JFSC
JERSEY FINANCIAL SERVICES COMMISSION

Risk Themed Examination Programme 2006
Summary Findings

Introduction

The aim of the Commission in conducting a series of themed on-site examinations is to concentrate on a specific area of conduct taken across a segment of the industry. For 2006, the chosen theme was risk management systems and controls as they relate to the underlying customer base of trust company businesses. This theme was repeated from 2005 as a result of the findings from that series of examinations and the importance placed by the Commission on the effectiveness of the risk management systems in trust company businesses. Following the same theme for two successive years has enabled the Commission to obtain a very good understanding of the risk systems used across a wide range of trust company businesses.

Specifically, the Commission's risk themed examination programme was designed to:

- Assess the types and efficacy of the risk monitoring systems;
- Identify any potential weaknesses;
- Highlight areas of best practice.

As with all on-site examinations, a business is assessed in terms of its performance against the relevant laws, orders and codes of practice. The objective in publishing summary findings from a programme of themed examinations is to share experiences as to how different firms seek to meet the requirements of the regulatory regime and to highlight the difficulties that are sometimes incurred.

Scope

The purpose of the themed examination was to focus on the risks posed by the underlying customer base and not the businesses' own operational risk. Examinations encompassed an assessment of the written risk management policies and procedures. Commission officers reviewed, on a sample basis, the records and files maintained by the registered person and held discussions with management and staff involved in operational and compliance matters. Results were then measured against the procedures and what might be considered best practice in this area.

Process

A cross-section of trust company businesses was selected. Each of these businesses was requested to complete a self- assessment questionnaire, covering a range of questions with a specific emphasis on the risk monitoring procedures, the risk profile of the customer base and what systems were in place to mitigate the risks. Responses to the questionnaires were analysed, any areas of potential concern were identified and this then set the agenda for the examination.

The results were reported to the respective businesses within the targeted timescale of three weeks from the conclusion of the examination.

Overview

A total of 14 risk-themed examinations were conducted during the course of 2006, compared with 21 in 2005. This was in addition to a further 18 examinations of a wider scope (33 in 2005). The risk monitoring systems were also examined in many of the wider scope examinations. The reduction in the number of examinations during 2006 was necessary to permit sufficient resources to be allocated to dealing with the issues resulting from the 2004 and 2005 examination programme.

The action taken by the Commission as a result of the themed examination programme was dependent on the materiality of the findings and is summarised as follows:

Action	**2006 Number**	**2006 percentage**	**2005 Number**	**2005 percentage**
Enforcement action	0	0%	0	0%
Follow up examination	3	21.43%	3	14.29%
Monitor implementation of recommendations	10	71.43%	8	38.10%
No formal monitoring	1	7.14%	10	47.61%
Totals	14	100%	21	100%

Of the 14 firms examined, the analysis by size of business (defined in terms of trust company business employee numbers) is as follows:

Size by number of TCB employees	**2006 number**	**2005 number**
Small (0-10)	9	8
Medium (10-30)	5	8
Large (30-50)	0	4
Super large (>50)	0	1
Totals	14	21

It was encouraging that all of the businesses examined had given consideration to the risk assessment of the customer base, although 22% (29%, 2005) of the businesses examined had not completed a full assessment utilising a formal documented process.

In approximately 30% of businesses, the risk scoring system employed did not produce a logical result in surfacing the high risk entities. In one instance, the risk rating form did not lead to any conclusive risk score. In another example of an illogical result, the rating system was heavily weighted in favour of the underlying customer's country of residence and failed to elevate into the high risk category an entity administered on behalf of a former politician from an Eastern bloc country, resident in the UK which received very large commission payments.

The Commission has worked closely with trust company businesses in order to enhance the efficiency of their risk management systems. In approximately 23% of businesses, there appeared to be an issue with a lack of guidance in the procedures regarding the completion of the risk assessment forms.

The majority of trust businesses have accepted the need to invest resources in the development of effective risk systems and the Commission has noted a significant improvement in this area in 2006 as compared with previous years. However, in many cases the systems require additional enhancement in order to be fully effective and backlogs in the risk review process need to be addressed.

