Risk Reward
riskupdate
The quarterly independent risk review for banks and financial institutions worldwide
Q3 – 2009

The Basel Committee

A REVIEW OF THEIR ANALYSIS OF THE TRADING BOOK QUANTITATIVE IMPACT STUDY

BANK FOR INTERNATIONAL SETTLEMENTS

Also in this issue

- UK & INTERNATIONAL SANCTIONS – AN URGENT COMPLIANCE ISSUE FOR ALL
- PROJECT APPRAISAL: ENSURING FUNDERS OBTAIN ADDED VALUE
- ISLAMIC FINANCE
- THE FSA & LIQUIDITY RISK
- WHEN THEY CALL YOU – WHO ARE YOU GONNA CALL?

© Risk Reward Ltd UK. All rights reserved. Available by subscription only – not for sale or resale

UK & INTERNATIONAL SANCTIONS – AN URGENT COMPLIANCE ISSUE FOR ALL

This article, contributed by David Blackmore, Director of Financial Crime, Risk Reward Ltd, is focused solely on the UK sanctions regime as part of a two-part series. The next edition of the Global Risk Update Part II will focus on EU and US sanctions and the growing ability of the US in particular to enforce its will outside its own borders

Sanctions – Nothing new then!

Those old enough to remember the early 1960's will recall the Wilson Government's sanctions against the Rhodesian UDI. Since then, sanctions have become the diplomatic norm in lieu of military action and/or blockade, which of course was the tactic of choice by British Governments in the 19th Century. Furthermore, the growth of international bodies such as the UN has reinforced the use of sanctions to achieve some or all of the following:

- To encourage a change in behavior in a target country or regime
- To apply pressure to comply with defined objectives
- As an enforcement tool when international peace and security are threatened and diplomacy has failed
- To prevent and suppress the financing of terrorism, terrorist acts and the proliferation of weapons of mass destruction (WMD)

Despite nearly 50 years' experience of applying sanctions with varying degrees of success, what is new is the extent to which financial institutions and other entities are now firmly in the front line as enforcement agents of both governments and international bodies.

The emergence of financial sanctions

In the UK, the Financial Services Authority (FSA) was established with a Statutory Objective of reducing financial crime. In its Handbook of rules "financial crime" is very widely defined as "… any kind of criminal conduct relating to money or to financial services or markets … including any offence … an act or omission which would be an offence if it had taken place in the UK". Nobody seriously doubts that breaches of sanctions legislation fall within this definition in so far as a regulated firm's systems and controls are failing to implement the legal framework.

Thus the growth of financial sanctions has become an underlying theme on the financial crime agenda in the last few years, and has become much more publicised recently by the FSA.

"The use of financial sanctions to deliver public policy objectives has risen rapidly up the political agenda in the UK, in the European Union and the United Nations. It is important that firms understand that having systems and controls relating to financial sanctions is an integral part of complying with the FSA's requirements on financial crime." – *Phillip Robinson, Former Director of Financial Crime and Intelligence Division, FSA.*

The UK Legal Framework

Four separate authorities have responsibilities for various aspects of the UK regime:

- UK policy on scope and conduct of international sanctions is decided by the Foreign and Commonwealth Office (FCO)
- HM Treasury is responsible for international financial sanctions and the prevention of WMD proliferation
- The Department for Business, Innovation and Skills (BIS) is responsible for trade sanctions
- HMRC is responsible for export controls on sensitive and dual-use goods, including arms.

A variety of legislative instruments have been devised over the years to construct this regime.

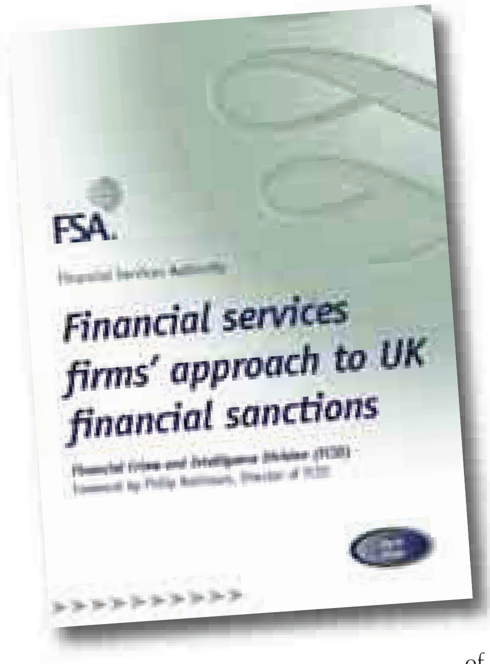
- Terrorism Acts, 2000 & 2006
- Anti-Terrorism, Crime & Security Act, 2001
- Proceeds of Crime Act, 2002
- Terrorism (U.N. Measures) Order 2009 / S.I. 1747 which replaced the 2006 Terrorism Order, S.I. 2657
- Al-Qaida & Taliban (U.N. Measures) Order 2006 / S.I. 2952
- Terrorism Act 2000 & Proceeds of Crime Act 2002 (Amendment) Regulations, 2007
- The Counter-Terrorism Act, 2008
- Regulatory Enforcement & Sanctions Act 2008

