

BIFS
ANNUAL WEEK OF
SEMINARS 2008
New Developments in the
Compliance Field

Presentation by BACO

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Risk & Compliance

An Economic Downturn or Recession

- Conflicting views among economists and financial analysts
- A recession? Possible recession? Imminent recession?
- Different schools of thought and no consensus to date
- Reality = Global Economic Downturn/Slowing Economy
- IMF has downgraded economic growth projections for several countries

News in the Financial Industry 2008

- UBS reports First Quarter loss of \$11 billion
 - To cut 5,500 jobs

- Bear Stearns bought by JPMorgan Chase
- Citigroup posts \$5.1 billion 1Q loss
 - To cut 9,000 jobs
- Societe General loses \$7.2 billion in biggest banking fraud in history
- Liechtenstein breach of confidentiality

News in the Financial Industry 2008

- Credit Suisse Group posts Q1 loss of \$2.1 billion
 - To cut 9,000 jobs
- JP Morgan slumps to a loss of \$2.6 billion in Q1
 - Its first quarterly loss in 4 years
- Merrill Lynch suffers net loss of \$1.96 billion

in first quarter

- To cut 4,000 jobs
- Deutsche Bank writes down \$4.2 billion in Q1
- Sub-prime Mortgage Crisis

Financial Institutions in an Economic Downturn

To survive in these times, financial institutions:

- Become more aggressive in the marketing of products and services
- Have to compete harder to attract clients/customers
- Need to maintain customer loyalty
- Consider the option of downsizing and streamlining

- May demand a lot of multi-tasking from their employees to cut costs

Compliance in an Economic Downturn

Compliance Department's
Nicknames/Re-branding:

- Complaints Department
 - Customer Deterrent Department (CDD)
 - Kick Your Clients Out Department (KYC)
 - Business Prevention Unit
 - Anti Money Loving (AML) Function
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- Appointment of Compliance Officer a tick in the box and to satisfy FITRR only?
 - Economic slowdown = good excuse to incapacitate this menace
 - Compliance is not a priority in these times of

global turmoil

Compliance in an Economic Downturn

Compliance is more important in an Economic
Downturn:

- Strong correlation between economic hardship and crime
- Crime thrives in a recession and economic slowdown
- Expected increase in proceeds of crime globally
- Consequent need to use financial system to launder these proceeds
- Significant challenges face compliance officers in these times

Approach to Compliance in an

Economic Downturn

The Compliance Department must recognize these challenges and:

- Move away from a rules-based, unrealistic and “one-cap-fits-all” approach to compliance
- Adopt and refine (if necessary) its risk based approach
- Implement and enforce the risk-based approach with specific emphasis on the overall risk profile
- Put in place measures to ensure that there are no unnecessary requirements which could cost the institution legitimate businesses and clients

Societe Generale: Breach of Trust

- The Bank announced in January 2008 that a single trader had cost the Bank \$7.2 billion
- Bank stated that trader acted alone
- Bank announced that it will be seeking 5.5 billion euros in financing
- Alleged “fraud” larger than transactions (\$1.4b) by Nick Leeson that led to the collapse of Barings Banks
- Long term debt ratings downgraded by two credit rating agencies
- Biggest bank fraud in history

Societe Generale: Breach of Trust

Profile of Bank

- France's second largest bank
- Named Equity Derivatives House of the Year by *Risk*
- Equities-derivatives business – biggest at any institution in the world and posted double-digit growth for past eight years
- Risk management practices believed to be some of the best in the industry
- Over 2000 employees working in the Compliance Department

Societe Generale: Breach of Trust

Profile of Employee

- 31-year-old male

- Joined Bank in 2000 working in Compliance Department
- Promoted to Delta One Team as Junior Trader in 2005
- Considerable computer skills
- Knowledge of inner workings, checks and balances of systems
- Salary - 74,000 euros; Bonus – 60,000 euros (2006)
- Considered “not a star”

Societe Generale: Breach of Trust

Modus Operandi

- Employee falsified documents
- Various levels of controls were breached

- Irregular trading patterns were ignored
- Compliance rules and triggers were circumvented
- Employee hacked Bank's computer systems
- Used log-in and passwords of colleagues in trading and technology departments
- Slipped when failed to deactivate part of Bank's warning system

Societe Generale: Breach of Trust

Red Flags

- Employee worked late hours
- Internal Compliance and control systems popped up over 24 alerts which raised no "*sufficient*" doubts

Societe Generale: Breach of Trust

Lessons

- Sophisticated Technology is no absolute substitute for compliance involving human intervention and manual processes
- Absence of policy to prevent movement of personnel to departments where systems could be circumvented
- Irrespective of compliance resources a breach of trust can still occur
- The role of compliance can not be underestimated
- IT Security should be kept up-to-date and audited

