Eidgenössische Bankenkommission
Commission fédérale des banques
Commissione federale delle banche
Swiss Federal Banking Commission

Implementation of the SFBC Money Laundering Ordinance

Second report of the SFBC

October 2005

Summary

For the financial year 2004, external auditors were required to provide the SFBC with a report on the implementation of the SFBC Money Laundering Ordinance by banks and securities dealers. Based on this extensive and very comprehensive audit, the SFBC is satisfied with the status of the implementation. The banks have properly implemented the provisions and in so doing, have used appropriate resources. They have structured their money laundering prevention procedure in a risk-oriented manner and have adapted their internal processes and systems to this new approach. The additional investigations relating to higher-risk business relationships were time-consuming and challenging for the banks. However, the banks proved equal to the task. In some isolated and – in terms of the number of relationships – insignificant cases, the status of the implementation was not yet satisfactory. The SFBC took up these cases with the external auditors and financial intermediaries involved. The SFBC is satisfied to note that the differentiated regulation has fulfilled its stated objectives. Accordingly, there is no need for any fundamental changes, only perhaps specific adjustments after a more detailed analysis of international developments.

1 Introduction

The new SFBC Money Laundering Ordinance (MLO SFBC) came into effect on 1 July 2003. The Ordinance requires banks to take a systematically risk-oriented approach to the prevention of money laundering. While they must apply the identification rules pursuant to the Agreement on the Swiss banks' code of conduct with regard to the exercise of due diligence (CDB 03) to all business relationships, there is a higher standard of due diligence when it comes to higher-risk business relationships and transactions. In these cases, the banks must not only gather the information necessary for all other client relationships, but must go further and make additional inquiries, for example as to the origin of the assets and economic background of a business relationship or transaction. The implementation of the risk-oriented approach is demanding from both an organisational and technical perspective. Banks are required to define criteria for identifying higher-risk business relationships and transactions, and to introduce a computer-based transaction monitoring system. They have to adapt their internal processes and control systems in order to ensure adequate risk monitoring. Lastly, the Ordinance imposes a number of requirements, which take into account the most recent international standards such as the 40 FATF recommendations and 9 special recommendations, as well as the Basel Committee principles concerning banks' due diligence obligations.

The risk-oriented approach is intended to allow the banks to tailor their money laundering prevention procedures to their business, its characteristics and the special risks relating to it. In order to ensure that all banks properly implement the MLO SFBC in accordance with their risks, the Swiss Federal Banking Commission (SFBC) introduced implementation auditing in 2003. All banks had to submit their implementation plans based on their own risk analysis, including the implementation timetable, to the SFBC by the end of September 2003 (see evaluation report at www.ebk.ch/d/publik/mitteil/2004/intex.html) or www.ebk.ch/d/publik/mitteil/2004/index.html).

For the 2004 financial year, the MLO SFBC required that the auditors' annual reports contain a separate report on the adequacy of the implementation by the banks. A total of 405 banks, 450 Raiffeisen banks and 69 securities dealers and their approx. 26.5 million business relationships were covered by this comprehensive implementation audit.

2 Summary of main findings

Practically all banks have properly implemented the provisions and are using adequate resources for this purpose. All banks have put in place a risk-oriented money laundering prevention procedure and have adapted their internal processes and systems to this new approach. Any remaining deficiencies are being rectified on an on-going basis. The main findings of the evaluation are as follows:

- **Higher-risk business relationships:** Almost all banks are using the criteria set out in the MLO SFBC to categorise higher-risk business relationships. A number of banks have added more specific in-house criteria, e.g. by using lists specifying business activities and countries involving special risks. The percentage of higher-risk business relationships in proportion to the overall number of business relationships varies greatly depending on the size and type of business activity. Generally, it is substantially lower for banks involved primarily in retail business and large banks than for banks involved in wealth management and smaller banks.

- **Higher-risk transactions:** Higher-risk transactions are also being assessed using the criteria prescribed by the MLO SFBC. Depending on their capability, some transaction monitoring systems can generate additional criteria for specific business relationships based on historical values. However, a transaction monitoring system only fulfils its purpose if it is integrated in the internal processes, and only generates as many transactions requiring investigation as can be managed by the resources made available.

