



**REDUCING BAHAMIAN AML/CFT REPUTATION RISK**  
*"AN EVOLVING ROADMAP"*

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Good morning and thank you for the invitation to the Nassau Conference. Today I propose to speak about how the Central Bank intends to improve the reputational terms of trade upon which our financial sector deals with the rest of the world.

Traditionally, the key elements in a sound reputation are twofold:

- Money entrusted to our care is safe; and
- Information entrusted to our care is also safe.

In the newer world, the key elements for small countries continue to include the need for money to be held and managed safely. The expectation on information, however, is that it is available to any person or entity in the world with a right to ask for it, but unavailable to any person or entity in the world lacking that right. With the rise of the internet, “in the world” now has a literal as well as a figurative meaning.

Finally, and no news to anyone here, there is a strong expectation that Bahamian financial firms will not facilitate financial crimes, including money laundering, terrorism, and tax evasion.

To some extent financial failure, information loss, and financial crime risks can be managed separately, and they each require specialist expertise. The better strategy, however, is for Bahamian institutions to create a comprehensive risk management strategy, within the context of each firm’s business strategy. Similarly, external perceptions of The Bahamas in risk terms combine elements of financial, information, and financial crime risk.

The Central Bank’s approach to reputation management recognizes that a necessary but insufficient condition is that Bahamian risks are well-controlled. In addition to deserving a good reputation, we have to proactively manage our relationship with the world’s opinion makers to achieve that reputation.

Let’s first look at what we are doing to deserve a good reputation. We start from the happy position that, by and large, Bahamian financial institutions are reasonably well managed from a risk perspective. But “reasonably well managed” is not going to be enough in an increasingly unstable and competitive world.

In late 2017, the Central Bank reformed several aspects of its financial institution supervision. These include:

- We clarified our supervisory communications;
- We shifted some of our effort from analysis to intervention; and
- We moved from an examination-led to a supervision-led approach to financial crime risks.

These steps are intended to improve the actual quality of supervision for all the risks facing our regulated flock. The Central Bank has already publicised these steps broadly, so for today’s purposes I will simply note that any attempt to improve Bahamian reputations must be firmly grounded in the reality of high quality Bahamian risk management.

For the remainder of this presentation, I will focus upon the steps we are taking to enhance the Bahamian reputation for sound AML/CFT risk management. This is important for many reasons, among which maintenance of reasonable correspondent banking services is high on the list.

## **The AML Sovereign Risk Rating Agencies**

When considering our international reputation for AML/CFT risk management, we first need to define which opinion-makers form that reputation. This group includes a community of de facto sovereign risk ratings agencies, who are roughly analogous to Moody's and Standard & Poor's in the sovereign debt risk rating field.

The six rating agencies we have identified include:

- The Financial Action Task Force and its nine regional affiliates, among which the Caribbean Financial Action Task Force is most relevant to us;
- The U.S. State Department, through Volume 2 of its International Narcotics Control Strategy Report;
- Four subscription-based ratings services, which build weighted index models ranking national AML/CFT risk. The largest inputs into all these models are usually the FATF mutual evaluation reports, and the State Department INCSR.

The ratings are used by, most notably, correspondent banks as they build their own risk models. They also impact more broadly on anyone who has an interest in AML/CFT risk.

The Bahamian ratings from these agencies range from medium to high risk. On average, and broadly applying debt rating concepts, we are about equivalent to where we are in the debt rating world, the boundary between investment grade and non-investment grade. This is clearly not a comfortable place to sit.

The Central Bank has decided to take a highly proactive approach to the ratings agencies. Among other things, we have resolved to devote an appreciable proportion of our research and analytics capacity to becoming a global leader in understanding sovereign AML ratings.

For the subscription approaches, our main objective is to clearly understand how each service forms its ratings, and to ensure that the Bahamian data they use is correct. The subscription services have generally welcomed our engagement with them. It is important to remember, however, that the value added in these services is not from primary analysis of AML risk, but from the sources and weightings they use to build their models. There is no practical way for us to improve our ratings here, unless we improve our ratings in the underlying data sources.

