

Compliance Audit:

Evaluating and Balancing Country Risk
and Regulatory Risk



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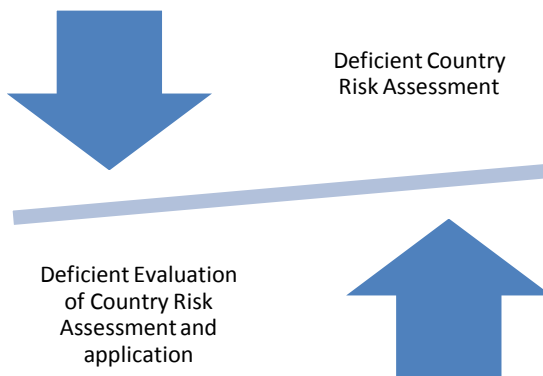
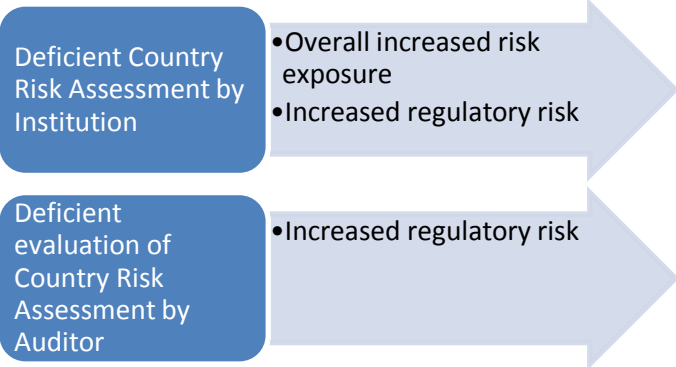
INTRODUCTION

An initial and on-going risk assessment is the foundation of any compliance system regardless of its scope and the starting point for an audit of a compliance system should be to review and evaluate the risk assessment.

Whilst a variety of risks have been identified by standard setters and regulators for more than a decade, evaluating the risk assessment presents a difficult hurdle to clear cleanly to scope the audit and produce a high quality reliable report.

The failure to accurately assess and appropriately apply country risk by an institution results in exposure to increased risk and this includes some regulatory risk.

The failure by a compliance auditor to accurately and properly evaluate the risk assessment of country risk may result in further increased regulatory risk where the Institution is mandated to arrange periodic compliance audits.



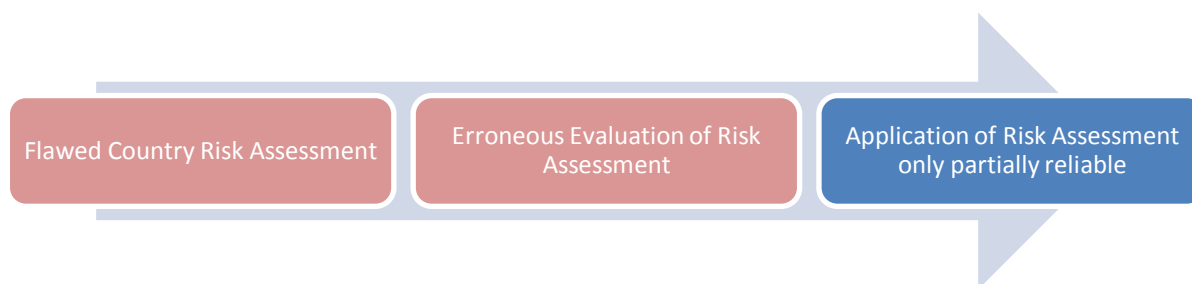
The ability to achieve the correct balance between regulatory risk and country risk assessments and evaluations is further hindered by the existence and use of “white and black lists” by regulators which are often reflective of political factors, limited, unreliable or based on old data.

In this paper, we identify and explore the compliance processes reliant on country risk assessments and how to evaluate that in the audit process. We refer to features of reasonable methodologies for country risk assessments highlighting how the assessment can counter regulatory risk arising from regulatory high risk country “black” lists. Whilst some jurisdictions allow reliance to be placed on introducers and intermediaries if in “white list” countries (countries with equivalent regulation) but also require enhanced due diligence when clients or transactions involve high risk countries. A small number of regulators list high risk countries, a number define them and many do not include reference to either.



