Risk Themed Examination Programme 2005 – 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 2005, the chosen theme was risk management systems and controls as they relate to the underlying customer base 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 reviewed entity 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 in connection with their risk monitoring procedures, the risk profile of their business and what systems were in place to mitigate those risks. Responses to the questionnaires were analysed, specific areas of potential concern were identified and this then set the agenda for the examination.

In the event that serious concerns were uncovered during the examination process, the scope of the review was expanded beyond the narrow focus of risk management.

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Twenty-one risk themed examinations were conducted during the course of 2005. This was in addition to a further thirty-three examinations of a wider scope, during which the risk monitoring systems may also have been included in the scope of the examination. The Commission has therefore obtained an understanding of the risk systems used across a wide range of trust company businesses.

The results were fed back to the respective businesses in the form of either a letter or a draft report. In each case, this was generated within the targeted timescale of three weeks from the conclusion of the examination. In the cases where draft reports were issued, the businesses were given the opportunity to comment on the factual accuracy of the findings. Final reports were all agreed and issued within the targeted timescale of three weeks from the conclusion of the agreement of the findings.

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

Action	Number	Percentage
Enforcement action	0	0%
Follow up examination	3	14.29%
Monitor implementation of recommendations	8	38.10%
No formal monitoring	10	47.61%
Totals	**21**	**100%**

Overview

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

Size by number of employees	Number
Small (0-10)	8
Medium (10-30)	8
Large (30-50)	4
Super large (>50)	1

Almost all the businesses examined have introduced some form of risk assessment system and are at least part of the way through a full assessment of their customer base, although there was one instance where no consideration had been given to risk management systems at all. In this case, we are working very closely with the business concerned.

It was encouraging to find that most systems appeared to highlight the higher risk entities. Some businesses claimed to have no high risk customers, although an examination of files suggested otherwise. Such incidents undoubtedly raise concerns within the Commission. There appeared to be a misconception that the Commission is concerned if trust companies handle higher risk business. It should be stressed that the concern is not necessarily with the risk inherent in the business itself, but rather the quality of the assessment of the risk and the means by which it is mitigated and monitored. For example, it may be acceptable for a trust company business to accept customers from high risk jurisdictions if it is part of a global network, which operates in such a way that representatives of the organisation are very familiar with the particular country for which they have responsibility. Other acceptable methods of risk mitigation, in the area of high risk jurisdictions, include hiring a local firm to verify information or the use of software systems such as Worldcheck or Lexus Nexus.

The reviews of customer files continue to reveal serious deficiencies in the standards of conduct of business. Examples include the following:

- lack of customer due diligence documentation,
- inadequate knowledge of customer's background,
- no recorded rationale for the structure,
- lack of legal opinions or tax advice, where relevant,
- serious backlogs in the production of financial statements,
- lack of periodic reviews,
- deficiencies in the periodic review process such that important issues are not surfaced and identified, and
- lack of monitoring of remedial action arising out of the review process.

There was a wide variation in the sophistication of the risk management systems and, interestingly, this did not always reflect a corollary with the size of the business. In just under 30% of cases there was a lack of a formal documented process and methodology in the risk scoring of customers.

Most trust businesses have appreciated the benefits to be gained by investing resources in the development of effective risk management systems and much excellent groundwork is in progress. However, in many cases the systems are not fully embedded to demonstrate substantive results, and require further enhancement in order to be fully effective in mitigating the risks inherent in the customer base.

Specific areas identified as requiring attention

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

Initial Risk Assessment and Update

There were instances where business had been accepted without a risk assessment having been completed, with that assessment then being carried out at an undetermined date in the future. In many cases, there was also no provision for an ongoing review of the risk assessment. The Commission would suggest that there is merit in new business being risk assessed prior to its acceptance and further that the risk assessment be re-evaluated regularly, perhaps as part of the periodic review process.