The Commission continued to encounter isolated cases where the business claimed to have no high risk customers. An examination of files then revealed entities with highly sensitive activities connected to high risk countries, such as those with a high score on Transparency International's corruption index (see website address at the end of this paper). In one such example, the business had assessed 99% of its customers to be low risk. A random selection of the low risk files quickly demonstrated that their interpretation of low risk was entirely at odds with their industry peers and indeed the Commission.

Specific areas identified as requiring attention

The observations detailed below have been drawn from on-site findings.

Risk Factors

The main areas to be considered in an effective risk system are as follows:

- Geographical risks
- Underlying customer's activities
- Underlying customer's background
- Activities of the entity under administration

(i) Geographical risks

Virtually every system had taken into account the obvious geographical risks associated with the underlying customer's residence or domicile. However, wider issues such as the location of the assets and the territory in which the entity is undertaking trading activities were not always considered.

Useful sources of information in evaluating the risk posed by specific geographic areas include:

- FATF blacklists
- Countries where corruption may be an issue
- Countries at high risk of drug trafficking
- International sanctions

It is recommended that each business should carefully consider various sources of information when compiling their own high risk jurisdiction lists. Some useful website addresses which may be of assistance in this respect are listed at the end of this paper.

(ii) Underlying customer's activities

Most businesses had considered the risk posed by politically exposed persons ("**PEPs**") or potentates. However a repeat finding from last year is that in approximately 23% of scoring systems (2005, 20%), the system did not automatically elevate such customers into the high risk category. This inevitably means that such customers are not subject to any form of enhanced monitoring. The Commission would recommend that the definition of a PEP is included in the risk procedures. For further information regarding the risks posed by PEPs, please refer to the Anti Money Laundering Guidance Update Issue 3, which was issued in September 2001.

Another common finding is that the scoring system does not consider the occupation or business activities of the underlying customer. This is relevant if, for example, the customer is engaged in a cash risk business as there may be a higher degree of risk in the potential for money laundering activities.

(iii) Underlying customer's background

The majority of systems had incorporated the obvious factors such as the quality of customer of due diligence information and the purpose of the structure. However, a repeat finding from 2005 is that, approximately 30% of systems (2005, 30%) did not consider the source of introduction of the customer or the customer's source of wealth as a risk factor. It was interesting to note how businesses performed verification on the information provided by customers. These ranged from simple internet checks using search engines such as "Google" through to the use of more bespoke systems. In some cases, verification was not performed on a consistent basis. The Commission would encourage businesses to make use of such systems both at the business acceptance stage and periodically during the ongoing relationship, with higher risk customers being checked at more frequent intervals.

(iv) Activities of the entity

The nature of the activity of the entity was generally factored into the risk assessment process. However a repeat finding from 2005 was that in just over 16% of systems (2005, 24%) the activities of trading companies were not always considered.

Another repeat finding is that the provision of registered office only facilities is often not included in the risk rating system. This is of particular concern to the Commission given that many businesses continue to consider this type of service to be low risk. In one case, the business had determined that registered office only services would be entirely excluded from the risk system as it presented no risk at all to the business. The Commission's view is that registered office only engagements, in fact, pose a higher degree of risk to businesses, as the very fact that they are not providing directors means that they may not be fully informed about the activities of such companies. A common examination finding is that very sparse information is held, in some cases even the most basic customer information has not been obtained and consequently the business is exposing itself to the risks associated with the misuse of the customer entity.

It was also noteworthy that approximately 26% of systems (2005, 19%) did not incorporate the possibility that a suspicious activity report may have been made by the business. This would appear to be a clear example of a matter, which should raise the risk profile of a particular entity.

Other factors, which should be considered are:

- Value of assets held within the customer entity;
- Overall complexity of structure;
- Appointment of third party directors or signatories;
- Issuance of powers of attorney;
- Requests for "hold all mail" facilities.

Risk Scoring Systems

As was the case in 2005, a wide variety of scoring systems was encountered. The best systems used a combination of an objective approach with provision for some subjectivity to act as a "sanity check". The development of software solutions by various providers has assisted some businesses in complying with the requirement to maintain an effective risk management system.