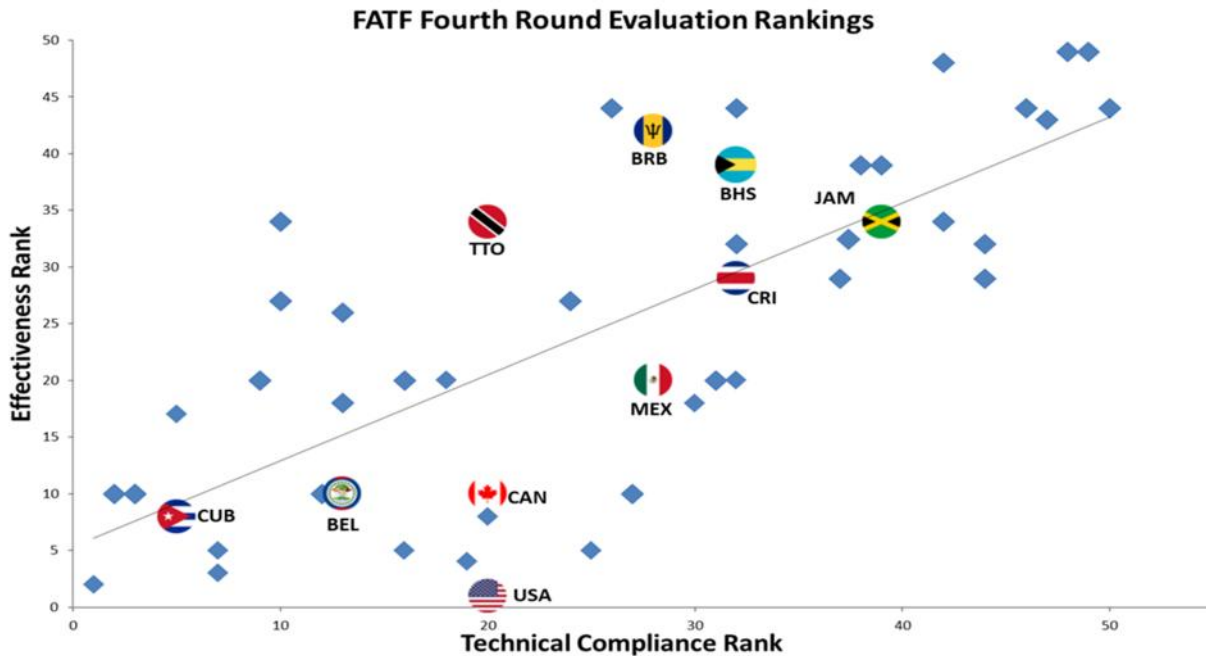
The State Department doesn't publish the INCSR as a ratings tool, but nonetheless it is used for that purpose by the subscription services, by the correspondent bankers, and by other interested parties. This is a source of considerable frustration to us, and possibly to the State Department. The underlying tool for the INCSR is a one page questionnaire distributed to each embassy for annual completion. The maximum 800 word responses may or may not be prepared by a diplomat with any AML expertise. This is a legislatively required exercise that was never meant to become a ratings agency. In the absence of any other primary source but the FATF, however, many people use the INCSR list as a ratings input.

The relevant Bahamian agencies, including the Central Bank but coordinated by the Attorney General's Office, have organised themselves to provide a more comprehensive input to the annual Bahamian

INCSR questionnaire. This may or may not improve our list position, but it will reduce the potential for any misunderstandings in the State Department's analysis of our national position on AML/CFT risk.

This brings us to the FATF. It's important to remember that the FATF is not only a de facto ratings agency, but a global policy developer and blacklist manager. We are here looking only at the ratings aspect.

FATF Mutual Evaluation Reports provide 40 technical compliance ratings and 11 effectiveness ratings, which means that the FATF could be viewed as providing 51 separate ratings for each jurisdiction. This is obviously unwieldy, so stakeholders develop their own methods to arithmetically transform the ratings. Our research suggests that combining all 51 ratings is not quite accurate, and it is better to consolidate into a technical compliance rating, and an effectiveness rating. Here we have the current Central Bank mapping of the approximately 50 jurisdictions, including The Bahamas, who have undergone fourth round mutual evaluations.



