

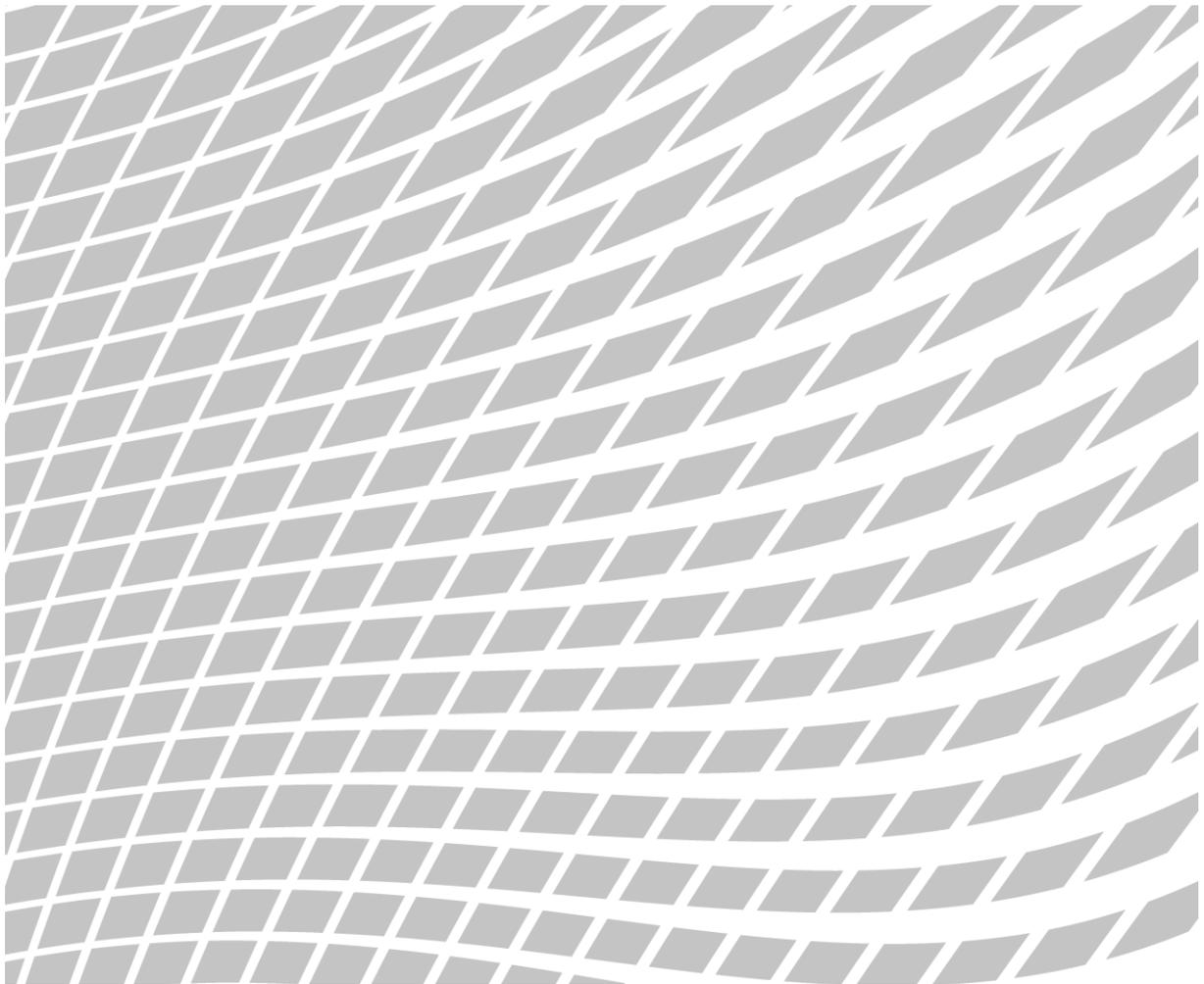
10 November 2011

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# **Due diligence obligations of Swiss banks when handling assets of “politically exposed persons”**