Risk Review Backlogs

In approximately 29% of businesses, the risk rating process was not fully completed. Often this was as a result of a new system being introduced. The Commission is concerned to ensure that such backlogs are addressed in a timely manner. Clearly the benefit of an effective risk system will only be derived when the exercise is fully completed and maintained.

Customer Files

There was a general improvement in the level of deficiencies found in the reviews of customer files. However, the Commission continues to find many examples where the administration of customer entities is not of an acceptable standard. The most common deficiencies found in the 2006 examinations were as follows:

- Lack of customer due diligence documentation;
- No recorded rationale for the structure;
- Lack of documentation to evidence transactions;
- Backlogs in the production of financial statements;
- Failures in the periodic review process such that important issues are not surfaced;
- Lack of legal opinions or tax advice, where relevant.

Transaction Monitoring

A repeat finding was that there was little evidence of trust company businesses having introduced transaction monitoring so that a profile of the anticipated pattern of activity is ascertained which will identify unusual, complex or higher risk activity that may indicate money laundering or terrorist financing activity.

Coupled with the deficiencies in customer due diligence which are evident in the file reviews, the lack of transaction monitoring is of concern to the Commission.

Given the obligations on trust company business to comply with the anti-money laundering legislation, the Commission would strongly recommend that procedures in this respect are reviewed.

Impact of risk assessment on administrative routines

Whilst many businesses have expended considerable effort in risk assessing their customers, the information is not always utilised in the most effective way. Some examples of adopting a risk based approach are:

- Undertaking periodic reviews on a more frequent basis for high risk customer entities;
- Including the risk score on forms used for processing transactions so that high risk entities receive a higher degree of scrutiny;
- Allocating more experienced staff to higher risk entities;
- Additional signing requirements for higher risk entities.

The majority of businesses recognised the need for the risk scores to be clearly highlighted on the customer files and/or the database. However, in some isolated cases, the information was retained at director level and not shared with the administrative staff.

Examples of best practice

The best systems incorporate all of the risk factors outlined in (i) to (iv) above, use an objective scoring system which produces a clear and logical result, which is easily understood by and communicated to staff employed to administer customer entities.

Following the risk assessment of the entire customer base, it is best practice for the board or risk committee to review the overall results to ensure that the system is producing a logical result.

The best systems used some form of verification process. This ranged from hiring a local firm to verify information provided, reliance on group representatives in particular countries or the use of software such as Lexus Nexus or World-Check.

Some of the best systems are based on software solutions but equally a satisfactory result can often be achieved by a well thought out risk assessment form.

Conclusion

Generally, systems and procedures are evolving in a positive and constructive manner and the Commission recognises the efforts being made across the industry to improve and upgrade. However, it is important that momentum is maintained. In many cases, systems would benefit from further enhancement in order to be fully effective in mitigating the risks inherent in the customer base. It was encouraging that, almost without exception, firms approached the examination process with a spirit of candour.

Given the imminent introduction of the new Handbook for the Prevention and Detection of Money Laundering and the Financing of Terrorism, which places more emphasis on a risk based approach to customer due diligence, it is important that the risk systems in place at trust company businesses are fully effective and it is therefore the intention to continue with this theme in 2007. However, additional themes have also been introduced in order to focus on anti-money laundering systems and the maintenance of liquidity requirements, the latter as set out in Section 5.1 of the codes of practice.

Any comments on the contents of this paper would be welcomed. We would also be happy to address any concerns or questions that the reader may have in this respect. Any such communications should be addressed to:

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List of useful websites

www.google.com/www.google.co.uk
www.worldcheck.com
www.192.com
www.royalmail.com
www.nigerianscams.org
www.iccwbo.org
www.fsa.gov.uk/enforcement/firm-alerts.html
www.companieshouse.gov.uk
www.bankofengland.co.uk/sanctions
www.met.police.uk/fraudalert
www.ustreas.gov/ofac
www.transparency.org (Transparency International corruptions index)
www.state.gov/p/inl (US State Department narcotics control report)
www.oecd.org/fatf