The Bahamian position on this map is somewhat worse than average, particularly on the effectiveness ratings. We are in the middle of a re-evaluation process, and we have hopes that our technical compliance rating will improve. Our expectation is that the FATF will not cede much improvement in the Bahamian effectiveness ratings, despite our significant efforts in this area over the past year or so.

The FATF mutual evaluation report is the single most important international signal of a country's AML/CFT position. It is prepared on a basis that is consistent with best practice for such evaluations, for example the IMF FSAP process. It is also prepared carefully and in considerable detail by a group of

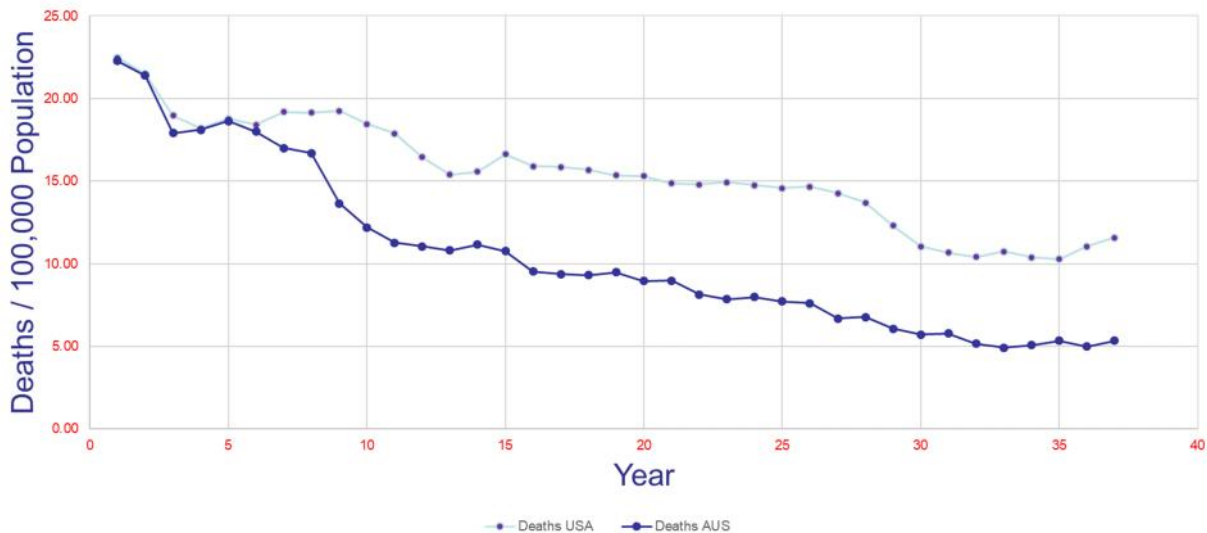
international experts. In this sense, the FATF MER is the gold standard for national AML assessments, and the world's AML stakeholders treat it this way.

Nonetheless, the FATF MER is from our perspective deeply problematic. There are three fundamental policy shortcomings in the FATF methodology.

- First and most substantial, the MER is a prediction model with no way to achieve model validation. Consider for a moment debt rating models. They are grounded in reality by observable default rates. If a lot of Moody's triple-A rated bonds default, that would lead to the justifiable suspicion that something is wrong with the Moody's rating model. But if countries with positive MER results experience a great deal of money laundering, this has no direct effect on the FATF ratings, or so far on the confidence in those ratings.
- Second, in the absence of any serious attempt to measure a dependent variable outcome, such as the amount of money laundered, terrorist acts illicitly funded, or narcotics paid for or financed, the FATF is forced to rely upon expert opinion from among its members to define what is important. We freely acknowledge that the FATF has found the best experts available, but there is no way to validate whether the essential criteria underlying the 40 and 11 assessment outcomes mean anything in a true effectiveness sense.
- Finally, the FATF's origins are in the American and then global war on drugs, with the group's initial mandate to suppress the major Latin American cross border narcotics smugglers. Later the group expanded its mandate to terrorism, proliferation of weapons of mass destruction, people smuggling, corruption, and so forth. But the war on drugs origin reflects in the FATF MER focus, not on observed quantitative inputs and outputs, but on legal and criminal justice rather than economic analysis. And that in turn leads to a focus upon indices of punishment in the MER, rather than indices of prevention. In the Bahamian case, for example, we are harshly rated on our ability to control terrorist financing, even though we have fortunately not had appreciable terrorist activity in our jurisdiction.

