CONSULTATION DOCUMENT

AML/CFT SUPERVISORY STRATEGY

Central Bank of The Bahamas

Bank Supervision Department

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Executive summary

The Central Bank of the Bahamas ("the Bank") regulates and supervises Bahamian banks, trust companies, co-operative credit unions, and money transmission companies (collectively, supervised financial institutions or "SFIs"). Traditionally, the Bank has focused its efforts upon ensuring SFI financial soundness. The Bank also periodically examines each SFI's compliance with the relevant obligations regarding anti-money laundering ("AML"), countering the financing of terrorism ("CFT"), and related requirements. These obligations are determined by Bahamian legislation, regulation, and supervisory guidance, which in turn are informed by international standard setting bodies such as the Financial Action Task Force (FATF), the Basel Committee on Banking Supervision, and others.

The Bank has concluded that Bahamas SFIs, and the Bahamian financial system, will be better served if the Bank shifts from periodic examination of AML/CFT risks, to continuous supervision of these risks. In addition to continuing the current examination regime, the Bank will substantially lift its offsite surveillance and assessment of AML/CFT risks. Broadly speaking, the Bank will deploy the same tools and resources on AML/CFT risks that it currently deploys on financial failure risks. This paper outlines the Bank's proposed approach to this task.

These reforms meet several of the Bank's objectives, as follows:

1) The Bahamian financial system, economy, and society will be better protected from financial crime, and the many harms that flow from this criminality.
2) The Bahamas' financial system will benefit from an appreciable improvement in its reputation for managing AML/CFT risks. At the jurisdictional level, this issue is broader than the banking system, or for that matter the financial system. Strong bank and trust company management of AML/CFT risks is necessary, though not sufficient, for The Bahamas as a jurisdiction to be perceived as lower risk.
3) Rather than imposing new and expensive requirements on the industry, we intend to achieve the above benefits by better organizing, and in some cases repurposing, the extensive national effort already flowing into AML/CFT risk management.

The Bank intends to commence continuous supervision of SFI AML/CFT risks from 1 January 2018.

The Bank is inviting comments from interested parties on any aspect of this paper. The bank intends to consult formally on a number of issues, with conclusions reached during 2018, on some specific questions raised in this paper. We anticipate that by December 2018, the Bank will release a "version 2.0" of its AML/CFT supervision regime, informed by the lessons learned and consultations undertaken during the year.

The Bank's supervision teams have been re-organized, within the same resource base, and the Bank has created a separate Analytics Unit to focus on AML/CFT Analytics, which should enhance AML supervisory framework and facilitate better interaction between prudential and AML/CFT supervision.

The new Analytics Unit will implement an ongoing and annual reporting regime, track and collect the relevant data, perform risk-focused assessments, support more targeted examinations of SFI compliance programs, and generally support inter-agency co-operation in the AML space, including participation in any national assessments of risk.

Coordinated but separate supervision of financial soundness and AML/CFT risks

It is possible for an SFI to present a sound financial position, with deficient AML/CFT risk management, or vice versa. Accordingly, the Bank will supervise SFIs for both financial and AML/CFT risks, and will intervene if either or both risks require intervention. The Bank will separately rate and rank SFIs, and respond accordingly, for their financial and their AML/CFT risks. SFIs will not be able to argue that supervisory intervention on one family of risks should be reduced because the SFI is strong in the other area.

The supervisory approach to AML/CFT risks

As with financial risk, the Bank proposes to supervise AML/CFT risks by deploying an annual cycle of supervision, supplemented by examinations when appropriate, and by supervisory intervention if needed. The AML/CFT supervision approach will likely rely relatively more on documents, and less on reported numbers, than the financial supervision approach.

The core elements in the annual supervisory cycle include:

1) Collecting information
2) Risk analysis, rating, and ranking
3) Updating and executing the supervisory action plan.

Collecting information

The financial supervision cycle relies upon a great many quantitative inputs. The Bank expects that the AML/CFT cycle will rely more heavily upon documentary input. For example, Examiners would seek to ensure that risk mitigation measures are documented in the SFIs' enhanced due diligence procedures for high risk clients. We also expect that the periodicity of the AML/CFT cycle will feature relatively more annual material, and less weekly, monthly, and quarterly material, relative to financial supervision.