Compliance: The Lifesaver

- Risk management is the ultimate responsibility of the Board of Directors despite delegation to senior management
- The Board must ensure that the institution's risk management framework remains effective, efficient and up-to-date
- The Compliance Function is also a “risk management” function
 - **Legal**
 - **Regulatory**
 - **Operational**
 - **Reputational**
 - **Business**
 - **Financial**

Compliance: The Lifesaver

- Financial institutions cannot afford a Societe Generale or LGT Bank type shock in the midst of the economic downturn and credit crunch
- The failure of the Compliance Function in these

times could be severe and far-reaching

- The Compliance Function therefore requires an adequate budget, sufficient resources as well as skilled and well trained personnel
- The reality of an economic downturn or recession has not eliminated the risks financial institutions have always faced and still face
- Statutory and regulatory requirements remain constant and are on the rise
- Risk exposures in these times will only increase and will not disappear

Compliance: The Lifesaver

- Compliance is not a problem but a **solution**
- The Board must carry out a Cost-Benefit Analysis and consider
 - **The FI's risk tolerance and appetite in the current economic climate**
 - **The repercussions of possible reputational damage to the institution**

- **The possibility of legal actions against the financial institution**
 - **The likelihood of a regulatory sanction, fine or suspension/revocation of its licence**
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- The Board should avoid making a permanent decision in a temporary situation
 - Adverse results could be achieved and a boomerang effect is imminent

Compliance: The Unsung Hero

Downsizing the Compliance Department during an economic downturn:

- Unsound risk management decision
- Increases overall risk exposure
- Sends a negative message to potential clients, investors and regulators

- Sends a positive message to potential money launderers and terrorist financiers.

The Compliance Officer

- Regulation 5 of the Financial Intelligence (Transactions Reporting) Regulations, 2001 requires financial institutions to appoint a Compliance Officer who shall ensure full compliance with the laws of The Bahamas.

Risk Rating Framework

- The FTRA and FTRR adopt a risk based approach recommended by the Basel Committee and the FATF which gives financial institutions the discretion to determine the appropriate level of information and documentation required to verify customer identity based on the nature and degree of risk inherent in the customer relationship.

- The Central Bank's AML Guidelines provides further guidance in this regard.
- The risk rating framework should be approved by the Board of Directors as being appropriate for the type of products offered by the Company, and capable of assessing the level of potential risk each client relationship poses to the Company.

Components of a Risk Rating Framework

- Differentiation of client relationships by risk categories (such as high, moderate or low)
- Differentiation of client relationships by risk factors
 - **Products,**
 - **Client type**
 - **Profession**
 - **Country of domicile**
 - **complexity of ownership and legal structure**
 - **Source of business**
 - **Type of assets**
 - **Type, size and volume of transactions**

- **Adherence to client activity profile**
 - A process for the approval of the downgrading/upgrading of risk ratings.
- Key Elements of the Risk Rating Framework**
- Risk Rating of New Clients Prior to Acceptance
 - Ongoing Monitoring and Review
 - Classification of Client Relationships into Risk Categories
 - Frequency of Risk Assessment
 - High Risk – Quarterly
 - Medium Risk – Semi-annually
 - Low Risk - Annually

Risk Criteria

- Geographical Origin of Client/Customer
 - **Nationality**

- **Country of Residence/Domicile**
- **Place of Birth**
- Geographical Sphere of Client's Business
- Nature of Client's Business
- Nature and Frequency of Activity
- Customer type
 - **Potentates**
 - **Politically Exposed Persons (PEPs)**
- Type, value and Complexity of the facility
- Complex Structure of Ownership – Corporate Entities
- Hold Mail/ No Contact Arrangements
- Inactive/Dormant Accounts

High-Risk Countries

- Certain countries are associated with predicate crimes such as drug trafficking, fraud and corruption and consequently pose a higher potential risk to the Company
- Business relationships with customers who are either citizens of or domiciled in such countries exposes the Company to reputational risk and

legal risk

- Caution must be exercised in dealings with individuals domiciled in or who are citizens of high-risk countries
- Restraint should also be exercised in respect of the acceptance of certified documentation from individuals and entities located in such countries and territories
- The Company should carry out appropriate verification checks on such individuals/entities to ensure their legitimacy and reliability

Existing Client Relationships

- All risk ratings and reviews **must** be documented.

The Compliance (and “Risk”) Officer

- The Compliance Officer must ensure that the potential risks inherent in each new client relationship are assessed prior to establishing

a business relationship.

- This assessment should take account of whether and to what extent a customer may expose the Company to risk, and of the product or facility to be used by the customer.
- Based on this assessment, the responsible employee should make a recommendation as to whether or not the Company should establish a facility for the customer concerned or to continue with it.
- Ongoing monitoring of clients' accounts should take place at pre-determined intervals and frequencies.