Some additional pictures here may be helpful. First, it is clear that nations and groups of nations can over time deploy public policy to change even deeply embedded social behavior.

## Vehicle Deaths USA & AUS



Here for example is a chart of American vehicle death rates from 1980. We see that those death rates have fallen substantially over many years, with the result that the social practices associated with driving in 2018 are killing tens of thousands fewer Americans than was the case in 1980.

On this same chart we have the Australian experience since 1980, but with an even larger reduction in death rates. This means, among other things, that one could have a data-driven debate about whether or not the Australians have done a better job than the Americans at reducing vehicle death rates over the past few decades, and more importantly, why this might be the case.

These reductions in death rates are not an accident, but a result of substantial policy reforms. These reforms have changed the way drivers take risks, and have also improved the safety of vehicles and the roads they drive on. Furthermore, there is a substantial applied and theoretical research literature predicting and then assessing how these reforms have and will affect accident and death rates. All this work is underpinned by a large and costly global effort to collect real information on vehicle crashes, injuries, and deaths.

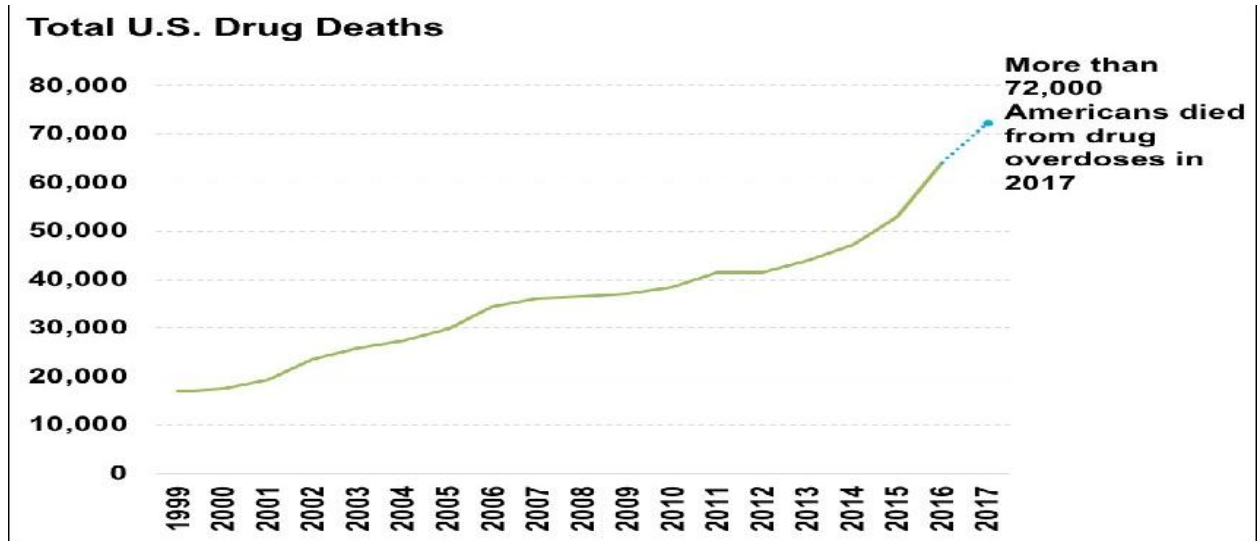
I note in passing that the current Bahamian death rate is about where Australia and the USA were in 1980. It's not the topic of my speech today, but if we adopted the same reforms that were undertaken in these and many other countries, The Bahamas could expect a similar reduction in accident, injury, and death rates.

