IMF Roundtable Discussion

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Issues in AML/CFT – Views from the Swiss Regulator

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Good afternoon,

It is a pleasure to be here and share with you some views and experiences on this very topical subject.

Over the past years enormous work has been accomplished in the area of standard setting and standards assessment:

- In 2001, the Basel Committee adopted guidance on customer due diligence for banks.
- The Financial Action Task Force (FATF) has done a remarkable job in reviewing the 40 recommendations, which will be adopted this summer.
- In cooperation with the International Monetary Fund (IMF), the World Bank and the sectoral standard setters the FATF drafted a methodology for the assessment of AML (Anti-Money Laundering) and CFT (Combating the Financing of Terrorism) standards, which has been used in several financial sector assessments.

In Switzerland, we did not lean back during that time. We undertook a revision of the AML and CFT rules applicable to banks and securities firms in Switzerland.

A new money-laundering ordinance that also takes into account the most recent developments on the international level was adopted in December 2002. It will enter into force on July 1 of this year.

The main features of the new Ordinance, besides the introduction of rules against terrorism financing, are the codification of a risk-based approach, the mandatory introduction of computer-based transaction monitoring systems and the requirement for internationally active Swiss to have in place a global KYC risk management program.

In recent weeks, it was my task to meet with representatives of the industry, both members of the management as well as compliance officers to explain the new rules. I would like to discuss with you some issues that were brought up repeatedly in those discussions:

- First, there is concern about the level playing field, both on the national and international level. The question that is asked is: Are the major financial centers and the competitors in the industry living up to the same rigorous standards?

- Second, another question, closely related, that is asked again and again is: How much due diligence is enough? How deep to we have to dig? How much time and money and efforts do we have to invest into due diligence?

- Third, there is concern about potential conflicts with foreign laws and the question asked is: How do we implement a global KYC risk management system within an international financial institution? Are our rules compatible with foreign laws or is their application being inhibited because of foreign data protection and secrecy laws?

Questions regarding an unleveled regulatory playing field always lead me to explain the work of your organizations as standard setters (BCBS, IAIS, IOSCO) and the role of the FATF and the IMF in the evaluation and monitoring process. Here your organizations have a very important role!

As I understand, it is the purpose of this Roundtable to discuss this evaluation process: In actual fact, how can one measure compliance with AML and CFT standards, not only formal compliance but material compliance?

We all agree that the emphasis should not merely be on whether or not the country has enacted laws but on whether the laws have been implemented effectively, and whether or not the Financial Intelligence Unit (FIU) and other institutions foreseen by the laws are actually in operation.

For example, there was a tendency to treat mere figures on suspicious transaction reports to FIUs as an indicator of success, entirely independent of the number of criminal investigations, convictions or confiscated funds they actually generate.

There is, indeed, a need for simple and abstract indicators and stereotyped procedures in order to conduct assessments and compare the results. However, we need to be aware of the risks if assessments focus solely at formal compliance with the letter of the standard rather than at genuine effectiveness of the measures.

What makes the assessment process even more difficult is that, although national systems all address the same AML elements, they still diverge considerably in their emphasis.

- For example, the primary interest of the Swiss AML system is to avert bad risks by tackling them already at the account-opening phase. Great emphasis is placed on customer due diligence (CDD) and Know-your-customer (KYC) rules. We are above all interested in keeping risky clients and dirty funds away from Switzerland's financial institutions. Considerable efforts are made in screening clients in the account-opening phase. This is why we believe that Switzerland is the country with probably the strictest CDD rules worldwide now:

    - Switzerland has very strict rules on identification and verification of the beneficial owners. For example, in some European countries it seems to be possible that client funds are placed in banks by the intermediation of fiduciaries, which are not required to disclose the identity of the beneficial owners to the banks. Banks thus are unable to know the beneficial owners. In Switzerland, this practice is prohibited since 1992 after an intervention of the SFBC.

    - As a result of this preventive due diligence approach, suspicious transaction reports (STR) are fewer than in other countries, such as the UK and USA, even in relative terms, but in Switzerland at least, they lead in more than 80 percent of the cases to the opening of a criminal investigation.

- In contrast, other systems place far more emphasis on an 'early warning system' with the recording of everyday transactions and the reporting of unusual or suspicious circumstances within the context of retail banking. They are more geared towards collecting massive amounts of data on every-day routine cash and electronic transactions for potential use in criminal investigations.

It is only now that, due to the international initiatives, we are moving towards harmonizing those approaches. As a result, there is a convergence in all jurisdictions towards a common standard that enhances both client-acceptance and ongoing monitoring procedures.

- On the one hand, these international standards define concrete rules, for instance, basic identification requirements and special rules for PEPs and correspondent banking.

- On the other hand, overall, they now increasingly adopt the "risk-based approach". For instance, the Basel Committee's Customer Due Diligence Paper of 2001 talks of „graduated customer acceptance policies" and of the need to be 'risk-sensitive'.

This risk-based approach, as we have implemented it in Switzerland, allows a relatively simple and ordinary procedure for retail banking and cases without specific risk factors in general.

However, as soon as risk indicators become apparent, banks are expected to react in a finely calibrated manner. They have to ask intelligent questions, build a body of information on their clients and match this information with the clients' transactions. They have to inquire the source of the wealth, possibly the destination, and the economic reasons for the transaction and, if these do not appear to be plausible, seek additional clarifications.