From each SFI, the Bank intends to collect the following material:

- The governance, risk management, and compliance reports relevant to AML/CFT. At minimum, each SFI will need an AML/CFT risk management strategy and plan, subject to no less than annual review by the board.
- Any relevant internal and external audit reports, with associated managerial responses, and the follow-up reports that audit items have been closed or are overdue. These reports should be issued to the Bank as they are received by each SFI.
- Context data to support institutional and national risk assessments, such as: (i) amount of business that is domestic or cross-border; and (ii) relative importance of different types of financial products (e.g. transaction volumes).
- The AML/CFT-related reporting generated for each SFI's Board of Directors (and the applicable Board Committee).
- The Bank intends to meet at least annually with each SFI's MLRO, without other management present. The Bank already holds separate meetings with internal auditors, and the scope of these meetings will expand to include more attention to AML/CFT matters.

- Information related to new staff training, and the date(s) and outcomes of the requisite annual AML/CFT training for extant staff.
- Some of the qualitative and quantitative data collected in the Correspondent Banking Survey, issued in 2015 and 2016, will also be integrated into these ongoing efforts.
- An annual and substantial self-assessment, with or without auditor review (see *Approach 2* below).
- Regarding suspicious activity, a reporting structure is proposed which would capture the number of STRs associated with:
    - CDD obligations
    - record keeping obligations
    - beneficial ownership information obligations
    - PEPs (domestic and foreign)
    - correspondent banking
    - wire transfers rules
    - targeted financial sanctions related to TF
    - higher-risk countries (as identified by the FATF)
    - the number of STRs sent about suspected misuse of legal persons or legal arrangements
    - the number of business relationships or transactions which have been rejected or terminated due to concerns about CDD

The Bank intends to track and collect additional material from other sources:

- The Bank is developing a mechanism to monitor some of the suspicious transaction data aggregated by the Financial Intelligence Unit (FIU). The data will be received on a recurring basis. This will help the Bank to spot trends, conduct peer reviews, develop typologies and, possibly, highlight systemic challenges faced by our SFIs. Over time, it is anticipated that this process will improve the quality of STRs produced.
- The Banking and Exchange Control Departments can also produce information useful to AML/CFT supervision.

Open issue: should the Bank commission thematic industry reviews? What is the role of auditors?

The Bank is considering how it might better coordinate with SFIs and the audit profession on AML/CFT matters. Some jurisdictions require extensive and formal auditor engagement with supervisors. The Bank is considering two potential approaches. Depending upon what is learned from consultation and supervision during 2018, the Bank may deploy either, neither, or both of these approaches.

Approach 1: Annual thematic reviews

Under this approach, every year the Bank would nominate a theme (such as onboarding, transaction monitoring, or SFT reporting) and prepare a standard template for each auditor to apply to relevant SFIs. The Bank would then receive and analyse these thematic reports, and would share the results publicly on an aggregate basis. Issues with individual SFIs would be raised as a supervisory matter with the relevant SFI.

It is an open question whether the Bank would require thematic reports from internal or external auditors. Consultation and a subsequent decision on this issue will occur during 2018.

Approach 2: Comprehensive self-assessments

The Bank could develop a standard format from which each SFI would undertake a self-assessment of its AML/CFT risk management and compliance. This self-assessment would be reported to each SFI's board, and (with any relevant board commentary or resolutions) reported to the Bank. At a minimum, such a self-assessment would require internal audit sign-off. The Bank is considering whether external audit sign-off would also be necessary. Furthermore, it may be the case that external audit sign-off is necessary less often than annually, perhaps on the initial self-assessment, and every three years thereafter.

Risk analysis, rating, and ranking

Having collected information across all SFIs, the Bank's supervisors will at least annually conduct a formal assessment of each SFI's AML/CFT inherent risks and controls. The Bank's intent, subject to experience as it commences continuous AML/CFT supervision, is that the annual review dates should be coordinated between the Bank and each SFI, such that any relevant SFI annual internal reviews would flow into the Bank's annual review.