## **An investigation by FINMA**

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## Key points

- Business relationships with PEPs (politically exposed persons) are not prohibited, but the law requires the banks to treat such relationships with greater care. Switzerland's regulations on the handling of business relationships involving PEPs fulfil or exceed the FATF provisions, which are the international standard. Switzerland's supervisory approach is also considered to be compliant at the international level. FINMA has not identified any need for action in terms of anti-money laundering regulations where PEPs are concerned.
- The imposition of three freezing orders by the Federal Council prompted FINMA to carry out an extraordinary audit of the handling of PEP relationships at twenty banks.
- The banks are aware of their obligations under the Anti-Money Laundering Act (AMLA) in connection with PEPs and, in the majority of cases, implement them in a satisfactory manner. Some of the banks audited complied in full with their AMLA obligations in connection with the PEP relationships examined. At the other banks, where minor shortcomings were identified, FINMA is monitoring the implementation of the measures initiated by those banks to remedy them and is stepping up the intensity of its general anti-money laundering supervision.
- FINMA has intervened by way of administrative proceedings against four of the banks audited, where more serious lapses have still to be investigated.

## 1 Freezing of assets

### 1.1 General considerations

On 14 January 2011 the regime of Tunisia's head of state Ben Ali was toppled. Five days later, on the basis of Article 184 paragraph 3 of the Swiss Constitution,<sup>1</sup> the Swiss government ordered the freezing of assets. In the case of Egypt, the freeze came into force after Mubarak stepped down on 11 February 2011. Events in Libya prompted the Federal Council to order a freeze on Libyan assets on 24 February 2011.<sup>2</sup>

The asset freezes were preventive measures designed to block the removal from Switzerland of any illegally acquired assets or embezzled public funds, and to enable the judicial authorities of the countries concerned to submit requests for legal assistance to Switzerland. The legality of the origin of the frozen assets is to be clarified in the context of national criminal proceedings on which the applications for legal assistance are based.

The freezing orders require Swiss financial intermediaries as well as all other individuals and legal entities affected to freeze the assets of the persons and entities listed, and to notify the Federal Department of Foreign Affairs (FDFA).<sup>3</sup> Most of those listed are politically exposed persons (PEPs).

### 1.2 Asset freezes at national and international level

	Switzerland	EU	US
<b>Measures involving Tunisia</b>	19 January 2011	4 February 2011	-
<b>Measures involving Egypt</b>	11 February 2011	21 March 2011	-
<b>Measures involving Libya</b>	24 February 2011	2 March 2011	25 February 2011

At the start of May, the FDFA announced that a total of CHF 830 million had been frozen. Of these, CHF 60 million relate to Tunisia, CHF 410 million to Egypt and CHF 360 million to Libya. In the case of

<sup>1</sup> "Where safeguarding the interests of the country so requires, the Federal Council may issue orders and rulings. Orders must be of limited duration."

<sup>2</sup> This order was replaced on 31 March 2011 by one issued under the Embargo Act. [http://www.admin.ch/ch/d/sr/c946\\_231\\_149\\_82.html](http://www.admin.ch/ch/d/sr/c946_231_149_82.html) (in German)

<sup>3</sup> Such reports are separate from reports to the Money Laundering Reporting Office Switzerland (MROS) under AMLA. For more detailed information and a general overview of the prehistory see the FINMA report dated 11 March 2011: "Due diligence obligations of Swiss banks when handling assets of 'politically exposed persons'", Section 5.2 p. 11 and p. 5ff.

Libya it should be noted that from the outset, the freeze was not limited to private individuals but also extended to banks, sovereign wealth funds and oil companies.

