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Implementing a Risk-Based Approach: The Swiss Perspective

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It is a great pleasure for me to be here and to have the opportunity to contribute to this important discussion on anti-money laundering measures and customer due diligence.

My topic is the implementation of the risk-based approach in Switzerland. As you are all in the business of managing risk there is little I can tell you about that topic that you do not already know. What I intend to talk about are the regulatory requirements and expectations of the Swiss regulator with respect to the implementation of the risk-based approach.

The risk-based approach is not new and is not a Swiss speciality. Both regulators and the industry have come to recognize that a “one size fits all” approach does not work and that a risk-based approach makes it possible to fight money laundering more effectively. The risk-based approach has been best practice in the industry for quite some time and more recently has also been endorsed on the international level. As such, Recommendation 5 of the revised forty recommendation of the Financial Action Task Force FATF stipulates that “*for higher risk categories, financial institutions should perform enhanced due diligence.*” The Basel Committee’s Customer Due Diligence for Banks, which was adopted in 2001, recommends that “*Banks develop graduated customer acceptance procedures that require more extensive due diligence for higher risk customers.*” (para. 20) The risk-based approach also underlies the Wolfsberg Principles which state that “*in its internal policies, the bank must define categories of persons whose circumstances warrant additional diligence.*” (para. 2)

The new Ordinance of the Swiss Federal Banking Commission

The Swiss Federal Banking Commission codified the risk-based approach in its Money Laundering Ordinance, which was adopted in December 2002. The Ordinance entered into force in July of last year. There is a transitional period until June 30, 2004 for certain provisions, in fact, those provisions that relate to the implementation of the risk-based approach. The Ordinance was elaborated in close collaboration with the industry and many of its requirements were inspired by the industry's best practices.

At its core is the obligation for all banks to “*carry out additional investigations into business relationships or transactions involving higher risk.*” (Article 17) This rule is not new and has been part of Swiss money laundering rules for some time. What is new is that banks are required to take a systematic approach and to put in place well-defined procedures for identifying, mitigating and monitoring risk associated with money laundering.

The Ordinance defines the main steps and minimum requirements for devising an effective anti-money laundering system. The first step for each individual bank is to make out vulnerabilities and potential gaps in its controls and to identify its money laundering risks. To this end, the Ordinance requires banks to define indicators for both higher risk customer relationships and transactions. The defined risk indicators should reflect the risks specific to the business activities of the individual bank. The Ordinance does not make any prescriptions; the only mandatory criterion for a higher risk customer relationships is the “PEP quality”. That is, all banks are required to treat business relationships with politically exposed persons (PEP) as relationships that require enhanced due diligence.

The Ordinance gives various examples for criteria that may be used as risk indicators for customer relationships and transactions:

- Examples of criteria for higher risk customer relationships are the country of residence or domicile of the customer, the business activity, the amount of assets deposited, the volume of inflows/outflows, the country of origin and destination of regular payments. While most banks use some or all of those criteria they may use additional tailor-made criteria or apply a scoring method that combines several criteria.

- Examples for parameters to be used in a computer-based transaction monitoring system relate to incoming and outgoing payments, unusual transactions within the normal behaviour of an account, significant divergence from the type, volume or frequency of transactions that would be normal in comparable customer relationships. A number of indicators for unusual transactions that require human controls are set forth in the annex to the Ordinance.

Rule-based and risk-based approach combined

Once the risk-criteria for customer relationships and transactions are defined, how are they applied? The Swiss Ordinance combines a rules-based with a risk-based approach. Rules based customer identification requirements apply to all customer relationships in order to ensure that minimum information on the customer and beneficial owner is available in all cases. In addition, the bank must - based upon the identified risk criteria - determine whether or not the customer relationship needs to be categorized as higher risk relationship. Banks are required to review all customer relationships, including those that existed prior to the entry into force of the new Ordinance, in order to determine whether or not they meet any of the risk criteria.

To find unusual transactions, the bank is required to use a computer-based system that monitors the transactions of all customers (and not only those that have been identified as higher risk) and identifies those transactions that meet predefined parameters. The Ordinance stipulates that higher risk customer relationships and higher risk transactions become subject to enhanced customer due diligence.

Enhanced Due Diligence for higher risk customers and PEPs

What does the required enhanced due diligence consist of? First, as soon as it becomes evident – at the beginning or during the course of a customer relationship – that a customer relationship entails higher risk, the Ordinance stipulates the requirement that the bank obtain more information, for instance, as to the origin of funds, the business of the client, the beneficial ownership, or the PEP quality of the customer. As a means to obtain that information, the Ordinance cites a number of examples, among others, the consultation of public databases, the use of intelligence networks, visits at the customer's business. The Ordinance explicitly places the responsibility for regular reviews and enhanced monitoring of higher risk customers on the senior management. Moreover, entering into business relationships with

politically exposed persons requires in all cases the approval of the most senior management. This rule that is also found in the recommendations of the Basel Committee (Customer Due Diligence Paper, sec. 44) and is now codified in the new Ordinance is not new in Switzerland. It has been developed in the Banking Commission's supervisory practice already in the late eighties.