In line with the Bank's current scoring system for risk assessments, the annual review will utilize the same numeric rating, ranging from 1 [low] through 5 [high], on the following AML/CFT risk factors:

Inherent Risks:

- ✓ Nature of business: the inherent risks relative to nature, scale, diversity and complexity of the business; that is, the type and frequency of transactions—volume and size, conflicts of interest or potential market abuse.
- ✓ Products & Services: the vulnerabilities of different product types and services, such as using multiple distribution channels, and attempts to disguise the source of property so that it cannot be linked to a criminal activity.
- ✓ Customers: inherent risks surrounding the target market and more specifically who is the customer. This can include the customer's profession, industry, source of income, source of wealth, high-risk customers, geographic location, and other demographic characteristics.
- ✓ Other risks: any other risks not specifically addressed that can inherently increase the possibility of the SFI being used to facilitate ML/TF through either its own activities or that of its customers. (See Annex I)

In line with the Bank's current scoring system for risk assessments, the annual review will utilize the same numeric rating, ranging from 1 [strong] through 5 [critically deficient], on the following AML/CFT control measures:

Controls:

- ✓ AML/CFT Governance: Senior Management, together with the Board, establish a robust risk management framework inclusive of risk taking policy along with a monitoring system of internal controls to effectively manage ML/TF risk and foster an effective compliance culture.

- ✓ Transaction controls: the effectiveness of the system and controls surrounding the scrutiny and monitoring of transactions to detect and prevent suspicious transactions/activities related to ML/TF; the process by which records are maintained and how suspicious transactions are reported internally and externally.
- ✓ Due diligence and customer acceptance: the policies and procedures governing the gathering of all relevant information on a customer, the effectiveness of the risk rating system used to assess the customer's relationship, the account opening and closing process and the periodic review of the relationship.
- ✓ Other controls: any other controls not specifically addressed that can mitigate the risk of ML/TF transactions such as experienced and competent staff, training, detective and preventative controls such as a robust three line of defense regime, and a strong regulatory relationship. (See Annex I)

Having completed ratings in each relevant category, the responsible supervisor will then assign a 1 to 5 rating for overall AML/CFT risks. SFIs will then be ranked by both overall AML/CFT risk, and in each risk category.

Ratings, rankings, and supervisory responses

The proposed rating and ranking experience is on its face identical to the Bank's extant approach to rating financial soundness risks. The critical difference, however, is that the most important financial risk rating is the overall risk number. For AML/CFT, *each* risk category is roughly as important as the others. This is because financial risks can to some extent be balanced out: high credit risk, for example, can be balanced by a strong capital position.

However, for AML/CFT risks, and in accordance with international expectations upon the Bahamian jurisdiction, the Bank intends to supervise on the basis that each substantive element in AML/CFT stands alone, and that strength in one area cannot be relied upon to offset weakness in another.

Accordingly, when ranking SFIs for AML/CFT, the Bank will use two scales. The first scale, as a matter of managerial interest, ranks SFIs on their aggregate AML/CFT risk. The second scale, which will drive supervisory interventions, ranks SFIs on their *worst* sub-factor. This means, for example, all SFIs with any "5" rating will be in the lowest Bahamian ranking group, and all such SFIs can expect vigorous supervisory intervention to improve their critical deficiencies.

The supervisory action plan

The Bank's AML/CFT supervision strategy combines elements of comprehensive and risk based approaches. All SFIs exposed to AML/CFT risk will be subject to a minimum level of supervisory attention, without regard to the risk assessment. The bulk of supervisory attention, however, is intended to flow to SFIs exhibiting deficiencies in their AML/CFT risk positions.

As with financial supervision, at any point in time many SFIs will have received communications from the Bank regarding necessary or desired improvements. The Bank has recently clarified its supervisory communications around four key words:

- Directives (or directions) refers to the most severe cases, where an SFI must immediately rectify a matter, or face intense intervention from the Bank;
- Requirements are statutorily required improvements, on matters of somewhat less urgency or import than Directives;
- Expectations covers matters where an SFI is operating away from best practice for an institution of that size and complexity, and the Bank is encouraging an improved position; and
- Requests refer to information gathering matters, which again have statutory backing.