Few figures have been published internationally. There have only been media reports claiming that as part of the international efforts, Libyan assets certainly in excess of USD 35 billion have been frozen, comprising USD 30 billion in the US, USD 2 billion in Canada and USD 3.2 billion in the UK.<sup>4</sup> FINMA's investigations have also confirmed the international dimension of the North Africa dossier. Assets have reached Switzerland from the countries concerned – Tunisia, Egypt and Libya – but also from banks in countries such as France, the US, the UK and Italy. Conversely, assets have been transferred from Swiss banks to banks in other countries, notably France and the US.

### 1.3 Anti-money laundering regulations

Switzerland adopted concrete due diligence rules governing the way in which banks handle the assets of PEPs as far back as 1998, and has been continually developing them ever since. Business relationships with PEPs are not prohibited, but financial intermediaries are subject to strict due diligence obligations set out in the Anti-Money Laundering Act (AMLA).

Switzerland's regulations on handling business relationships involving PEPs fulfil or exceed the provisions of the Financial Action Task Force (FATF), which represent international standards. Switzerland goes further than the FATF standard:

- in the definition of PEPs, which also encompasses persons closely associated with them, and
- in terms of the requirement that such business relationships be reviewed annually by the most senior executive body or at least one of its members, and a decision taken as to whether they should be maintained.

Switzerland's supervisory approach is also considered internationally to comply with the requisite standards. The PEP regulations established under AMLA and the associated implementing provisions satisfy international requirements in this area. Back in 2005, the FATF stated that the Swiss model was largely compliant with its standards. Additional measures adopted since that time have further improved Switzerland's compliance with the FATF requirements, as the FATF's follow-up report from October 2009 confirms.<sup>5</sup>

The PEP issue was examined in 124 jurisdictions in a report published by the World Bank in 2009 entitled "Stolen Asset Recovery – Politically Exposed Persons – A Policy Paper on Strengthening Preventive Measures".<sup>6</sup> In this report, the World Bank noted that only 16 percent of the 124 countries evaluated were compliant or largely compliant with the relevant FATF recommendation on PEPs. Switzerland is one of the 16 percent that meet the requirements. On the basis of its now-completed

<sup>4</sup> This figure is drawn from a number of – albeit unverifiable – independent press reports.

<sup>5</sup> [http://www.fatf-gafi.org/infobycountry/0,3380,en\\_32250379\\_32236963\\_1\\_70327\\_1\\_1\\_1,00.html](http://www.fatf-gafi.org/infobycountry/0,3380,en_32250379_32236963_1_70327_1_1_1,00.html)

<sup>6</sup> <http://siteresources.worldbank.org/EXTSARI/Resources/5570284-1257172052492/PEPs-ful.pdf?resourceurlname=PEPs-ful.pdf>. The report was compiled by the Stolen Asset Recovery Initiative (StAR Initiative), a partnership between the World Bank Group and the United Nations Office on Drugs and Crime (UNODC).

investigation, FINMA has likewise identified no need for action in connection with anti-money laundering regulations in this area.

#### 1.4 The role of FINMA

As a state supervisory authority, the Swiss Financial Market Supervisory Authority (FINMA) is endowed with sovereign authority over banks, insurance undertakings, stock exchanges, securities dealers, collective investment schemes and other financial intermediaries. FINMA grants operating licences for companies and organisations that are subject to its supervision, and also monitors compliance by supervised institutions with the laws, ordinances, directives and regulations as well as ensuring that they fulfil the licensing requirements at all times. Where necessary and to the extent permissible by law, it imposes sanctions, provides administrative assistance and acts as a regulatory body. FINMA monitors compliance with the due diligence obligations of the anti-money laundering legislation – which also includes PEPs. If it emerges – either as part of a supervisory law audit or otherwise – that the anti-money laundering provisions are not being complied with, FINMA ensures that the institutions concerned make every effort to comply with them in future and reviews the measures taken to do so. In serious cases, it may take further measures and even impose sanctions. On 11 March 2011 FINMA published a short report on the due diligence obligations of Swiss banks when handling assets of PEPs.<sup>7</sup>

FINMA assists the offices charged under the Federal Council orders with implementing the sanctions. It also publicises the sanctions and requires all financial intermediaries strictly to comply with the sanction orders. It is not part of FINMA's responsibilities regularly to examine compliance with freezing orders. Where there are indications that these orders are being infringed, FINMA can however intervene under supervisory law and, where appropriate, report the financial intermediaries concerned to the FDF.

