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“ON-SITE SUPERVISION PERSPECTIVE”

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Thank you for allowing me to address you on the topic “On-site Supervision Perspective”.

In my address today, I am going to give you first a general overview on the current status of the on-site supervision process.

Next we are going to discuss the scope of an examination and then the methodology employed by the examiners to conduct an on-site examination.

Later we look at how the Examiners are monitoring the corrective actions licensees were required to undertake as a result of the Report of Examination.

Finally we are looking at the examination process as we go forward.

1. General overview:

The on-site examinations were anticipated by the industry with great trepidation and many rumors emanated as a result of the first few on-site visits by the Central Bank examiners, a process, which started in February of last year. Since then, the Examination Group has examined in excess of 200 licensees and 116 Reports of Examination have been issued.

To those who already did some math I have to say, sorry, no we are not late with 80 plus reports. We have consolidated reports where more than one licensee is administered under the umbrella of another licensee in order to avoid duplication.

For instance, as we enter the 2nd cycle of examinations, we may issue separate Reports of Examination for Managed Banks and Managed Branches of foreign Banks depending on the status of such Bank’s transition to physical presence. The deadline for the completion of the transition is June 2004.

Where our examination findings were unsatisfactory, it was necessary to schedule follow-up examinations to ensure that examination recommendations would be addressed immediately. We carried out 17 follow-up examinations.

Who are the licensees, Bank Supervision Department deals with on a regular basis you might ask?

We could categorize them into four distinct groups:

- a. The self-governing stand-alone offshore institution licensed in The Bahamas for which the local regulator is the sole regulatory body;
- b. The offshore institution, a subsidiary or a branch of a foreign bank where primary regulatory responsibility lies with the regulator in the parent bank's home jurisdiction (provided it is a first schedule country);
- c. The offshore institution with domestic banking activity where the regulator in the parent bank's home jurisdiction has primary regulatory responsibility, (again provided it is a first schedule country); and,
- d. The domestic bank for which the local regulator is the sole regulatory body.

In tandem with the introduction of an enhanced bank supervision culture, the Central Bank issued guidelines governing various areas of Bank Supervision including the:

- Guidance Note on Accounting and other Records and Internal Control Systems and reporting accountant's reports thereon, already issued in May 1998;
- Guidelines for the requirements for the transition of Managed Banks to full physical presence first issued in May 2001, and amended, 23 January 2002;
- Guidelines with respect to the requirements for the continuation of the management of Branches of foreign banks (currently without a physical presence), dated 23 January 2002;
- Guidelines with respect to the requirements for the continuation of the Management of restricted Banks and Trust Companies (currently without a physical presence), dated 17 May 2002; and,

- Guidelines for the Corporate Governance of Banks and Trust Companies licensed to do business within and from within The Bahamas, dated 13 December 2001.

These Guidelines, together with the various acts passed by Parliament in December 2000 and directives given to the Examiners by the Central Bank of The Bahamas constitute the mandate of the on-site examination team.

A new Guideline is presently being drafted. At the end of June a copy of the draft has been reproduced on The Central Bank's Web site (Centralbankbahamas.com) for industry consultation. The proposed name for the new guideline is:

- Guidelines for the minimum physical presence requirements for Banks and Trust Companies licensed in the Bahamas.

2. Scope of the Examination:

The letter by the Central Bank informing a licensee of the forthcoming visit of the Examiners forms an integral part of the examination process. The Examination Group usually initiates contact with the licensee in advance of sending the letter in order to discuss wherever possible a mutually convenient time schedule.

With that letter, the Central Bank informs the Licensee of the examination date, sets out the scope of the examination and requests documentation to be either sent to Bank Supervision Department well in advance of the on-site examination or be held available and ready for the start of the examination.

Licensees must follow the instructions of the letter and where so required must make every effort to provide the information on a timely basis. In several instances, the tardiness by licensees to provide information either in advance or on-site affected the efficiency of the examination and the length of time examiners where on site.

Licensees may have noted that the scope of the examination has been expanded over the period of the past eighteen months.

Originally our focus was directed to the areas of Know Your Customer, Anti-Money Laundering and Staff qualification, knowledge of and training in the aspects of the year 2000 legislation.

With the introduction of the Corporate Governance Guidelines our focus widened to provide assurance for a safe and sound operation. This includes a review of the oversight and governance responsibilities and accountabilities by a Licensee's board and its members as well as functional line reporting requirements in the case of licensees forming part of an international conglomerate.

As you probably all know, the on-site examination is not a financial audit nor has it been designed to replace independent checks and balances introduced by senior management of your respective institutions.

Well, what is it then?

The examination process is designed to provide the Central Bank with reasonable assurance that licensees comply with the form and substance of the laws, regulations and guidelines.

There are three primary objectives governing every examination:

- A. To determine whether the organization has adopted appropriate and effective policies, processes, and procedures to ensure compliance with applicable laws, regulations, supervisory guidelines, and best business practices and to provide assurance for a safe and sound operation;
- B. To determine whether the organization's corporate governance process and its risk management program, and considering its internal controls, internal audit, and/or independent review processes as well as its external audit, provide assurance that the risk in its business activities and operations are appropriately and effectively identified, measured, monitored, and controlled;
- C. To determine whether the organization's management and staff have appropriate experience, knowledge, training, and technical skills to implement adequate compliance with applicable laws, regulations, supervisory guidelines, and best business practices.