REGULATORY RISK

The frequency and scope of compliance audits will directly affect regulatory risk. However, since the evaluation of the risk assessment is the foundation for the audit then any deficiencies in this evaluation could undermine the audit itself and thereby also increase regulatory risk.



Where this risk falls depends on the regime. Where the auditor's evaluation of the risk assessment fails to identify weaknesses in the risk assessment, then the auditor will face regulatory risk if the regulator approves auditors either formally or informally. In this case the institution also faces regulatory risk for the deficient risk assessment although it may be afforded some excuse if the auditor does not identify and report on the weakness in its evaluation.

However, it may be argued that the risk assessment whilst the foundation for the audit, is affected by so many factors beyond the scope of a compliance audit¹ that the institution should be responsible for the evaluation of its risk assessment by additional independent means.

Nonetheless, the auditor needs to be able evaluate the risk assessment as full and objective and its consistent application. The first step is to fully explain to the client the features of a reasonable methodology for risk assessments and stress the importance and relevance of this in the audit.

To mitigate any liability, auditors should establish a benchmark for "Reasonable Country Risk assessments" for the purpose of compliance audits. This will enable the auditor to focus on the evaluation of the application of the risk assessment.



When a risk assessment is evaluated as deficient, communication with the client is necessary and the scope and timing of the audit may be changed. The audit report should clearly note any concerns regarding the risk assessment and limitations of the review to ensure the report is of value and also to manage the auditor’s liability and regulatory risk.

COUNTRY RISK

Country risk, in conjunction with other risk factors, provides a useful indicator to potential money laundering risks. According to the Wolfsberg Principles, the evaluating factors that may result in a determination that a country poses a higher risk include if the country is:

- Subject to sanctions, embargoes or similar measures issued by, for example, the United Nations (“UN”).
- Identified by the Financial Action Task Force (“FATF”) as non-cooperative in the fight against money laundering or identified by credible sources as lacking appropriate money laundering laws and regulations.
- identified by credible sources as providing funding or support for terrorist activities
- Identified by credible sources as having significant levels of corruption, or other criminal activity².

The Third EU Money Laundering Directive refers to third country equivalence but the proposed 4th Directive will remove the provisions relating to positive "equivalence", as the customer due diligence regime is becoming more strongly risk-based and the use of exemptions on the grounds of purely geographical factors is less relevant.

The current provisions of the Third Money Laundering Directive require decisions to be made on whether third countries have anti-money laundering/combating terrorist financing systems that are "equivalent" to those in the EU. This information is then used to allow exemptions for certain aspects of customer due diligence.

The non-exhaustive list of geographical risk factors referred to in the Directive, are set to remain the same, only the use and application will change.

ANNEX 3 POTENTIALLY HIGHER GEOGRAPHICAL RISK FACTORS	ANNEX 2 GEOGRAPHICAL LOWER GEOGRAPHICAL RISK FACTORS
(a) countries identified by credible sources, such as FATF public statements, mutual evaluation or detailed assessment reports or published follow-up reports, as not having <i>effective anti-money laundering/combating terrorist financing systems</i> ;	(a) other EU Member States;
(b) countries identified by credible sources as having significant levels of <i>corruption or other criminal activity</i> ;	(b) third countries having effective anti-money laundering/combating terrorist financing systems;
(c) countries subject to <i>sanctions, embargos or similar measures issued by, for example, the United Nations</i> ;	(c) third countries identified by credible sources as having a low level of corruption or other criminal activity;
(d) countries providing funding or support for <i>terrorist activities</i> , or that have designated terrorist organizations operating within their country.	(d) third countries which are subject to requirements to combat money laundering and terrorist financing consistent with the FATF Recommendations, have effectively implemented those requirements, and are effectively supervised or monitored in accordance with the Recommendations to ensure compliance with those

Many regulators now require that a risk based approach be adopted by institutions and the absence of rules and prescription mean that all and any risk assessment requires full and careful attention.