- **Documentation:** Adequate client identification documentation and additional investigations should also enable third parties to follow the history of all business relationships and their risk assessment. The auditors judged the type and scope of documentation with respect to higher-risk business relationships as being generally adequate, although in some cases not sufficiently informative and still requiring improvement.

- **Training:** Implementation of the Ordinance places high demands on employees of banks, in particular on client advisors. They must be made aware of risk factors and be in a position to decide what additional investigations are required in specific instances. The MLO SFBC cannot be properly implemented without well-trained employees. Employee training is very satisfactory. Only in a few instances did some institutions still underestimate its importance, and in this area there is a need for them to improve. The SFBC is looking into these cases.

- **Global monitoring of reputational risks:** The SFBC was notified by a few institutions of problems with the cross-border monitoring of legal and reputational risks as foreign local laws were said to present an obstacle to cross-border data transfer. However, effective global monitoring of legal and reputational risks may also be achieved through organisational measures in many cases. The SFBC intends to clarify these issues with the banks and supervisory authorities involved.

- **Payment orders from Switzerland:** Following a conversion of internal systems by the banks, the requirement to include information about the instructing party with any payment order from Switzerland, is generally being observed.

- **Organisation:** All banks have designated internal anti-money laundering units. In a few cases, the responsibilities of such units in relation to the front office and interfaces with other functions still have to be more clearly defined.

- **Role of the external auditors:** Implementation audits are very demanding not only for financial intermediaries, but also for auditors. The auditors are required to have an in-depth knowledge of the risk profile and specific money laundering risks in order to be in a position to adequately evaluate implementation.

- **No regulatory action required:** As a result of the positive evaluation results, the SFBC currently sees no need for regulatory action to either tighten or relax measures. The SFBC still believes that the regulatory provisions make sense and allow for money laundering prevention measures that are risk-oriented and adapted to the various transactions.

3 Scope of reporting

Based on a **standardised questionnaire,** the auditors were requested to address various points, in particular the following:

- criteria used to determine higher-risk business relationships and transactions
- type and method of additional investigations
- number of higher-risk business relationships
- transaction monitoring
- training concept
- global monitoring of legal and reputational risks
- the mention of the ordering party's name on payment orders abroad
- organisation of designated anti-money laundering unit
- services provided by internal auditors in connection with implementation of the Ordinance

The external auditors were required to address all areas of the MLO SFBC and compliance with the identification rules under the Agreement on the Swiss banks' code of conduct with regard to the exercise of due diligence (CDB 03). For some institutions, the money laundering prevention procedure was a key theme in the 2004 financial year audit.

4 Risk-oriented assessment and investigations of business relationships

Financial intermediaries must **define criteria for higher-risk business relationships and transactions** that are tailored to the particular business activity of the institution. Compared with other business relationships, higher-risk business relationships require additional investigations, but should not be regarded as prohibited client relationships. All financial intermediaries used the **list of criteria contained in the Ordinance** to categorise risk. Practically all used the **criterion "risk country**" in connection with either the place of residence, nationality, or place of business of the contracting partner and/or beneficial owner. As an aid for evaluating this criterion, some of the financial intermediaries created their own lists of "sensitive" countries and these lists vary depending on the institution and geographical focus of the financial intermediary's business. However, even where the "risk country" criterion applies, once additional investigations are carried out, a business relationship can still turn out not to entail any special risks.

Where the criterion "**amount of assets deposited**" is used, the set maximum limits vary according to the business activity involved. As a rule, institutions specialised in private banking set the limits higher than institutions offering full-service banking. Often, an initial, relatively low limit is defined for assets deposited, which then, if other criteria are also met, may result in a business relationship being categorised as higher-risk.

The **type of business activity** carried out by a client is another criterion used on a regular basis. Many financial intermediaries have drawn up lists specifying business activities that are regarded as risky. Activities often found on such lists include arms trading, commodities trading, trading in precious stones or metals, trading in real estate, casinos, currency exchange offices, money transfers, fiduciaries, lawyers and notaries. Some institutions have drawn up lists of activities that they regard as particularly susceptible to corruption.

Some financial intermediaries include the criterion "**lack of personal contact**" with the contracting party or beneficial owner. Some institutions even prohibit to start a business relationships where it is not possible to have any personal contact with the contracting party.