Where Licensees are providing Managing Agent services, we add a fourth objective:

- D. To determine whether the services provided by the organization to managed licensees or other affiliates includes verification of those entities' compliance with know-your-customer/anti-money laundering requirements and the Guidelines for the requirements for the transition of Managed Licensees to full physical presence.

As you will have noted, the objectives of each examination are inextricably linked with the objectives of the legislation, regulations and guidelines.

The Bahamas' Bank and Trust oversight and regulatory regime is guided by international standards as published from time to time in releases issued by international organizations and agencies such as the FATF, OECD, Basel Committee on Banking Supervision etc.; publications which are also accessible to the general public on the Web.

3. Methodology of the Examination:

The methodology employed by the on-site examiners has been developed prior to the commencement of the on-site examinations and has been adapted and modified since, in line with new guidelines and experience gathered during the many examinations conducted.

The methodology serves as the examiner's manual and templates have been developed for the process of examination rendering assistance and guidance relative to individual segments of that process and to ensure that a consistent approach to licensees is achieved.

A licensee's policies and procedures manuals provide further guidance for the development of the examination process and strategy. Examiners will compare the actual processes and procedures with those required in the licensee's manuals.

Documented policies and procedures should cover all aspects of the Licensee's business activities including trust and company administration, credit, investment management, funds transfers and cash handling procedures, the process of control, human resource management,

information technology, KYC and anti-money laundering, document storage and retention, disaster contingency plans and sundry administrative tasks.

Examiners will request insight into the minutes of board of directors' and committee meetings, review audit reports by external as well as internal auditors, including self-assessments conducted by licensees and examine actions taken as a result of instructions or recommendations.

It is vital to understand that examiners are required to make assessments, which are based on their knowledge and interpretation of the respective legislation as well as based on experience and industry best practice. Examiners are not requested to make final judgments but will submit critical or disputed issues for review by the Central Bank's legal counsel and the Inspector of Banks and Trust Companies. Counsel's opinion is communicated to the licensee or forms the basis of the Report of Examination's recommendation. On any critical issue the licensee is free to seek and should indeed obtain advice from their legal advisor.

In pre-examination meeting(s) Licensees and Examiners discuss the process of the examination, administrative details and procedures to be followed. It is the Central Bank's policy to provide supportive and constructive assistance to the industry whilst insisting that any deviation from expected conduct be corrected forthwith and that recommendations made in the Report of Examination be addressed within a reasonable period of time.

Depending on the size of the institution, the examination team may consist of two or more members working on-site for whatever period of time is needed to conclude each member's assigned responsibility. Ongoing exchange of information among the team members is important in order to avoid duplication and to minimize disruption to the licensee's business.

In our opinion, due diligence begins with the quality of management and the culture of the licensee which translates into effective policies, procedures and processes designed to develop and sustain the licensee's operations.

Each examination is risk-based in that an assessment of the licensee's risk profile is carried out prior to the commencement of every examination. From this assessment and using sampling techniques and practices we will establish the sample of client relationships required for our in-depth review of documentation standards and account activity review. Normally we

endeavor to select a sample of new, long-standing and less than active client relationships.

The cross section allows us to reach an opinion on whether the licensee has in place, is applying and is sustaining policies, procedures and processes designed to ensure compliance with the enabling legislation.

When assessing the due diligence process examiners must also consider the quality of management reporting and the process of control that is being applied throughout the operations of the licensee.

When these attributes are put together - that is the quantitative procedures coupled with the qualitative assessment tools and techniques - the examiners are able to obtain a good understanding of the strengths and the areas requiring attention at each licensee.

There are two other significant attributes of the examination processes that are important elements of the assessment of the due diligence process. They are:

- The process to identify unusual transactions; and,
- Staff knowledge and how the staff knowledge of the existing laws, regulations and guidelines is sustained through effective training programs.

The timely identification and reporting of unusual activities is an important element of control. Our examination procedures require that we look at how unusual transactions are identified, monitored and escalated in a timely manner to senior management to ensure that as required, the suspicious transaction reporting requirements are being followed – emphasis is placed on segregation of duties and responsibilities as well as the techniques being applied to identify suspicious transaction thresholds.

The other important attribute referred to is how the licensees keep staff up to date on the due diligence requirements of the laws, regulations and guidelines. To come to an opinion on the methods used by a licensee to sustain the required awareness the examiners will focus on the degree of emphasis the licensee places on staff training programs. We consider the performance appraisal process, the confirmation from each employee that

they are aware of the licensees' code of conduct and have confirmed their compliance with the code of conduct. We will interview a small number of employees to discuss the training programs and how the training programs carried out reinforce the form and substance of the enabling legislation.

Once we have completed the quantitative requirements of an examination we focus on the qualitative measures that a licensee has put in place. This assessment primarily deals with the degree of senior management and board of director oversight that in our opinion is critical to success and effectiveness of every licensee.