A risk assessment must not be arbitrary. The more comprehensive and objective an assessment is, the lower the regulatory risk.

Risk Assessment Mistakes

Not considering a variety of sources for the assessment

Inconsistent application

Failing to update assessment

Thus, an already potentially subjective process may require more than reasonable steps to fully assess risks and there should be design changes in response to new events.

An obvious pitfall is to not respond to key changes to business plan or changes in the business environment³ and generally the frequency of updates of the risk assessment depends on the type of institution and its experiences.

OBSTACLES TO ASSESSMENT AND EVALUATION OF COUNTRY RISK

- The country risk assessment serves many purposes within the compliance system and the needs of those differ.
- Recently, both Sanctions and Corruption compliance have been added to existing AML and AFT compliance systems and country risk can have different implications for those.
- High risk country lists further complicate the process unless well designed, ideally as a resource.⁴ Black lists will usually increase regulatory risk and hinder business unnecessarily. Since fixed lists may not accurately reflect country risk and may not give clear direction on how the list is to be applied, regulatory risk may be increased.

HSBC CASE 2012

The HSBC case involved a failure to observe official US warnings about the risk of money laundering in Mexico.⁵ The Annual International Narcotics Control Strategy Report (INCSR) issued by the US State Department¹ annual report issued by the lists Mexico as high risk because of the prevalent drug crime in the country. Although HSBC failed to adopt the highest risk rating for Mexico based on the US reports, the primary problem was that the bank's own risk rating system and compliance process was flawed or overridden. Whilst acceptable for the client risk rating process to override the country risk assessment this was not documented correctly.⁶

Pertinently the primary country risk in Mexico is of drug trafficking and corruption, which relates to source of funds but Mexico's regulation of AML is considered to be acceptable and some regulators include Mexico on a white list. This illustrates how lists can confuse the assessment and thereby present additional regulatory risk.

¹ Department of State Bureau for International Narcotics and Law Enforcement Affairs

Despite the information and warnings regarding money laundering risks in Mexico, from 2002 until 2009, HSBC assigned its lowest risk rating for AML purposes to Mexico. As a consequence, under bank policy, clients from Mexico were not subjected to enhanced monitoring, unless they were also designated a Special Category Client, which was a relatively rare designation that indicated high client risk. This meant that client risk, of which country risk is an element, overrode the country risk. As a result the bank did not conduct AML monitoring on most of its Mexican client accounts and wire transfer activity involving substantial funds.

HABIB BANK CASE 2012

In May 2012 the UK Financial Services Authority imposed fines on Habib Bank. Almost half of its client base was outside the UK and about half of its deposits came from jurisdictions which reportedly had less stringent AML requirements or were perceived to have higher levels of corruption than the UK.

Habib maintained a high risk country list which excluded certain high risk countries⁷ on the basis that it had group offices in those countries, which the bank argued gave it local knowledge of these countries, which negated the otherwise assessed higher risk of money laundering. Where deposits or clients were located in high risk countries, the regulator found that the bank failed to conduct adequate enhanced due diligence.

The regulator noted that the bank's belief that local knowledge of a country through a group office mitigated the higher money laundering risk posed by that country was entirely misconceived.

Guidance⁸ issued by the regulator the year before the Habib case highlighted examples of poor practice:

- Ranking higher risk countries as 'low risk' because they had 'lots of dealings' with the entities there.
- Exempting relationships from country risk assessments because the bank's parent had a presence in the higher risk country.

The lesson to be learned from this case is that it is safer to conduct a risk assessment using objective data and sources. To override risk assessments resulting from regulatory or credible sources presents significant regulatory risk.

The better approach is to adopt and record the higher risk assessment but then tailor the enhanced due diligence or other compliance process according to all the factors and risks present. In all the cases the higher and more independent the approval obtained for the decision the better wherever there are high risk factors.

GOOD REGULATORY PRACTICE

The Jersey Financial Services Commission has issued excellent and extensive guidance on country risk assessments⁹ including a very useful resource listing countries and factors affecting the country risk of each.