The majority of the institutions use **further criteria** beyond those set out in the MLO SFBC, including:

- contracting party not the same as the beneficial owner of the assets

- client involved in a pending proceeding or legal dispute
- client's group structure is complex
- use of numbered accounts
- presence of client in the media (VIP criterion)
- amount of client's overall assets

5 Client categories and methods used to classify clients

Around two-thirds of the financial intermediaries divide their clients into **two categories** (“not higher-risk” – “higher-risk”), which is sufficient under the MLO SFBC. One-quarter have opted for three categories, including either a special category for PEPs (10% of the cases) or a “slightly higher-risk” category (15% of the cases). The other institutions have put into place various systems with genrally four to five client categories, the maximum encountered being nine client categories.

The further division of higher-risk business relationships into various sub-categories can make sense as a means of differentiating them according to various requirements for additional investigation and monitoring, and thus allocating resources in the best possible way.

The banks use **various methods** for dividing clients into risk categories. Some classify a business relationship based on a single criterion, others on variously weighted criteria (the “scoring” method), or on a “mixed system”. The scoring method used by some institutions evaluates business relationships witha point-based system. Business relationships that reach a certain score are deemed to be higher-risk business relationships within the meaning of the MLO SFBC. In the case of “mixed systems”, on top of the primary criteria requiring that a business relationship be allocated a risk category, secondary (cumulative) criteria are used for which the scoring method is applicable. Some institutions permit a downgrading of business relationships from the “higher-risk” category, provided certain requirements are met and there is management approval.

By the end of 2004, around 70 percent of the financial intermediaries had introduced an automated system for allocating client relationships, even though this is not a mandatory requirement under the MLO SFBC. **Different levels of automation** have been observed. Around one-third of the institutions has introduced IT systems that automatically identify and flag higher-risk business relationships based on pre-defined parameters and information provided by client advisors. Such fully automated systems facilitate identification of higher-risk business relationships, but require the development or purchase of special software. Other institutions have entered their client data into an internal database and allocate risk categories manually. There are similar automated procedures in place for PEP searches. Thereby, a client database can be searched automatically and in regular intervals for PEPs. By the end of 2004, over 63 percent of the banks used such automated systems to identify PEPs.

Which method is ultimately used is not as important as ensuring that the method allows higher-risk business relationships to be identified and, once identified, that the required additional duties of due diligence such as further investigation and increased monitoring are complied with.

In the case of banks that have many business relationships or institutions that operate exclusively in retail banking, the percentage of higher-risk business relationships is generally smaller. Thus, the large banks, regional banks and Raiffeisen banks in proportion see fewer relationships as being exposed to high risk than banks involved in the asset management business. The proportion of higher-risk business relationships tends to be greater for banks with fewer business relationships than for banks with many business relationships. On an individual basis, however, there are big deviations. Significantly higher percentages may not necessarily be a result of risky business policy, but may also be due to a more conservative approach to risk analysis. Ultimately, the objective of risk classification is the optimal use of resources for the purpose of conducting further investigations. Institutions should avoid investing a disproportionate amount of time and money investigating specific business relationships, leaving insufficient resources to carry out the required investigation of other relationships. By creating additional sub-categories for high-risk business relationships, the banks may be able to fine-tune the requirements for additional investigations and a more intensive monitoring in line with risk assessment.

6 Criteria for identifying higher-risk transactions

In accordance with the MLO SFBC, all banks use both **absolute and relative threshold values** as criteria for identifying higher-risk transactions. The institutions often set absolute threshold values for each client at different levels depending on the appropriate client category (retail client, business client, wealth management client, etc.). Relative threshold values, i.e. deviations from the standard types, volumes and frequency of transactions in the same or comparable business relationships are generally applied using automated transaction monitoring. Similar to the classification of business relationships, some institutions also use “scoring systems” to identify higher-risk transactions. Factors included are the inflow and outflow of assets, deviations from the standard pattern for transactions in the relationship and incoming and outgoing payments to and from risk countries.