#### 1.5 Object, content and scope of the investigation

FINMA took the opportunity of the Federal Council freezing orders to carry out an extraordinary audit of compliance with AMLA due diligence obligations in dealing with PEPs at institutions affected by the orders. In early 2011, FINMA requested the 20 banks concerned to provide a wide range of documentation. In particular, they were required to supply FINMA with account opening documents, client correspondence, internal memos, statements of account movements since 1 January 2009, details of deposits and withdrawals related to certain transactions, documentation on special clarifications, the relationship initiation process and any reports made to the Money Laundering Reporting Office Switzerland (MROS), as well as internal directives. They were also asked to supply FINMA with information on the identification of PEPs and the IT tools used to carry it out.

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<sup>7</sup> <http://www.finma.ch/e/finma/publikationen/Documents/br-pep-20110311-e.pdf>

## 2 Results of FINMA's investigations

### 2.1 Identification of PEPs

Of a total of 29 PEP client relationships (certain banks maintained business relationships with more than one listed person), 22 were identified as such. Seven client relationships were not identified as PEPs or were identified as PEPs but not treated as such.

FINMA essentially pinpointed three problem areas. First, one bank's internal definition of a PEP was too narrow.<sup>8</sup> Second, three banks carried out only an "exact match" search when initiating the client relationship, although a phonetic search, possibly accompanied by Internet research, would have been appropriate. Third, in two cases there were indications that the client relationships may have been deliberately treated neither as PEPs nor as higher-risk business relationships even though they had been identified as such. The last two cases are currently being investigated in depth as part of enforcement proceedings.

<b>Best practice – exemplary approach</b>	<b>Poor practice – unsatisfactory approach</b>
<ul style="list-style-type: none"> <li>• <i>Regular check of the entire client base using an intelligent PEP name matching tool</i></li> <li>• <i>Phonetic search when initiating new client relationships, especially involving PEPs from countries that do not use the Latin alphabet</i></li> <li>• <i>Additional Internet research</i></li> </ul>	<ul style="list-style-type: none"> <li>• <i>Exact-match search only, without further checks when initiating new client relationships</i></li> <li>• <i>Declassification of PEPs and failure to treat them as higher-risk business relationships</i></li> <li>• <i>Excessively narrow definition of PEPs in internal directives</i></li> </ul>

### 2.2 PEP processes

In 19 of the 22 client relationships identified as PEPs, the banks complied fully with the prescribed PEP processes. The initiation process and the annual review were conducted in their entirety and at the most senior executive level. In three cases, the annual decisions on maintaining the relationships were inadequately documented.

<b>Best practice – exemplary approach</b>	<b>Poor practice – unsatisfactory approach</b>
<ul style="list-style-type: none"> <li>• <i>Annual review of maintenance of the relationship, based on a comprehensive and updated dossier on the PEP</i></li> </ul>	<ul style="list-style-type: none"> <li>• <i>Inadequate documentation of the annual decision on maintaining the relationship at the most senior executive level</i></li> </ul>

<sup>8</sup> For example, the following definition is too narrow because it does not cover all persons closely associated for family reasons: "relation ascendante ou descendante directe par rapport au PEP concerné".