It advises that the following types of countries or territories may be considered to present a higher risk, those:

- With strategic deficiencies in the fight against money laundering and the financing of terrorism e.g. Identified by the FATF as having strategic deficiencies.
- Identified as major illicit drug producers or through which significant quantities of drugs are transited, e.g. those listed by the US Department of State in its annual International Narcotics Control Strategy Report.
- That do not take efforts to confront and eliminate human trafficking, e.g. those listed in Tier 3 of the US Department of State's annual Trafficking in Persons Report.
- that have strong links (such as funding or other support) with terrorist activities, e.g. those designated by the US Secretary of State as state sponsors of terrorism; and those physical areas identified by the US (in its annual report entitled Country Reports on Terrorism) as ungoverned, under-governed or ill-governed

where terrorists are able to organize, plan, raise funds, communicate, recruit, train, transit and operate in relative security because of inadequate governance capability, political will or both.

- That are involved in the proliferation of nuclear and other weapons, e.g. those that are the subject of sanctions measures in place in Jersey, or, as appropriate, elsewhere.
- That are vulnerable to corruption, e.g. those with poor ratings in Transparency International's Corruption Perception Index or highlighted as a concern in the Worldwide Governance Indicators project, or whose companies engage in bribery when doing business abroad, e.g. those with poor ratings in Transparency International's Bribe Payers Index.
- in which there is no, or little, confidence in the rule of law, in particular the quality of contract enforcement, property rights, the police and the courts, e.g. those highlighted as a concern in the Worldwide Governance Indicators project.
- In which there is no, or little, confidence in government effectiveness, including the quality of the civil service and the degree of its independence from political pressures, e.g. those highlighted as a concern in the Worldwide Governance Indicators project.
- that are politically unstable, e.g. those highlighted as a concern in the Worldwide Governance Indicators project, or which may be considered to be a "failed state", e.g. those listed in the Failed State Index (central government is so weak or ineffective that it has little practical control over much of its territory; non-provision of public services; widespread corruption and criminality; refugees and involuntary movement of populations; sharp economic decline).
- That are the subject of sanctions measures that are in place in Jersey or elsewhere, e.g. those dealing with the abuse of human rights of misappropriation of state funds.
- That lack transparency or which have excessive secrecy laws, e.g. those identified by the OECD as having committed to internationally agreed tax standards but which have not yet implemented those standards.
- with inadequate regulatory and supervisory standards on international cooperation and information exchange, e.g. those identified by the Financial Stability Board as just making material progress towards demonstrating sufficiently strong adherence, or being non-cooperative, where it may not be possible to investigate the provenance of funds introduced into the financial system.

Contrary to the Habib case, the recent guidance from the Jersey regulator, states that a relevant factor in the assessment would be the institution's familiarity with a country or territory, including knowledge of its local legislation, regulations and rules, as well as the structure and extent of regulatory oversight, for example, as a result of a relevant person's own or group operations within that country. Without giving an institution the ability to factor this in is to take away a disproportionate amount of valuable knowledge and information that can be more accurate than public data sources. Also, contrary to the 2011 FSA guidance, the JFSC states that the transparency of the customer may indicate lower risk. For example, persons subject to public disclosure rules, e.g. on exchanges or regulated markets or subject to licensing by a statutory regulator.

In conclusion, the Jersey regulator's approach is an excellent one to follow in the assessment of country risk. Further, in both the Habib Bank and HSBC cases the significant regulatory risk that resulted in the fines was more a result of the abuse of the banks' own processes rather than directly a result of the regulatory requirements. By way of illustration it is noted that the FSA generally commended banks with sophisticated risk assessment models that are consistently applied.¹⁰

AUDITING THE RISK ASSESSMENT

FREQUENCY AND SCOPE

Many regimes now also require compliance with sanctions orders and have anti-corruption legislation in place. Whilst in most jurisdictions there is no requirement to audit systems designed to ensure compliance with Sanctions and Corruption regulation, in many cases the penalties are high and strict liability applies, and given that AML, ATF, corruption and sanctions risks are inextricably associated with each other, then it makes sense to include sanctions and corruption within the scope of any compliance audit.