7 Transaction monitoring systems

According to the completed questionnaires submitted by the auditors, at the end of 2004, over **80%** of the institutions surveyed had a **computer-based transaction monitoring system**. Given the increasing use of e-banking, this is of particular importance. In individual cases, it is difficult to distinguish between computer-based and manual transaction monitoring. In the case of a manual transaction monitoring system where bank employees review transaction lists for certain criteria such as threshold values and the country from which a transfer originated or to which a transfer is destined, the auditors will have to examine whether this manual procedure without further automation is adequate in light of the type and scope of the business activity and resources available. A computer-based monitoring system must be able to apply several parameters simultaneously when checking transactions.

The monitoring and investigation of transactions and of the automatically generated transaction lists are generally carried out by two separate departments, as the transaction lists are first processed by the client advisor and subsequently checked by the anti-money laundering unit.

8 Documentation

In most cases, the auditors rated the type and scope of documentation relating to higher-risk business relationships as being adequate. In some instances, however, the **informative value of the documentation** requires further improvement. Documentation of higher-risk business relationships and transactions and any additional investigations is only adequate if it allows third parties, such as external auditors, to follow the history of the business relationship and the determination of the risk category. It will not be possible to trace back the history of a business relationship, and thus have proof that the appropriate duty of care was used, if any existing implicit knowledge is not documented. In addition, information must be quickly accessible, which requires a client data management system, except where the number of clients is small.

9 Training

Employee training was found to be **very satisfactory**. Some institutions still underestimate its importance and need to improve in this area. The risk-oriented approach requires a basic understanding of the money laundering risks and Swiss regulations, and their institution-specific implementation. The MLO SFBC therefore requires regular training for client advisors and all other employees affected. The training concept must not be limited to new employees, but must ensure that the knowledge of all employees involved is refreshed on a regular basis. Self-study using internal directives is not enough. Rather, employees involved should be made familiar with the applicable regulations and internal directives through case studies.

10 Global monitoring of legal and reputational risks

Around **20% of the institutions audited have branches and/or subsidiaries abroad.** The MLO SFBC requires that banks apply the basic principles under the Ordinance group-wide, i.e. not just at their Swiss head office, but also at the foreign branches and subsidiaries of Swiss banks.

One of these basic principles is the risk-oriented approach. Initially, risks, or higher-risk relationships, can only be identified locally. However, they must then be recognised at group level, limited and monitored. To this end, the banks must be able to exchange information about higher-risk business relationships between the head office and branch offices and subsidiaries abroad. The Ordinance does not require a central database, only access by group compliance officers and internal auditors to data about business relationships at branches and subsidiaries abroad, where necessary. Group companies abroad should immediately provide the executive bodies at their head office in Switzerland with any information necessary for global monitoring of legal and reputational risks. A case in point would be any indication that a client has connections with terrorist organisations. If it is not possible for the responsible executive bodies of the group to have direct access to the information at branches and subsidiaries abroad due to restrictive provisions under foreign laws, the SFBC must be notified. Conversely, Swiss branches that are part of a consolidated group of a foreign financial intermediary or foreign financial group must provide the supervisory bodies of the foreign parent company with access to information about specific clients and beneficial owners if such information is necessary for a consolidated monitoring of reputational risk. Central databases that include information about clients of Swiss subsidiary banks or branches are also not necessary (and not allowed) in this context. However, should it be needed in any specific instance, such access must be granted to the executive organs of the foreign parent bank since they cannot be denied what is considered a requirement for the supervisory bodies of Swiss financial intermediaries at subsidiaries or branch offices abroad for the purpose of global risk management.

The SFBC was notified by a few institutions that information on high-risk relationships could not be transferred from some jurisdictions to Switzerland even where the legal entity was the same. However, effective global monitoring of legal and reputational risk may often also be achieved through organisational measures where local foreign law is an **obstacle to cross-border data transfer**. In one jurisdiction, there are problems with the use of companies whose main activity is to hold clients' assets in trust and manage business relationships with banks since these companies do not disclose the identity of the end-client and, pursuant to local banking practice, are not required to do so.

The SFBC intends to clarify these issues with the banks and supervisory authorities involved.

11 Payment orders from Switzerland:

The **requirement to include information about the instructing party with any payment order from Switzerland is being observed by the banks,** which have changed their internal systems accordingly. Since it has become international practice to include information on payment orders to foreign countries, only few financial intermediaries use the exception provision. In some cases involving standing orders, for example, the information is not repeated each time.