## 2.3 Further clarifications

Where business relationships with PEPs are concerned, the banks are required to carry out further clarifications and, inter alia, to establish the origin of the assets deposited, the origin of a PEP's wealth, the background of larger incoming payments and other details. Financial intermediaries must ensure there is a plausible outcome of their clarifications and document them. In a ruling issued on 30 August 2000 in connection with the Abacha case, the Swiss Federal Banking Commission (SFBC), one of FINMA's predecessor organisations, made the following comments on the identification of PEPs:<sup>9</sup>

- Business relationships with customers from states where there is significant state influence on economic activity combined with widespread corruption and with systematic human rights abuses and political violence require particularly close attention and thorough clarification, especially when such customers wish to invest sizeable sums.
- PEPs are not always immediately identifiable as such and the requirement for clarifications is not automatic in every business relationship. Under certain circumstances, however, special clarifications in respect of potential PEP status are acceptable and necessary.
- The bank must confirm the plausibility of the information supplied by the customer. Under certain circumstances (e.g. given the young age of the customer and their country of origin in conjunction with an unusually large amount of assets), it must not automatically accept the information provided by the customer but must instead require them to submit further confirmatory documentation, such as annual reports, contracts, commercial register excerpts or the like.

In the Montesinos case, the SFBC issued a ruling on 28 August 2001 containing the following comments on the requirement for banks to obtain further clarification:<sup>10</sup>

- If a beneficial owner is active in a sensitive area of business, the bank is obliged to familiarise itself with at least the basic features of the political situation in the country concerned, and actively to solicit information on the client concerned.
- In certain cases, especially where large amounts of assets are concerned, it is not sufficient entirely to rely on oral and unsubstantiated information provided by third parties.
- Financial intermediaries must take particular care to assess whether they wish to enter directly or indirectly into relationships with PEPs and accept assets from such persons or hold them in custody. Banks entering into business relationships involving large amounts of assets that do not maintain direct contact with the client or beneficial owner but instead receive all information about them from a third party are subject to an enhanced duty of due diligence.

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<sup>9</sup> See SFBC bulletin 41/2000, p. 15ff (in German)

<sup>10</sup> See SFBC bulletin 42/2002, p. 123ff (in German)

In certain cases, the clarification requirements set out above were not complied with in full. Clarifications were almost always carried out, but in some cases not in the necessary depth. In some instances, clarifications were carried out solely with a view to the bank's own reputation, with little consideration being given to the risk of money laundering. Clarifications must be appropriate to the purpose.

<b>Best practice – exemplary approach</b>	<b>Poor practice – unsatisfactory approach</b>
<ul style="list-style-type: none"> <li>• <i>Commissioning a specialised outside firm to compile a comprehensive dossier on the PEP</i></li> <li>• <i>Obtaining confirmatory documentation from the client</i></li> <li>• <i>Terminating the business relationship with a paper trail and, where appropriate, exercising the right to file a report if there are no concrete indications of money laundering but the origin of the assets cannot be satisfactorily established</i></li> </ul>	<ul style="list-style-type: none"> <li>• <i>Accepting the information supplied by the client without further ado</i></li> <li>• <i>No direct contact with the client</i></li> <li>• <i>Risk monitoring geared solely to the bank's reputation (e.g. following political developments) with little regard to the risk of money laundering</i></li> </ul>

## 2.4 Communication

Financial intermediaries are obliged to inform the MROS if they have reasonable grounds to suspect criminal activity. They also have the right to file a report on the basis of a simple suspicion. Such reports are separate from those under freezing orders.

During the FINMA investigations it emerged that one bank had failed to identify the listed person after a freezing order had been issued and did not report the matter to the FDFA's Directorate of International Law until instructed to do so by FINMA. It was however established that the client held an identification document bearing a name which, probably because of its transcription into the Latin alphabet, is different from the name listed in the appendix to the corresponding FDFA order.

## 2.5 Overall assessment

Business relationships with PEPs are not prohibited, but the law requires the banks to treat such relationships with greater care. Overall, the positive finding is that the majority of banks are well aware of their AMLA obligations in connection with PEPs and implement them efficiently, albeit in a few instances with less than the required intensity.

