non-compliance triggers grey-listing, which severely impacts a country's access to the global financial system.

## Question 4

### **De-risking occurs when financial institutions:**

- A. Terminate relationships with entire categories of customers or regions to avoid perceived AML risk
- B. File more Suspicious Activity Reports to demonstrate compliance
- C. Hire additional compliance analysts to manage growing alert volumes
- D. Invest in better transaction monitoring technology

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De-risking is the wholesale withdrawal from customer categories or regions. Rather than managing risk, the institution avoids it entirely — which pushes affected customers into unmonitored channels and can increase financial crime risk overall.

## Question 5

**A compliance analyst notices that a restaurant owner deposits exactly \$9,900 in cash three times per week. The US reporting threshold for cash transactions is \$10,000. What should the analyst do?**

- A. File a Currency Transaction Report (CTR) for each deposit
- B. Close the customer's account immediately without investigation
- C. File a Suspicious Activity Report (SAR) for suspected structuring
- D. Nothing — each deposit is below the reporting threshold

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The pattern of deposits just below \$10,000 is a classic red flag for structuring (“smurfing”) — deliberately splitting deposits to avoid the CTR threshold. The analyst should file a SAR. The individual deposits are below the CTR threshold, so (B) does not apply, but the pattern itself is suspicious.

## Question 6

**A bank is onboarding a new corporate customer. The company is incorporated in a FATF grey-listed jurisdiction, its beneficial owner is a Politically Exposed Person (PEP), and it operates in the precious metals trade. What level of due diligence is required?**

- A. Enhanced Due Diligence (EDD) with senior management approval
- B. Simplified Due Diligence (SDD)
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Three high-risk indicators are present: grey-listed jurisdiction (geographic risk), PEP beneficial owner (customer risk), and precious metals (product risk). Any one of these would trigger EDD; all three together require maximum scrutiny with senior management sign-off.

## Question 7

**A compliance officer files a SAR and then tells the customer: “We reported your transactions to FinCEN. You may want to speak with a lawyer.” What is the legal consequence?**

- A. No consequence — transparency with customers is good practice
- B. FinCEN will investigate the compliance officer for filing a false report
- C. The compliance officer has committed “tipping off,” which is a criminal offense
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Tipping off is a criminal offense in most jurisdictions. The institution must not disclose to the customer (or any third party) that a SAR has been filed. This protects the integrity of the investigation and prevents the customer from destroying evidence or fleeing.

## Question 8

**A VASP (Virtual Asset Service Provider) processes a €5,000 crypto transfer. Under the FATF Travel Rule, the originating VASP must:**

- A. Transmit the sender's name, account number, and address to the beneficiary VASP
- B. Block the transaction until the sender provides a notarized identity document
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The Travel Rule (FATF Recommendation 16) requires the originating VASP to transmit identifying information about the sender to the beneficiary VASP. This mirrors the wire transfer rules that traditional banks already follow. The threshold is typically \$1,000/€1,000.

## Question 9

**A bank's transaction monitoring system generates 2,000 alerts per day with a 97% false positive rate. How many alerts per day are likely to be true positives requiring SAR consideration?**

- A. 200
- B. 600
- C. 20
- D. 60

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**A bank's transaction monitoring system generates 2,000 alerts per day with a 97% false positive rate. How many alerts per day are likely to be true positives requiring SAR consideration?**

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True positive rate =  $100\% - 97\% = 3\%$ . True positives =  $2,000 \times 0.03 = 60$  alerts per day. The remaining 1,940 alerts are false positives that must still be investigated and documented, consuming the vast majority of analyst time.

## Question 10

**An analyst must determine the beneficial owner of a company. The ownership structure is: Person X owns 40% of Company A, which owns 60% of Company B, which owns 100% of Company C (the customer). Person X's indirect ownership of Company C is:**

- A. 60%
- B. 100%
- C. 24%
- D. 40%

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- D. 40%

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Indirect ownership =  $40\% \times 60\% \times 100\% = 24\%$ . Under most jurisdictions, the beneficial ownership threshold is 25%. At 24%, Person X is just below the threshold — but the institution should still investigate whether X exercises control through other means (e.g., board seats, voting agreements).

## Question 11

**A sanctions screening system flags a payment to “Mohammed Al-Rahman” because the name partially matches “Mohammed Al-Rahmani” on the OFAC SDN list. The compliance analyst should:**

- A. Ask the customer if they are the sanctioned person
- B. Investigate the hit by comparing additional identifying information (DOB, address, nationality) to determine if it is a true or false match
- C. Release the payment because it is not an exact match
- D. Automatically block the payment and report it to OFAC

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Fuzzy name matching produces many near-matches. The analyst must investigate using additional identifiers to determine if the flagged party is the same person on the sanctions list. Automatic blocking without investigation causes unnecessary delays; releasing without investigation risks a sanctions violation.

## Question 12

**A bank's AML compliance program costs \$50 million per year. Regulators fine the bank \$200 million for AML failures. The bank estimates that strengthening its program to avoid future fines would cost an additional \$30 million per year. From a purely financial perspective, the bank should:**

- A. Outsource compliance to a third party to eliminate liability
- B. Keep the current program and treat fines as a cost of doing business
- C. Shut down the AML program entirely to save \$50M
- D. Invest the additional \$30M/year, since one \$200M fine exceeds several years of investment

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The \$200M fine is equivalent to  $200/30 \approx 6.7$  years of additional investment. Beyond direct fines, AML failures trigger DPAs, reputational damage, and possible loss of license — making the expected cost of non-compliance far higher than the \$30M/year upgrade.