The challenging aspect of the „risk-based approach" is that it is primarily up to the financial institutions to implement it and to develop the indicators and specified procedures to deal with increased risk situations. For instance, Swiss banks are required to review all business relationships, both existing ones and new ones, and see for any individual business relationship if, according to the chosen indicators, it constitutes - in abstract terms - a higher risk. For those business relationships associated with higher risk, financial institutions will have to apply enhanced due diligence and conduct additional clarifications if they have not already done so.

The risk-based approach shifts part of the responsibility for defining the risks and for implementing a dynamic risk management onto the institution.

A new challenge on a national as well as an international level will be a harmonization of the risk strategies that are being adopted by different institutions in different countries, and for the international experts of the IMF and the FATF, in particular, the comparability and adequacy of the risk strategies..

Globalization also implies global risks, therefore, not only do we need a common set of regulatory standards, to be truly effective, we need to make sure that these standards are adopted on a consolidated basis encompassing the parent banks or head office and all foreign branches and subsidiaries. Whether money laundering occurrs at the local head office or at a foreign branch or subsidiary makes no difference to the harmful effect that such incidence may have on the reputation of the financial institution.

That said, it is necessary that international financial institutions have a global KYC program that applies equally to all establishments within a group worldwide, including both banking and non-banking financial institution. The new Swiss AML ordinance therefore requires explicitly that internationally active Swiss banks apply the general principles of the ordinance on a global level. Furthermore, it requires that institutions manage their legal and reputational risks associated with higher risk business relationships on a global consolidated basis.

To that end, the ordinance formulates several requirements:

- Banks must establish information channels between the Swiss head office and its foreign establishments. Head office/group compliance should be able to know what the group's global exposure to any specific higher risk relationship is and, to that end, need to have access to information on individual customer relationships on an ad hoc basis. Head office needs to have policies and procedures for ascertaining whether other branches or subsidiaries hold accounts for the same party and for assessing the group-wide reputational and legal risks posed by the customer's reported activity.

- The mechanism must also work the other way around: foreign establishments must, if necessary, be able to inform head office on individual business relationships that present higher risk indicators (observing, however, local tipping-off prohibitions where an STR has been filed).

How do we verify compliance with those requirements?

In order to verify compliance with Swiss KYC and due diligence standards on a global basis, internal and external auditors of the parent must face no impediments in verifying the bank's compliance with KYC policies. That is, if necessary, they must be able to go onsite in other jurisdictions and have access to customer files. You cannot adequately monitor reputational and operational risk on a purely abstract basis.

This approach was put into practice and tested in 2001, when we had the external audit firms of 36 Swiss incorporated banks carry out an extensive program of in-depth examinations in 75 subsidiaries or branches located in 12 host countries, mainly offshore financial centres (Antigua, Bahamas, Bermuda, British Virgin Island, Cayman Islands, Gibraltar, Guernsey, Isle of Man, Jersey, Liechtenstein, Monaco, Netherlands Antilles), to verify compliance with Swiss KYC standards.

We insisted that the Swiss audit firms go on-site and have access to individual customer files and identities to randomly check compliance. Initially, the auditors encountered some problems. In one jurisdiction, they were threatened with imprisonment if they attempted to gain access to customer files. Ultimately all host country authorities granted access. The results were overall satisfactory. In individual cases, some improvements were necessary, mainly in the area of the establishment of beneficial ownership where local laws were often less stringent.

The new Ordinance requires all banks with branches and subsidiaries abroad to implement a global KYC management program. When we adopted that provision some institutions expressed concern about conflicts with foreign secrecy and data protection laws that would disallow any communication of customer information to across borders. As a compromise, we maintained the provisions but introduced the requirement that the SFBC be informed where banks encounter problems with the implementation because of local secrecy or data protection laws.

We will carry out an implementation control later this year when banks will have to respond to a number of questions on the implementation of the ordinance, among them, also the question of whether or not they are encountering any obstacles in the implementation of a global KYC risk management program in foreign jurisdiction. We hope to have a clearer picture on remaining obstacles within a year, but hopefully, there won't be any!

This brings me to a close. I wish again to repeat three points I made earlier:

- First, I would like to stress the importance of implementation. Implementation is key. This must be taken into account when conducting AML assessments in jurisdictions. And it is not enough to focus on the domestic situation. For AML/CFT rules to be really effective we need to take a global approach which consists of two key elements:

    - The implementation of customer acceptance policies, procedures for customer identification and monitoring of higher risk accounts on a consolidated basis

    - Procedures for information sharing within a group which are necessary to implement consolidated risk management for AML/CFT risk.

- Second, effectively implementing AML /CFT concepts is done in a triangle involving international institutions, government agencies and the private sector. This means that a system only works if financial institutions take their share of the responsibility and, under regulatory oversight, actively engage in risk management.

- Finally, while much progress has been made, there still remains a need for more coherence of international approaches, both across sectors and across jurisdictions. Yet, I am confident that with all the initiatives under way we are moving in that direction. Not at least to ensure global competitiveness and to overcome those discrepancies, the Federal Banking Commission supports all efforts towards international harmonization at the international level.