Scoring Systems

We encountered a wide variety of scoring systems. The most effective systems were clear, logical and well understood by all of the staff in the business. However, some systems had the potential to cause confusion. For example, in one case there were two separate scoring systems with no mechanism to calculate an overall result. This resulted in the same customer entity being assigned two different risk ratings. Some systems were overly complicated. One example we saw comprised sixteen different risk categories, the allocation of each category being dependent on the risk characteristic inherent in each entity. It was not clear which category would be assigned if an entity displayed more than one of the defined risk characteristics.

Staff Awareness

It was not always apparent that all relevant staff had been properly trained to understand the operation of the risk system and, in two cases, the directors had not shared the information with the trust administrators. The Commission would recommend that all such staff should be aware of the risk score of each entity and that they are encouraged to surface issues which arise during the administration of their entities which may have an impact on the risk score.

Risk factors

We would expect the following main areas to be incorporated into an effective risk system:

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

(i) Geographical risks

The majority of systems had taken into account the obvious risks associated with the underlying customers' residence, although domicile was not always taken into account. What was not often considered were wider issues such as the location of the assets, the territory in which the entity is undertaking trading activities, the jurisdiction in which the entity itself is incorporated and the taxation and litigation risks which might arise out of dealings with territories such as the USA and Canada.

Factors which can be considered, regarding the degree of risk associated with particular countries are: FATF blacklists; international sanctions; specific alerts issued from time to time by the Commission (such as that issued in relation to Zimbabwe) and countries considered as high risk from a corruption or drug trafficking perspective. 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 as an appendix to this paper.

(ii) Underlying customer's activities

Most businesses had considered the risk posed by politically exposed persons or potentates. However, approximately 20% of the scoring systems did not automatically elevate such customers into the high risk category. The majority of systems did not drill down further in considering the occupation or business activities of the underlying customer. For example, if a customer is engaged in a cash rich business, it may be desirable to increase his risk profile. Ideally, the risk assessment system would also incorporate a mechanism to feed changes in customer circumstances, which may be gleaned from meetings or generally from the developing relationship, into a customer's profile and the risk assessment process.

(iii) Underlying customer's background

The quality of the customer due diligence information and the rationale for the structure were generally considered by most businesses to be important factors in the risk assessment process. However, it was disappointing to note that, in just under 50% of the businesses examined, file reviews revealed that the business held inadequate information regarding the underlying customer. In some instances, there was doubt as to who was in fact regarded as the beneficial owner of the entity. In over 30% of businesses examined, cases were identified showing that full customer due diligence documentation had not been obtained. In view of the obligations on trust company businesses to comply with appropriate anti-money laundering legislation, these findings were of serious concern to the Commission.

Around 30% of businesses did not factor in the source of the introduction of the customer or the customer's source of wealth. We were interested to see how businesses performed verification on the information provided by customers and noted that these ranged from simple internet checks using search engines such as "Google" through to the use of more sophisticated systems. Around 30% of businesses were not utilising such verification on a consistent basis. The Commission would suggest that all customers should be checked at the business acceptance stage and that the higher risk customers should be checked on a regular basis and more frequently than the lower risk category.

(iv) Activities of the entity

The nature of the activity undertaken by the entity was not factored into the risk assessment process in around 25% of cases. The degree of risk assigned is somewhat dependent on the overall risk appetite of the trust company business. Activities defined by the Commission as "sensitive" were generally assigned a higher risk rating. We would expect businesses to apply this standard to all companies irrespective of whether the company is incorporated in Jersey or elsewhere in accordance with principle 3.1.7 of the codes of practice.

The activities of trading companies were not always carefully considered. Clearly the type of activity being undertaken can expose the trust business to significant risks. When reviewing the files during the examination process, we noted entities recorded as "low risk" being engaged in activities such as trading with sanctioned countries and sensitive activities such as dealing in pharmaceutical products.