Given that country risk is closely relevant to all, then at least the risk assessment would entail all four and should be included in the risk assessment evaluation.¹¹

What is very important to examine is how sanction lists of countries might be confused with high risk countries for AML and AFT purposes. Some rationale for the ranking should thus be evident in the risk assessment.¹²

The focus and design of the audit regarding country risk should be:

- Evaluate the Country Risk Assessment
- Assess the Application of the risk assessment

EVALUATING THE COUNTRY RISK ASSESSMENT

The auditor should check that risk assessment:

- Is based on objective sources
- Has more than one set of results
- Is fit for purpose
- Is updated periodically

A concern will arise and should be discussed with the client and reported upon, if a single list is used for numerous processes such as client acceptance, residence of client, source of funds and enhanced processes for example PEPs. The following chart documents how different categories of risk evidenced by a variety of data sources are relevant to compliance processes:

Category of Risk	Compliance Process
Money Laundering and Terrorist Financing	<ul style="list-style-type: none">▪ Client risk (source of funds, source of wealth, residence)▪ Acceptance of and reliance on Counterparties▪ Decline business
Financial Transparency and Standards	<ul style="list-style-type: none">▪ Know your client (understanding business)▪ Monitoring▪ Reliability of documents (e.g. audited financial statements)
Public Transparency and Accountability	<ul style="list-style-type: none">▪ Client risk (public body)▪ Identifying PEPs▪ Reliability of documentation (evidence of identity etc.)
Political and Legal Risk	<ul style="list-style-type: none">▪ Identifying PEPs▪ Reliability of documentation (evidence of identity etc.)▪ Verification methods▪ Acceptance of and reliance on Counterparties
Corruption Risk	<ul style="list-style-type: none">▪ Enhanced due diligence for PEPs

ASSESS THE APPLICATION OF THE RISK ASSESSMENT

The system must be tested by means of file reviews and staff interviews to check how the country risk assessment is applied and a number of compliance processes must be included in the review. Training should also include reference to the risk assessment for staff involved with processes affected by the risk assessment.

Where regulatory white or black lists apply then it is recommended that the institution conduct its own assessment of country risk and then purely for regulatory risk management overlay or adjust the assessment and act upon that accordingly.

SOLUTIONS

A solid and sophisticated country risk assessment is required and fortunately, an expert-developed market solution, the Basel AML Index, is available to objectively conduct country risk assessment and can be applied according to the purpose and application of the assessment.

Basel AML Index

The Basel Institute AML Index¹³ can be used as an authoritative source for assessing country risk. The Index is available as a public version of a limited number of countries or by subscription as a comprehensive rating of more than 200 countries.¹⁴

Category of Risk	Data source
ML/TF	FATF 40 recommendations plus nine special recommendations
	Financial Secrecy Index (Tax Justice Network)
	US International Narcotics Control Strategy Report
Financial Transparency and Standards	World Bank: Business Disclosure Index
	IDA Resource Allocation Index (Financial Sector)
	World Economic Forum, Global Competitiveness report (Strength of Auditing and Reporting and Regulation of Securities)
Public Transparency and Accountability	International IDEA Political Finance Database
	International Budget Partnership – Open Budget Index
	IDA Resource Allocation Index (Transparency, accountability and Corruption)
Political and Legal Risk	Freedom House – Freedom in the World & Press Freedom Index
	World Economic Forum, Global Competitiveness report (Institutional Strength)
	Bertelsmann Stiftung Transformation Index 2012 - Rule of Law
Corruption Risk	TI CPI Perception of Public Corruption