## Question 13

**A country is placed on the FATF grey list. Which of the following is the most likely immediate economic consequence?**

- A. The country's stock market crashes
- B. The country is expelled from the United Nations
- C. International correspondent banks reduce or terminate relationships with the country's banks, increasing transaction costs and reducing access to global finance
- D. All foreign investment in the country is automatically frozen

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Grey-listing signals to global banks that doing business with the country carries elevated AML risk. Correspondent banks raise fees, impose additional checks, or exit entirely — making cross-border payments slower, more expensive, and sometimes impossible. This is the primary enforcement mechanism of FATF.

## Question 14

**A FinTech startup offers instant peer-to-peer payments with no minimum balance and remote onboarding via selfie verification. Compared to a traditional bank, which AML risk is most elevated?**

- A. Customer risk, because FinTech customers are inherently more suspicious
- B. Geographic risk, because FinTechs only operate in high-risk jurisdictions
- C. Product/channel risk, because non-face-to-face onboarding increases identity fraud risk and instant payments reduce the window for intervention
- D. Regulatory risk, because FinTechs are exempt from AML requirements

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Non-face-to-face onboarding (remote KYC) and instant payments create elevated product/channel risk. Remote identity verification is more susceptible to fraud (deepfakes, stolen documents), and instant payments reduce the time available for compliance checks before funds are irrevocably sent.

## Question 15

**Terrorist financing often involves small, legitimate-looking transactions. Why does this make CFT harder than traditional AML?**

- A. Because banks are not required to report suspected terrorist financing
- B. Because terrorist financing transactions are often below monitoring thresholds, originate from legal sources, and look indistinguishable from normal activity
- C. Because terrorist financing always uses cash, which is untraceable
- D. Because FATF does not issue recommendations on terrorist financing

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Unlike money laundering (which involves large sums of illegal money), terrorist financing often uses small amounts from legal sources. A \$2,000 wire transfer from a salaried individual looks identical to millions of legitimate transactions — making pattern-based detection extremely difficult.

## Question 16

**A bank reduces its transaction monitoring thresholds, generating 40% more alerts. Six months later, the SAR filing rate per alert decreases from 4% to 2%. What is the most likely explanation?**

- A. Lower thresholds captured more noise (false positives), diluting the proportion of genuine suspicious activity
- B. Financial crime in the bank's customer base decreased
- C. The compliance team became more effective at clearing alerts
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Lowering thresholds increases alert volume but primarily captures additional false positives. The absolute number of true positives may remain similar, but they are now a smaller proportion of a larger alert pool. This is the classic precision vs. recall trade-off applied to AML monitoring.

## Question 17

**DeFi protocols have no central operator to impose KYC. A regulator proposes requiring all DeFi users to register with a government identity service before interacting with smart contracts. What is the strongest practical objection?**

- A. DeFi protocols are too slow to process identity checks
- B. Smart contracts are permissionless and cannot distinguish between wallets — there is no enforcement point to require registration
- C. Users would simply register with fake identities
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DeFi protocols are open-source, permissionless smart contracts that execute automatically when conditions are met. There is no “front door” where an identity check can be imposed. Users interact directly with the blockchain, and the protocol cannot distinguish a compliant wallet from a non-compliant one without external infrastructure.

## Question 18

**The beneficial ownership threshold in most EU jurisdictions is 25%. A criminal structures a shell company so that four associates each hold 24% while the criminal holds 4% but has a secret side agreement giving them full control. Has the AML framework been defeated?**

- A. No — all shareholders above 1% are always identified as beneficial owners
- B. Yes — no individual exceeds 25%, so no beneficial owner is identified
- C. No — the 4% holder automatically triggers EDD
- D. Partially — the 25% threshold is not met, but the institution should still investigate who exercises effective control

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The 25% threshold captures ownership, but FATF and most regulations also require identifying persons who exercise *control* through other means. The institution should look beyond percentages to identify who actually directs the company. However, secret agreements are hard to detect — this is a known weakness of the framework.

## Question 19

**A policy proposal suggests replacing the current SAR system with a centralized, real-time data-sharing platform where banks and FIUs share transaction data continuously. What is the most significant trade-off?**

- A. It would make FIUs unnecessary
- B. It would be cheaper than the current system
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Real-time data sharing would allow detection of patterns that span multiple banks (which the SAR system cannot do), but it raises fundamental privacy concerns: bulk financial surveillance of all citizens, potential for misuse, GDPR compliance, and the risk of data breaches exposing sensitive financial information.

## Question 20

**A senior executive argues: “Our AML program costs \$80M/year and has a 96% false positive rate. We should dismantle it and donate the savings to law enforcement, which would do more good.” Evaluate this argument.**

- A. The argument is correct because false positive rates above 90% prove the system is useless
- B. The argument ignores that AML programs serve multiple purposes: deterrence, regulatory compliance, legal protection for the institution, and intelligence generation
- C. The argument fails only because dismantling AML programs is illegal
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The argument treats AML purely as a crime-detection tool. In reality, AML programs serve four functions: (1) deterrence (criminals avoid monitored institutions), (2) legal compliance (avoiding fines and prosecution), (3) safe harbor (protection from liability), and (4) intelligence (SARs feed law enforcement). A high false positive rate is a real problem, but dismantling the program would remove all four benefits.