The key instruments are the two Statutory Instruments passed in 2006 and 2009. The Terrorism (U.N. Measures) Order 2009 / S.I. 1747 and the Al-Qaida & Taliban (U.N. Measures) Order 2006 / S.I. 2952 make it an offence to make funds, economic resources or financial services available to anyone, including individuals and corporate entities directly or indirectly involved in terrorism and/or terrorist financing/activities; to deal with funds or economic resources; to participate knowingly in activities aimed at circumventing the above (new); for an institution to fail to disclose to HMT their dealings.
UK sanctions apply to all UK citizens wherever they work in the world and to all UK incorporated and resident entities,

US INTERNATIONAL SANCTIONS – AN URGENT COMPLIANCE ISSUE FOR ALL CONTINUED

subsidiaries and branches. Sanctions do not apply to non-UK incorporated subsidiaries. The legal consequences of failing to comply with the Orders can be substantial and include fines and/ or imprisonment. HM Treasury has established the Asset Freezing Unit (AFU) to implement the sanctions regime. The AFU maintains a Consolidated List of targets established by the UN, the EU and the UK itself. The unit has seen a substantial increase in activity and funds frozen over the last three years. Some 400 accounts and over £4million are currently frozen. This is despite a number of legal challenges to the Orders, both at the UK and EU levels. At the time of writing the outcome of the leading cases is unknown and so for the foreseeable future it will be "business as usual".

The FSA Report



Following a thematic review in 2008, the FSA published its Report in April 2009 ("Financial services firms' approach to UK financial sanctions"). Its verdict was scathing.

"There are inadequacies in firms' systems and controls to reduce the risk of a breach of UK financial sanctions in all sizes of firms across all financial sectors." *(Para 1.2 "Findings", FSA Report, April, 2009)*.

Serious deficiencies were found in the assessment of the risk, the lack of senior management involvement and drive to implement the process, the absence of approved policies and procedures and the lack of effective staff training. Misconceptions and misunderstandings were in rich profusion, including:

- Financial limit--- there is none!
- No UK-based targets on list--- yes there are!
- Not relevant if don't hold client money--- completely false!
- Tipping – off? --- not an issue since those on the sanctions list already know they are on the list!
- Not relevant if financial crime risk of the firm is low--- not an issue!
- PEPs are same as sanctions targets--- not so, but some PEPs may also be on the sanctions list!
- Not applicable to insurance--- completely wrong!
- AML due diligence = sanctions list screening--- not so, but is clearly linked to it!
- Sanctions are a risk-based approach--- no it is not! Sanctions compliance is a completely discrete legal regime.
- We can rely on others to have done sanctions checks when passing business to us--- not so, unless the accepting firm has verified that the referring firm has completed recent sanctions screening!

In addition the FSA took issue with some firms' use of IT screening products which if not properly installed with adequate data quality and appropriate systems rules will not achieve the desired outcome. Many firms were also ignorant of the procedures to follow if they did have a match or what appeared to be a match to a name on the UK sanctions list. Both the FSA and HM Treasury have promised further reviews and these are highly likely to lead to significantly upgraded enforcement action if firms do not raise their game quickly.

As if this were not enough, HM Treasury recently activated the Counter-Terrorism Act 2008 (CTA) by issuing a Direction on 12th October 2009 prohibiting dealings with 2 Iranian entities suspected of assisting with that country's alleged WMD programme. The CTA contains significant powers of direction for credit and financial institutions thus adding to an already large compliance burden. Coupled with these new obligations are the export control measures and the prohibited investment lists maintained by HM Treasury, HMRC and BIS which together place significant customer due diligence (CDD) requirements on firms, again with a clear linkage to the requirements of the Money Laundering Regulations 2007 and the Proceeds of Crime Act 2002.

Action firms can take

- ✓ Get a clear, firm-unique strategy
- ✓ Senior management to reinforce a compliance culture within the firm as sanctions compliance is not a risk-based regime!
- ✓ Conduct a Gap Analysis to the FSA Sanctions Report, and the CTA Interpretive Notes of HMT
- ✓ Implement JMLSG Guidance, Part 3 – coming soon!
- ✓ Address risks beyond the strictly legal obligations:-
  - o Reputational
  - o Civil liability
  - o US extra-territoriality
- ✓ Review/ upgrade and document your Risk Assessment and Action Plan
- ✓ Ensure the Risk Assessment is approved at senior management level
- ✓ Make sure you can implement your plan, preferably from within but if resource is scarce or the required skill sets are missing then
- ✓ Use experts who understand the risks, especially on I.T. solutions and provide cost effective and helpful solutions
- ✓ Incorporate the results of the above into your staff training and awareness programme
- ✓ Include the upgraded sanctions compliance regime in your Audit Plan/Horizon (internal / external).

The next article is this series will focus on the European Union and USA sanctions and the growing ability of the US in particular to enforce its will outside its own borders.