12 Organisation

All banks have set up internal anti-money laundering units, in most cases assigning this function to the compliance department. For some smaller institutions, it is difficult to set up an independent office that is separate from the client advisors. Some of these institutions have commissioned external specialists to deal with tasks carried out by designated anti-money laundering units, such as specialists from other banks hired to assist in difficult cases. Smaller institutions also use the option of **outsourcing** to closely associated financial intermediaries, in particular to parent companies or persons specialising in the prevention of money laundering, such as lawyers. In all cases, it is important that there be a clear definition of tasks carried out by a designated anti-money laundering unit and the unit's relationship to the front office and other functions. In particular, the unit’s role as a monitor of risk classification is essential.

In most cases, internal anti-money laundering units **report to management** or individual members of management responsible for the particular areas. At smaller financial intermediaries, the report is often made to the board of directors. Financial intermediaries that form part of a financial group often also report to a money laundering prevention unit that is tasked with regional or global prevention of money laundering.

13 Role of the external auditors

Implementation of the MLO SFBC does not only place high demands on financial intermediaries. For external auditors too, auditing the implementation of the MLO SFBC is a big challenge. They have to review the risk-oriented approach chosen by banks for adequacy. The auditors not only have to examine the adequacy of internal processes, but also, through random audits, need to examine whether any given risk classification allocated is adequate and traceable based on the documentation, and whether the type and scope of the duty of care exercised is appropriate. In the view of the SFBC, the **external auditors** have **proved equal to this task.**

14 Efforts and costs

Based on the information regarding financial institutions' costs obtained in the first implementation audit, the SFBC unfortunately has to note that the results of efforts to determine costs for implementation of the MLO SFBC **have little informative value**. For these reasons, during the second implementation audit, the SFBC did not ask the institutions any questions about costs. **Obtaining information about costs** before or after the introduction of any new regulation requires an in-depth analysis of the initial situation, and detailed planning and monitoring. These are in turn **time-consuming and costly**. They also raise **difficult questions regarding methodology**. Costs can vary quite significantly from one financial institution to the next, depending on the status of the money laundering prevention procedure and IT system prior to the Ordinance coming into force. In addition, the causal link between compliance costs and the actual regulatory measure must always be examined. For example, the introduction of the MLO SFBC has been a good opportunity to introduce computer-based client relationship management (CRM) for banks that did not already have it. Additionally, as a result of better client profiling, services have been improved and synergy potential utilised (avoiding duplication in client identification).

15 Measures and follow-up

At practically all financial intermediaries, the external auditors evaluated the implementation as adequate, and are issuing recommendations to some for improvements. The audit at the end of 2004 showed that there were still some serious deficiencies at some institutions. This affects only around 0.1 percent of the business relationships existing on 31 July 2004, so the problems can be considered negligible in terms of risks. Specifically, the following deficiencies were noted:

- too restrictive risk definitions
- inadequate calibration of the automated transaction monitoring
- inadequate training concept
- documentation of business relationships not being traceable
- additional investigations not yet completed

- deficiencies in the monitoring system with unclear responsibilities and reporting obligations

In these instances, the SFBC decided on a **case-by-case basis** what **measures** had to be taken and ordered **additional audits** where necessary. In the meantime, a large part of the deficiencies have been rectified.

16 Conclusion

In the view of the SFBC, the **results** of the evaluation are **positive**. The **risk-oriented approach allows for the optimal use of resources** for compliance purposes. The banks have largely adopted the risk definition requirements contained in the MLO SFBC. This is resulting in a comparable level of implementation across the board. The banks are also using the option of selecting **different criteria** in order to adapt the risk-oriented approach to their particular business activity. For this reason, no further supervisory requirements for implementation of the risk-oriented approach are necessary for the moment. At the same time, the SFBC will still deliberately refrain in future from issuing special provisions for individual client categories or business areas, even if this is often done abroad. Each special provision would only serve to **jeopardise the credibility of general principles and the coherence of the regulation.** It stands to reason that effective and credible prevention of money laundering does not primarily mean adopting the exact wording of international texts in internal regulations. It is not the form that is key, but the substance and a credible and practical implementation. The only changes necessary would perhaps be to make adjustments in individual areas of the current regulation following a thorough analysis of **international developments.**