One very common finding was that registered office only entities were often considered as low risk. Due to the low remuneration, which is typically received by the trust business, they are not always reviewed as frequently or as thoroughly as entities for which the full range of services are provided, including the provision of directors. The Commission would suggest that registered office engagements often pose a higher risk to businesses, as the fact that they are not acting as directors means that they may not always be fully informed about the activities of those companies. A common finding, on examination of files, is that very sparse information is held and consequently the business is exposing itself to the risk of the misuse of the entity for improper purposes.

Other factors which could be incorporated into the risk system are: the value of the assets, the complexity of the structure under administration, the appointment of third party directors or signatories i.e. individuals who are not employed by the trust company business, the issuance of powers of attorney, requests for "hold all mail" facilities and any suspicions which may have developed during the course of the relationship.

Transaction Monitoring

Very few businesses have introduced any form of transaction monitoring, such that a profile of the expected degree of activity is clearly defined and recorded at the outset of the relationship and exceptions to the expected pattern are then highlighted and fed back into the risk assessment process. It is acknowledged that this may be a difficult area for trust company businesses but it is, nevertheless, a useful tool in the detection and prevention of money laundering and also as a means of protecting businesses from the risks of the improper use of entities for which they are responsible.

Given the obligations on trust company businesses to comply with the Proceeds of Crime (Jersey) Law 1999, the Money Laundering (Jersey) Order 1999 and follow the standards set out in the Anti-Money Laundering Guidance Notes, the Commission would recommend that trust company businesses review their procedures with this in mind. Monitoring is not a mechanical process and does not necessarily require sophisticated electronic systems. The key elements of any system are having up to date customer due diligence information and asking pertinent questions to elicit reasons for unusual, complex or higher risk activity or transactions in order to determine whether they may represent money laundering or terrorist financing.

Impact of risk assessment on administrative routines

Whilst many businesses have undertaken the task of introducing a risk assessment system, they are not always utilising this valuable information. It would, for example, be useful in adopting a risk based approach to the administration of the customer base in order to maximise the use of resources. Periodic reviews could be conducted on a less frequent basis for the lower risk segment of the customer base; risk scores could be considered when processing transactions; more senior staff could be allocated to the higher risk cases.

Examples of best practice

The best systems use a scientific scoring methodology, which captures the essential factors described in this paper, and provides a clear and logical result. This can be achieved by the use of a well thought out risk assessment form or an appropriate software solution. The information should then be used as an integral part of adopting a risk based approach to managing the business and be shared with all relevant members of staff. One of the most efficient systems we observed was an electronic system devised by a trust company business which prompted different banks of questions according to the risk characteristics of the customer entity. Equally, we found some well designed risk assessment forms, which took account of all the material risks.

Many businesses had decided to base the frequency of their periodic review programme on the basis of the risk rating and the Commission would encourage such a risk based approach. Database systems were flagged with the risk rating and the rating was entered on forms used to process transactions such as trust distribution checklists, so that an enhanced level of scrutiny was applied to the high risk customers.

Conclusion

The Commission has found that examination of this topic has been extremely valuable in assessing a wide cross section of firms, as effective risk management is integrally linked with well managed trust company businesses. It is, therefore, the intention that this theme will be continued during 2006. It is also anticipated that the subject may be expanded to include a limited overview of the investment process in relation to discretionary trusts. However, the main emphasis for 2006 will remain on the examination of risk systems, in respect of the underlying customers of trust company businesses.

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

1. www.google.com / www.google.co.uk
2. www.worldcheck.com
3. www.192.com
4. www.royalmail.com
5. www.nigerianscams.org
6. www.iccwbo.org
7. www.fsa.gov.uk
8. www.fsa.gov.uk/enforcement/firm_alerts.html
9. www.companieshouse.gov.uk
10. www.bankofengland.co.uk/sanctions
11. www.met.police.uk/fraudalert
12. www.ustreas.gov/ofac/
13. www.transparency.org - Transparency International
14. www.state.gov/g/inl - US State Dept narcotics control report
15. www.oecd.org/fatf - FATF