SFIs failing to meet the Bank's Directives, Requirements, Expectations or Requests face the potential for enforcement action, in the most severe cases including delicensing. Senior executives and board members of such institutions, particularly in severe and protracted cases, also face the potential for the Bank to consider whether or not such persons are fit and proper to continue as senior persons in the banking and trust industries.

For the great bulk of SFIs, fortunately, experience suggests that cooperation on financial matters should extend to cooperation with supervisors on AML/CFT matters. Over time, the Bank expects to report on aggregate supervisory outcomes achieved in the industry for AML/CFT risks.

Administrative arrangements to support continuous AML/CFT supervision.

The Central Bank's Bank Supervision Department has reorganized itself to balance financial soundness supervision with AML/CFT supervision. Among other things:

- All SFI supervisor job descriptions now explicitly call for AML/CFT supervision capability;
- Supervisor portfolios are now segregated based not only upon the foreign or domestic nature of the license, but whether or not the SFI is home or host supervised. This segregation frees up supervisory time from SFIs where financial soundness is relatively less complex, to focus upon SFIs where AML/CFT risks are relatively higher.
- The Bank Supervision Department has created an AML/CFT Analytics team to manage and improve the supervision process, and to conduct ongoing work to improve the quality of the Bank's analysis, supervision, and intervention as regards to these risks.

To facilitate communication, the Central Bank intends to develop an AML/CFT hub on its website for news, typologies, newly released FATF guidance, industry briefings and events.

Consultation responses

The Bank intends to discuss this paper with relevant industry participants and other interested parties. Any person who takes an interest in this subject should feel free to submit comments or suggestions by 31 March 2018, preferably via email to AMLAnalytics@centralbankbahamas.com.

Summary

By moving to a continuous AML/CFT supervision regime, the Bank expects that the Bahamas' jurisdiction will improve both its actual and perceived risks in these areas. Furthermore, as outlined in this paper, the Bank is hopeful that these improvements can be achieved at modest additional costs to itself and to the industry. As with financial soundness supervision, the Bank intends to proceed on the firm expectation that SFIs will cooperate with the Bank as it collectively manages and reduces the Bahamas' AML/CFT risk. Also as with financial soundness supervision, to the extent that expectations of effective cooperation are disappointed, the Bank is prepared to deploy the various tools at its disposal to achieve the desired result.

In the medium term, the Bank's objective is to see the Bahamian banking, credit union, and trust industries both actually, and perceived as, among the global leaders in effective AML/CFT risk management. The steps outlined in this paper are important facilitators of this objective.

ANNEX I: Examples of Risk Factors and Controls

Inherent Risks		**Controls**	
Nature of Business	Nature, scale, diversity and complexity of the business; inclusive of type of entity (private bank, MTBs, trust company)	*AML/CFT Governance*	ML/TF risk appetite and risk management strategy
	Locale of operations (head office, branches, subsidiaries, outsourcing providers)		Board process (ML/TF related board /management reporting, approvals, attestations & assessments)
	Frequency of transactions, conflicts of interest, potential market abuse		ML/TF risk assessments and understanding & independent assessment of compliance function
Products & Services	Anonymity (omnibus accounts, non-face-to-face, ATMs, payable through accounts)	*Transaction-Related Controls*	Ongoing transaction monitoring against client's risk profiles
	High value/volume (private banking, trading accounts)		Internal & external suspicious transaction reporting policies and procedures
	Complexity (creation, use and management of legal persons and arrangements, trade finance)		Sanction list screening, transaction blocking
Customers	Type of customer (PEP, cash intensive business, offshore company, trust, self-employed individual)	*Due Diligence & Customer Acceptance*	Risk-based approach to customer due diligence (simplified, normal, enhanced) inclusive of level of verification and periodic reviews
	Geographic location (jurisdiction of residency, citizenship, income, transaction origination/destination)		Customer risk rating methodology
Other Risks	Customers introduced by third parties	*Other Controls*	Fitness and propriety of compliance staff, level of ongoing AML/CFT training
	Electronic payment systems and emerging technologies		Segregation of duties, recordkeeping, information sharing and confidentiality
			Regulatory compliance/ relationship with regulator and level of cooperation with regulators, FIU and law enforcement agencies