It is important to stress that the regulator only defines the minimum requirements and general framework for the risk-based approach. The banks remain responsible for identifying the risks and developing processes to monitor those risks. Some representatives of the banks and of the audit profession voiced concerns about the risk-based approach and would prefer more prescription. Ironically, these are often the same persons that moan about too much regulation in Switzerland. The risk-based approach should allow a proportionate and potentially cost-effective approach to anti-money laundering.

There is, however, a certain amount of subjectivity in assessing risk and devising appropriate processes. One challenge for the regulator is the comparability of the banks' various risk strategies. To obtain an overview of the risk strategies adopted by the banks, all banks were required to submit to the SFBC, by September 2003, their concepts for implementation of the new Ordinance along with an audit opinion on their adequacy: The evaluation of those concepts showed that the majority of the banks take implementation very seriously. It also showed diversity of practice amongst firms, which varies according to the size of the banks, the number of customers, the volume of transactions and a host of other factors. Finally, it showed that the implementation is not cost free. The main cost factors turned out to be the development of the technology for the introduction of automated transactions monitoring systems as prescribed by the Ordinance, staff training in the use of the new technology, support and maintenance of the monitoring systems, additional staff time in investigating reports produced by transaction monitoring systems, and the conduct of additional clarifications of certain customer relationships. In a minority of banks the results were not satisfactory. These substandard reports confirmed that banks cannot develop an adequate anti-money laundering policy without taking the basic steps of identifying and assessing their own specific money laundering risks.

An effective system should protect your institutions against money laundering related legal and reputational risks. This is in your own best interests. We all know that the best systems can fail and may be

circumvented. However, only by having an effective anti-money-laundering system and good internal controls can your institution make a credible claim not only to the regulator, but also and more importantly to the public that it has undertaken everything that could reasonably be expected to avoid the risk.

Global KYC risk management

In line with the international standards of the Basel Customer Due Diligence Paper (Sec. 64), the Swiss Ordinance requires that its principles also apply to branches and subsidiaries located abroad. Among those principles is the risk-based approach, which requires enhanced due diligence for higher risk customer relationships.

For globally active financial institutions the Ordinance specifies that they are required to identify, mitigate and monitor the legal and reputational risks associated with money laundering on a global basis.“ The reason is that reputational risk cannot be contained within national borders.

In order to manage higher risks on a global basis it is necessary to identify them on a local basis according to the risk-based approach. However, a common group-wide risk strategy cannot be adopted unless the information on specific higher risks that are significant for the entire group can be consolidated and shared within the group. In other words, banks should have procedures for ascertaining whether other branches or subsidiaries hold accounts for the same higher risk customer and assess their group-wide exposure to that customer and the associated reputational risk..

The ordinance requires that the head office, for instance a global compliance function or the group internal audit function, has access to information on individual higher risk customer relationships in foreign branches and subsidiaries for global KYC risk management purposes.

What is required of Swiss financial institutions cannot be prohibited for foreign institutions with establishments in Switzerland. Therefore, Article 9 of the Ordinance explicitly states that “*financial intermediaries forming part of a financial group, either from Switzerland or abroad, shall allow the group’s internal control bodies and external auditors to access any information which may be required concerning specific business relationships, provided that such information is essential for the management of legal and reputational risk on a global basis.*“

These provisions implement the requirements for the global management of reputational risk as set forth in the Consultative Paper on Consolidated KYC Risk Management of the Basel Committee that is a key theme at today's discussions. Yet, they do not lay out in detail how these requirements are to be implemented. They only stipulate that the creation of a centralised database of customers or a centralised access is not what is required.

In implementing these provisions Swiss banks may be caught in a quagmire. By abiding by the Ordinance, they may breach local laws that prohibit access to customer information. The ordinance therefore stipulates that if they identify serious impediments to accessing information on customers in certain jurisdictions they shall inform the Banking Commission. While the banks still have time until the end of June to implement these provisions, we have already been advised of impediments encountered in some countries.

Many jurisdictions do not explicitly regulate the flow of customer information within group companies for anti-money laundering purposes. As a result, there is considerable legal uncertainty. Barriers to cross-border information flows are found in data protection or bank secrecy laws. In some jurisdictions, these barriers can be overcome by obtaining written consent from the customer or giving proper notification to the customer.

The Swiss Federal Banking Commission is aware of these impediments and therefore encourages initiatives to remove them by adopting the necessary amendments to the relevant laws. Data protection concerns need to be weighed against the need of a globally active institution in being able to prevent fraud and money laundering and to make group-internal control mechanisms work effectively.

In the meantime, we encourage financial institutions to work within the existing frameworks to find pragmatic solutions which give assurance to them regarding their risk strategies, for instance, via group compliance or internal audit functions that do not physically transfer information across borders.

Conclusions

To close, I wish again to stress two points I made earlier regarding the challenges that lay ahead for the regulator and the regulated:

- (1) The challenge for the regulator is to define and to refine the minimum requirements and general framework for the risk-

based approach. The ultimate responsibility for a successful implementation that achieves the goal of effectively fighting money laundering, however, lies with those at the front, the banks themselves.

- (2) The challenge for the banks is to exceed that minimum. It is essential to be at the forefront of improving risk-based anti-money laundering systems. Only by having a state-of-the-art system can the institution make a credible claim not only to the regulator, more importantly to the public, that it has undertaken everything that could reasonably be expected to avoid the risk.