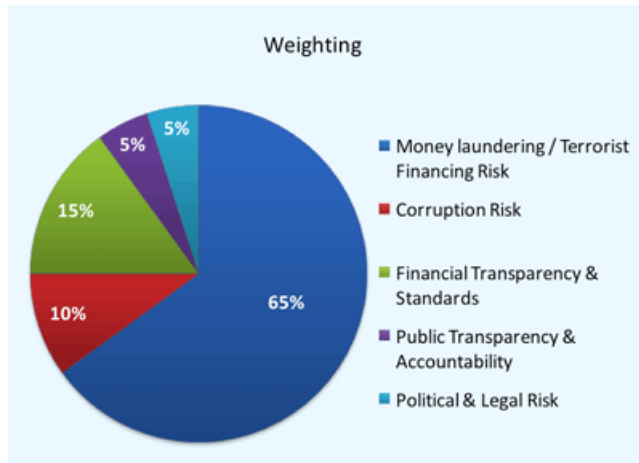
The following features of the Index, which make it a valuable resource, can be looked for in other commercial solutions or when designing in-house assessment processes:

- On-going independent verification of the sources selected to ensure that they are credible and relevant sources to identify money laundering/terrorist financing risks.
- A project methodology¹⁵ that scales and weights the risk factors to give an overall assessment of a country's vulnerability to money laundering.
- Option for users to tailor the weightings as a tool for the application of the rating to compliance processes. There are sub-indicators which may be selected and deselected to apply to processes more appropriately.

Countries are listed as the most vulnerable to money laundering and terrorism financing, based on their poor performance by indicators and measurements that have been used in the Index. The main factors are

inadequate money laundering and terrorist financing legislation; however, additional variables and factors are also considered. It aggregates various external sources and raw data into one index.

The FATF Mutual Evaluation Reports recommendations¹⁶ are used and weighted¹⁷ as the primary source to reflect countries' compliance and implementation of AML/CTF regulations. Additionally, related aspects such as banking secrecy, corruption, financial regulations, judicial strengths and civil rights are factored in. This provides a holistic and comprehensive risk score to identify a country's overall risk level and its financial vulnerability, but these can be filtered out to suit specific risk assessment and compliance process needs.



The Basel AML Index comes with a number of disclaimers¹⁸ and of note since there is no objective standard in creating a composite index, choices and judgments on variables and weightings are based on a qualitative expert assessment of the variables.

Nonetheless, since the user is able to select and deselect all 15 indicators then the solution is far better than most commercial alternatives currently available.

If the Basel Institute was unable to obtain more reliable data, then most institutions' compliance personnel are unlikely to improve on that.

Whilst the weighting is fixed, users may filter to suit the purpose but the audit should check that filters are not used to give precedence to commercial factors. Thus, dependent on the capacity and expertise of the Institution using the index, the overall score may only rarely be used for country risk assessments and compliance processes.

CONCLUSION

To reduce the conflict between regulatory risk and country risk, a solid and sophisticated country risk assessment is required. Where regulatory white or black lists apply then it is recommended that the institution conduct its own assessment of country risk and then for regulatory compliance purposes overlay or adjust the regulatory list and amend and act upon that accordingly. This is the best course as it ensures:

- An appropriate assessment of country risk that may be relevant to operational or legal risks, and
- Clearly demonstrates the impact of any high risk country lists to regulators and stakeholders.

¹ E.g. operational risk, legal risk, financial and investment risk.

² The 2013 International Narcotics Control Strategy Report (INCSR) is an annual report by the US Department of State to Congress prepared in accordance with the Foreign Assistance Act. It describes the efforts of key countries to attack all aspects of the international drug trade in Calendar Year 2012. Volume I covers drug and chemical control activities. Volume II covers money laundering and financial crimes.

³ Jersey Financial Services Commission notes concerns where the business did not identify when a new venture, product or market would be reason to revisit the risk assessment and noted a need to link risks identified to underlying customer base, and the strategy to combat the risks and then to its adopted policies and procedures (2013 Trust Company Business Report paras 5.7 and 5.8.)