This segment of an examination now has a more exciting title – It is now referred to the assessment of the Corporate Governance regime.

We believe we have a responsibility to senior management and the board to advise them, within the confines of an examination, of any material weaknesses in the established policies, procedures and processes and to offer an opinion on the quality and degree of the process of control that has been put in place at each licensee. Our opinion takes into consideration the size, complexity and the risk profile of the licensee.

It is for this reason, amongst others that our formal Report of Examination is not only provided to the senior officer of the licensee but also to each member of the Board of Directors.

4. Monitoring corrective action:

The Report of Examination most likely will contain recommendations and it is expected that the Licensee respond to the recommendations by the deadline stipulated and monthly thereafter until all the recommendations have been addressed to the Central Bank's satisfaction.

These recommendations may address any areas of shortcomings under the Banks and Trust Companies Regulation Act, 2000 or indeed any other legislation that affects the industry subject to that Act. Recommendations may also include observations and suggestions concerning areas which ought to be reviewed by senior management or the board of directors particularly with regard to the latter's corporate governance responsibilities where the Licensee falls short of its own policies and procedures requirements or where inadequate care and attention is given to control and

audit functions, segregation of duties and other critical aspects of our industry which could place such licensee at risk.

It is important to understand that the off- and on-site supervision process of the Central Bank is designed to assist Licensees to recognize risks inherent in their business activity, thereby minimizing among other risks the reputational risk a Licensee may be exposed to, as well as the reputational risk of the Bahamas as a financial center.

Where considered necessary, follow-up visits have been undertaken within a short period of the initial examination in order to assess first hand the progress a Licensee would have made since the release of the Report of Examination. These follow-up examinations form a substantive part of an effective regulatory environment and ensure that adequate and timely corrective actions have been implemented, that these new (policies) processes and procedures are in the process of being or have been properly documented and approved by the appropriate management level including the board and are being followed.

5. Going forward – ongoing examination process:

The on-site examination team, as mentioned earlier, has basically completed the first round of examinations with only the large foreign clearing banks to be examined. It is obvious that the resources required to perform the examination of the large foreign clearing banks are quite different from those necessary to examine one of the smaller banks or trust companies. This means, that during the course of the next twelve to eighteen months, from time to time, we will need to concentrate our limited resources on the task of examining these larger institutions.

Nevertheless, we have also started the new round in the examination process.

As a result of our “inside” knowledge gathered during our initial examination, the examination team established an internal risk rating for each licensee based on much of the criteria that we have been discussing. This rating formed the basis of our assessment when we scheduled the second round of our examination activity.

The examination team is intent to continue to bring value to the process of examination by advising the industry in a constructive and supportive way. Examiners concerned with the second round examination will not necessarily be the same that performed the initial examination. Whilst the designated team-leader is free to devise his examination strategy, the review of the existing examination file is a must for both the leader and his team. As a result, it can be anticipated that a second round examination will commence with a review of the activities, which have taken place after the initial examination taking into account the exchange of correspondence between the Examiners and the Licensees relative to the Report of Examination recommendations.

The existing BSD file as well as the working files compiled as a result of the initial examination will provide ample background information to allow the examiners to be well prepared for the task at hand. It should therefore substantially reduce the time senior management will have to spend in order to familiarize examiners with the company. On the other hand it will assist the examination team to speed up the process and to focus on specific issues. Some of the areas the second round examination will be focusing on are:

- The implementation of the requirements outlined in the new Corporate Governance Guidelines with regard to collective and individual responsibilities of members of the board and senior management, including:
 - a. The progress in establishing committees, drafting mandates, delegating authorities and formulation reporting requirements;
 - b. Risk assessments, risk management and certification of the governance process.
 - c. Management's approach to testing processes in place regarding compliance account activity and other issues either through exception reporting, high-level management reviews, cross-department assessments etc.
- The progress made relative to the KYC documentation and information process and the implementation of control statistics and reporting requirements for senior management of new, declined and opened accounts including exception reports where KYC

documentation is still not in line with legislative requirements but where account activity is taking place;

- The progress made relative to the Anti-money laundering provisions in particular with regard to the monitoring of account activity;
- The continued efforts by Licensees to assist management and staff to increase awareness of their responsibilities and accountabilities as a result of the introduction of the year 2000 legislation through continued training, tests and information campaigns including the distribution of related articles, which may appear in print or on the Web;
- The segregation of dormant and inactive accounts (including suspense items) either due to the stipulated time reference or the non-compliance with KYC documentation; and,
- The progress made relative to the management of banks and branches of foreign banks in transition to full physical presence.

Within days of the passing of the year 2000 legislative package, the Central Bank of The Bahamas started the process of on-site examinations in addition to its off-site supervision activities, which the Central Bank has performed for many years. In collaboration with the industry and after some initial apprehension, the examination efforts have generally been greeted as a necessary exercise. However, in many instances certainly in the recent past, the process has resulted in very positive comments by a number of licensees.

Going forward, we hope that we can extend this win – win situation to all the licensees in this jurisdiction.

Thank you for your kind attention.

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