### Public Policy: Australian Cigarette Smoking



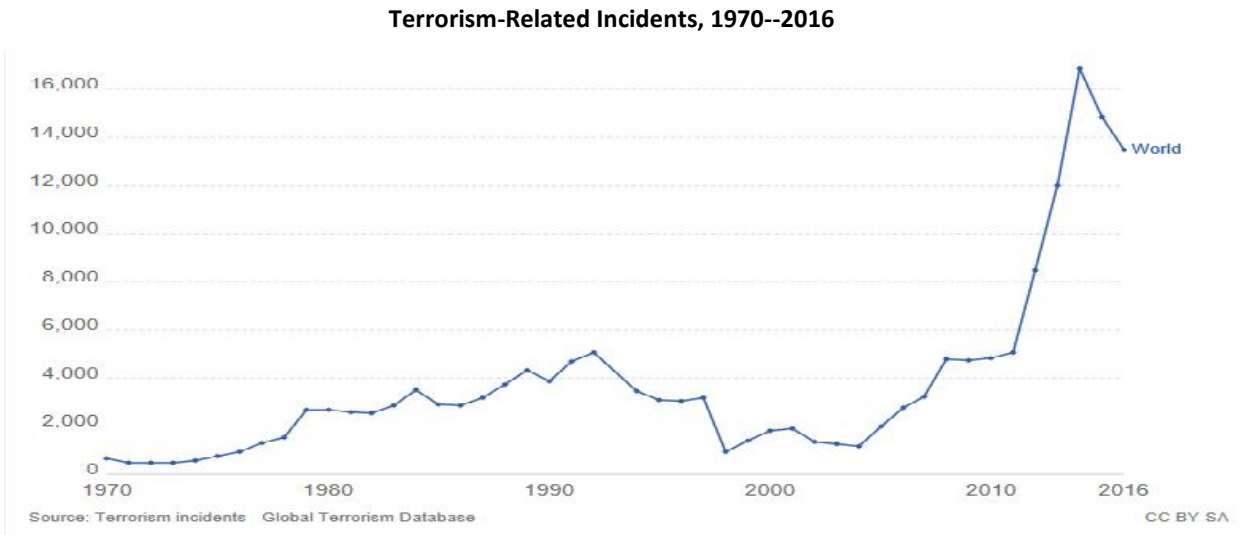
There is an even longer history of research linked to policy outcomes for reducing tobacco consumption. Here for example is a chart showing the reduction in average Australian cigarette use over many years. For many western countries, cigarette smoking peaked in the early 1970s, and has decreased by a factor of two thirds to three quarters since. Again, we know this because many agencies have undertaken costly and comprehensive data gathering exercises on the rates of tobacco consumption.

What about the war on drugs? I expect everybody in this room knows the answer. According to the UN Office of Drug Control, after more than forty years of fighting the war on drugs, global cocaine and opium production are both at all-time highs.



If the social policies associated with the war on drugs had been as successful as the policies associated with reducing vehicle accidents and smoking, then we would see similar charts showing major reductions in the number of drug users, and the volumes and dollar value of illicit drug purchases. But as this tragic chart shows for our near neighbor, the opposite result has held.

Similarly, one may consider the global incidence of terror, since the War on Terror was declared in 2001.



So how is all this relevant to The Bahamas? We are being held to standards prepared by the global body that has the mandate to fight the financial side of the war on drugs and the war on terror. Neither of these wars have been successful in reducing the incidence of drug use or terrorist incidents, and in neither war is quantitative-based assessment of money laundering and related issues anything like reliable.

This is not to say that the FATF has been useless or unsuccessful. It is clearly not in the Bahamian or any other country's interest to support terrorists, drug dealers, and other criminals, and following the FATF standards helps us avoid that outcome.

But it does go some way to explaining why it is so difficult for The Bahamas to demonstrate improvement in managing AML/CFT risks, because there is no objective and quantitatively validated standard to which we can be held. We are being assessed against opinions mainly formed by large state representatives about small states, and those opinions don't necessarily have any empirical backing. Nonetheless, our national progress towards a better international AML/CFT position requires us to improve those opinions.

Happily, the story at the correspondent banking level is more positive. The world's major banks pay attention to the AML ratings agencies, but they form their own view on customer AML risk. The Central Bank has identified a number of steps that should increase correspondent bank comfort with Bahamian risks, and the same steps should help our general reputation.

These steps fall into two buckets: public information flows, and private information flows.