⁴ Handbook for the Prevention And Detection of Money Laundering and the Financing of Terrorism for Financial Services Business Regulated under the Regulatory Laws, JFSC Feb2013 Appendix D2 – Countries and territories identified as presenting higher risks

⁵ State Department INCSR reports

⁶ HSBC created a chart listing its country risk assessments, sent the chart to its affiliates characterizing its assessments as recommendations, and then allowed each HSBC affiliate to make its own assessment decisions. The country risk assessments were compiled every six months by an AML compliance officer who gathered information from a number of sources, assigned numerical scores to each source, and then compiled aggregate scores for over 200 countries. Those scores were then supposedly used to assign risk ratings. In fact, however, countries receiving similar scores often received different risk ratings. Those differences were attributable, in part, to a “discretion” factor which was listed as an official factor in the risk assessment process, included in the risk assessment chart, and used, to alter the risk ratings for over 60 countries in 2009. The OCC noted that the bank offered “no discussion or documentation as to what constitute[d] permissible reasons to change the risk rating” using the discretion factor and also found that the bank did not apply its risk-rating methodology “in a consistent manner”. The regulator criticized the bank’s country risk assessment process for not taking into account readily available country-specific information on money laundering and drug trafficking risks, including in the annual State Department INCSR reports. Although INCSR information was often included in bank’s KYC client profiles, the INCSR country-specific risk ratings were inexplicably excluded from the official bank’s country risk assessment scoring matrix. - United States Senate Permanent Subcommittee on Investigations Committee on Homeland Security and Governmental Affairs U.S. Vulnerabilities to Money Laundering, Drugs, and Terrorist Financing: HSBC Case History July 2012

⁷ The assessment by the regulator was based on reports of independent international organisations most likely the EU and FATF.

⁸ Banks’ Management of High Money-Laundering Risk Situations, FSA June 2011

⁹ Handbook for the Prevention And Detection Of Money Laundering and the Financing of Terrorism for Financial Services Business Regulated under the Regulatory Laws, JFSC Feb2013

¹⁰ Banks’ Management of High Money-Laundering Risk Situations, FSA June 2011

¹¹ This would not affect regulatory risk but would affect country risk

¹² See the FATF Report, Specific Risk Factors in Laundering the Proceeds of Corruption, Assistance to Reporting Institutions. June 2012

¹³ First issue April 2012

¹⁴ “Basel Institute Launches AML Risk Index”, B. Monroe, MoneyLaundering.com, April 25 2012

¹⁵ The Basel AML Index Project Description 2013

¹⁶ Note not all FATF Mutual Evaluation Reports are conducted annually thus comparability of the scores is somewhat limited.

¹⁷ The sources used to rank the Money Laundering and Terrorist Financing Risk a. FATF 40 recommendations plus nine special recommendations (the Mutual Evaluation Reports available will be based on the old 40+9 and reports from 2012 on the new Forty) b. the Financial Secrecy Index (Tax Justice Network) and c. the US International Narcotics Control Strategy Report overall contribute to 65% of the ranking. Countries that do not have any variables within the ML/TF category and countries with missing or insufficient data (less than 50% of the overall indicators) are marked. Fifteen percent weighting is then given to Financial Transparency and Standards World Bank – Business Disclosure report and IDA Resource Allocation Index (Financial Sector) and the World Economic Forum, Global Competitiveness report (Strength of Auditing and Reporting and Regulation of Securities); 10% to Corruption Risk based on Transparency International’s Perception of Public Corruption Index and 5% allocated to each of Public Transparency and Accountability and Political and legal Risk International IDEA – Political Finance Database, International Budget Partnership – Open Budget Index, World Bank – Business Disclosure report and IDA Resource Allocation Index (Transparency, accountability and Corruption), Freedom House – Freedom in the World & Press Freedom Index, World Economic Forum, Global Competitiveness report (Institutional Strength) and Bertelsmann Stiftung Transformation Index 2012 - Rule of Law scores.

¹⁸ The ranking is based on a composite index, meaning it provides a simplified comparison in the area of money laundering/terrorist financing that scores summarize a complex and multidimensional issue, and should not be viewed as a factual or quantitative measurement of money laundering/terrorist financing activity or as a specific policy

recommendation for countries or institutions. Also, the Index does not calculate for a margin of error, uncertainty analysis or sensitivity analysis.