It is also clear that there are no qualitative differences in the ways that large and small banks handle PEPs. Shortcomings were identified in a small number of cases, and FINMA will be taking appropriate follow-up action to deal with them.

### **3 FINMA measures**

For the banks investigated by FINMA that were found to be wholly satisfactory in terms of compliance with their AMLA obligations relating to the PEP relationships examined, the investigations are now at an end.

At the banks where minor shortcomings were identified, FINMA is monitoring the implementation of the measures initiated by those banks to remedy them. FINMA is also stepping up the intensity of its general money laundering supervision at those banks.

FINMA has intervened by way of administrative proceedings against four banks where more serious lapses are suspected.

## 4 Case studies

### 4.1 Examples of good practice in handling PEP relationships

#### 4.1.1 Case A: Commissioning an outside company

When opening an account, a bank's compliance unit engages an external consultancy firm to supply additional, comprehensive information on the PEP by investigating in more detail the PEP's business activities and the origin of the assets. The consultancy firm draws up an extensive report containing a summary of its key findings, several extracts from private electronic databases, various detailed press articles and official information on the companies held by the PEP. This is distributed to all the responsible decision-makers within the bank. The committee within the bank that is responsible for decisions on initiating and maintaining PEP relationships now has all the relevant information it needs to assess the situation expertly and to express an opinion on the business relationship.

#### 4.1.2 Case B: Involving management at the most senior level

A relationship is initially treated not as a PEP relationship but as one involving higher risk. When reports on the PEP appear in the press, the bank conducts a review and classifies the client as a PEP. The bank involves a number of bodies: the PEP unit carries out the clarifications, which are reviewed and approved by the bank's compliance unit. PEP applications are drawn up which are approved by the client advisor and their line manager, the due diligence unit, the senior person responsible for the business area, the PEP unit and the senior person responsible at regional level, who is also a member of the bank's most senior executive body. Thereafter, annual PEP assessment meetings are held, which are attended by the bank's CEO.

#### 4.1.3 Case C: Detailed background information on the PEP dossier

The PEP is a businessman from a wealthy family. The bank's PEP dossier contains all the necessary identification documents and internal background memos as well as extracts from several different private electronic databases on the PEP, copies of Internet research and background information on the companies, plus copies of all contracts that the companies have signed which are relevant to the business relationship.

## 4.2 Examples of poor practice in handling PEP relationships

### 4.2.1 Case D: The PEP is deliberately not treated as such and the business relationship is not classified as higher-risk

Owing to his family circumstances, a bank client should normally be classified as a PEP. There are also indications of illegal transactions. Another bank that had treated the client as a PEP terminated the relationship as it deemed the risk to be too high. The new bank identifies the client as being related to a ruler but deliberately fails to treat him as PEP. The reason given is that he has never held public office, has not maintained any business relationships with the ruling elite, and has not been linked to them in any professional way. Additionally, the bank fails to classify the client as a higher-risk business relationship because in its assessment he does not satisfy the relevant criteria as set out in its internal directives.

### 4.2.2 Case E: Suspicious deposits into a PEP's account are not clarified

According to the bank's information a PEP is "semi-retired" and draws his income from long-term contracts with multinational companies. Seven-figure deposits are regularly made into the PEP's accounts. However, the bank's files contain no documents on the PEP's links to the companies named that provide information on the nature of the agreements and the resulting income – although they had been requested internally by senior management. The PEP has for many years been a client of one of the bank's senior managers, who was also his client advisor. It is not impossible that the client advisor blocked attempts to investigate the PEP, arguing that he would vouch for his integrity.

### 4.2.3 Case F: The PEP is not identified as such

A bank claims that it failed to identify a PEP because his first name could be written in a number of ways. However, when inspecting the documents supplied by the bank, FINMA notices that the bank had identified the PEP as the son-in-law of the ruler and the corresponding PEP box had been ticked on the client profile.