The public information flows include the new national AML/CFT conference, of which the first edition was held a few weeks ago. We intend with our Bahamian regulator colleagues to continue with an annual conference series on AML/CFT risks. This conference creates a stronger basis for Bahamian AML/CFT risk management, as we ensure that the public and private sectors are better aligned and have a better mutual understanding. The fact that we can run a world-class event in this space—nearly as good as the Nassau Conference—indicates to our stakeholders that The Bahamas should be taken a bit more seriously.

We will shortly issue the first in an annual series of publications, summarizing the state of AML/CFT risk management in The Bahamas. This publication is intended to fill the need in the AML/CFT space that the Central Bank's Financial Stability Report fills in the financial risk space. The first edition will necessarily represent a work in progress, notably for some statistical time series that we are just getting off the ground. Overall, however, we are confident that this report will become a handy and reasonably comprehensive reference document for local and international use. Our ability to present this document to a high standard, as well as the information it contains, is another demonstration that The Bahamas is willing and able to conduct its financial affairs in a way that effectively suppresses financial crime.

By early 2019, we intend to launch, again with substantial input from other regulators and agencies, a national website serving as a central archive and news source for matters relating to Bahamian AML/CFT risk. In combination with the annual publication, The Bahamas will offer comprehensive and easily accessible information on local money laundering and financial crime issues. By increasing the



information available, and lowering the search costs, we are making it easier for correspondent banks and other stakeholders to assess the risks of engaging in The Bahamas.

I wish to emphasise that both the annual publication and the website will feature any negative as well as the substantial positive news. They are reference documents, not advertising venues. Ideally our progress will be smooth and un-newsworthy, but from time to time the statistical inevitability is that The Bahamas will need to report on something gone wrong. Please strive to minimize this necessity.

With the launch of the national website, we also intend to create an associated email list or lists. Among other things, we are considering a tailored email service for all the correspondent bankers currently or potentially active in The Bahamas.

In addition to these regular public information flows, the Central Bank intends to significantly increase its AML-relevant applied research output. We intend to focus upon AML ratings agency research, but we also intend to produce and encourage a broad range of quantitative AML research. The holy grail here, which unfortunately is many years away, is an empirically defensible method to assess relative and absolute sovereign AML risks.

As for private information streams, the Central Bank's Bank Supervision Department has announced a new program to lift its communications with bank and trust company boards. Under this program, and subject to a bit of variation in the startup year, each board will receive a letter from us in May summarizing our view of the institution's financial soundness, and recent history of compliance on supervisory and other matters. Each October, starting this month, boards will receive a letter outlining our views on the state of their AML/CFT risk management, and any associated issues. I hasten to add that the October 2018 letters will only go to a subset of our regulated flock, and the remainder will receive their AML/CFT letters in May, with their financial soundness letters.

Normally these letters would be confidential between the Central Bank and each supervised financial institution. Using available statutory powers, we will allow these letters to be shared with relevant professional stakeholders, notably including correspondent banks. We also expect these letters to be shared with auditors.

This arrangement means that every correspondent bank doing business with a Bahamian bank, or considering engaging in a correspondent relationship, knows that there are two letters available from the Central Bank which probably have something interesting to say. Furthermore, because the letters are drafted in a common format that uses identical language for the key messages, correspondents will be more easily able to compare and contrast among their Bahamian respondents.

We are hopeful that making this substantial new private data resource available to correspondent banks will increase their propensity to do business in The Bahamas. We also note that this approach means that our regulated flock has that much more incentive to quickly and effectively respond to our supervisory directives, requirements, and expectations.

In summary, the Central Bank, often in cooperation with other Bahamian regulators and government agencies, is progressing a substantial body of reforms designed to reduce AML/CFT risk. This risk reduction will flow from an actual reduction in financial crime risk, and from a more proactive program of international engagement, to secure the reputation benefits of this actual reduction.

We do not expect that this process will be easy or quick—any person with an easy or quick way to improve our international AML/CFT reputation is welcome to contact me at any time.

But we do have confidence that this approach will help protect the Bahamian financial system from the direct and reputational losses associated with ineffective AML/CFT risk management.

I wish you a very successful conference.

**Charles W. Littrell**

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