GLOBAL riskupdate

10 Years and Growing

APRIL 2012

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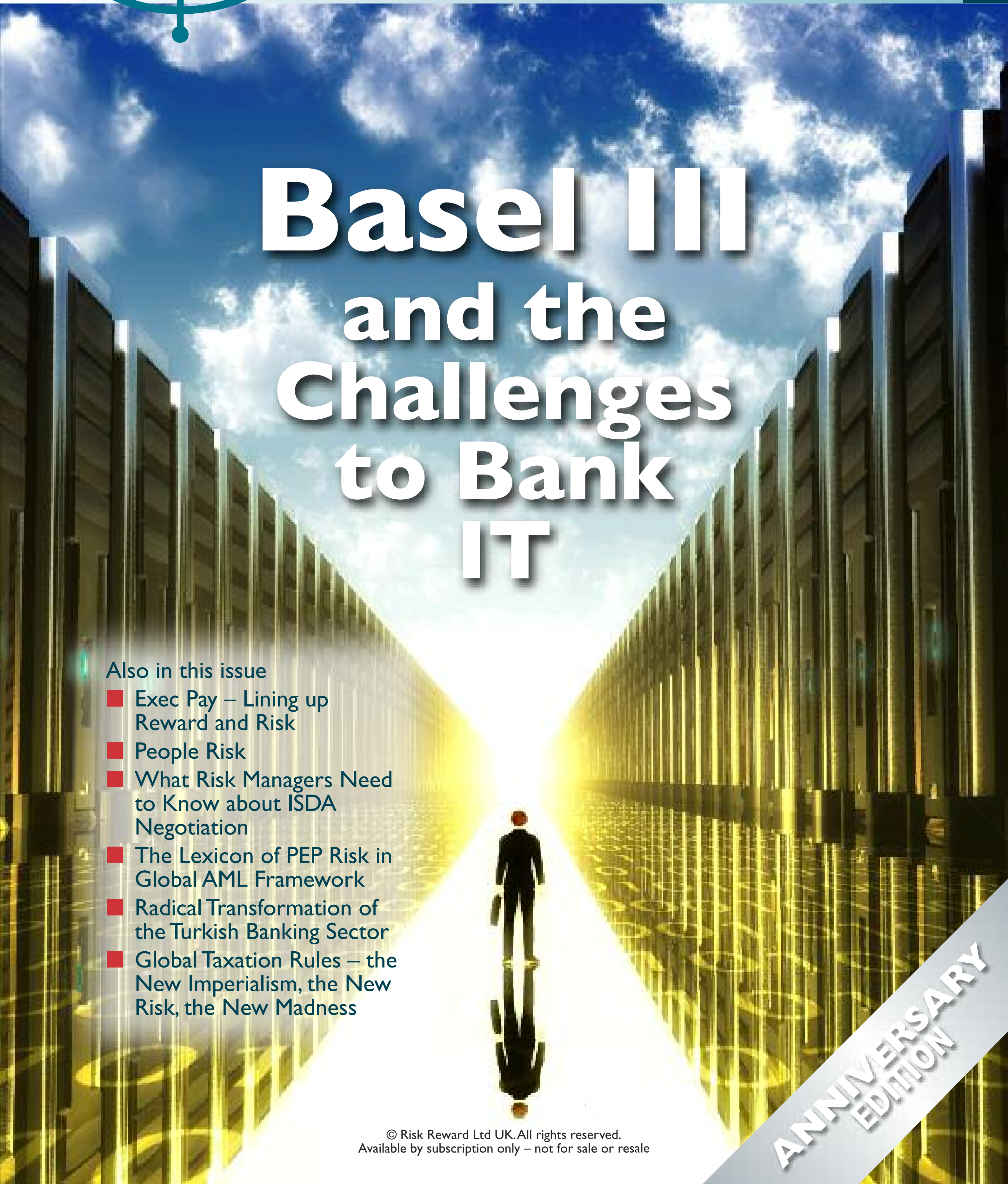

Basel III and the Challenges to Bank IT

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ANNIVERSARY EDITION

Dear Subscriber

10 Years and Growing

As we celebrate Risk Reward's 10th Anniversary we are amazed at the changes in global banking and finance since January 2002.

After reeling from the impact of September 11th 2001 and the Risk Waters Conference taking place at the top of the World Trade Center, the risk management community was literally devastated for several years.

Then came the fall of Amaranth in 2006 which we believe signalled the moving into high-gear of the global credit and liquidity crisis. Each quarter our experts opined on the state of risk management, emerging markets growth and investments, and internal audit. By June 2009, the *Global Risk Update* published a **Compendium** tracking the advance of the financial devastation which was about to bottom out in Q3.

There has been much written about who was to blame, who saw the financial crisis coming, and the causes. Those *GRU* subscribers would have indeed seen it coming as they read the original articles regularly identifying, describing and offering insights and critical analysis on the topics which ultimately broke major financial institutions, impacted the change of political leadership and set an entire financial sector as an object of vilification by many in society across borders and continents.

In this *GRU* 10th Anniversary Edition our practitioners focus on looking at how the regulators and players are coping with change and their efforts to 'go back to basics' to bolster the weakened sector. These issues constitute what we might refer to as the critical 'infrastructure' of the global financial markets: people risk, information technology, cross-border taxation, anti-money laundering, legal documentation and review of the risk management crisis in a sleeping giant, Turkey and its way forward.

We hope you will enjoy this special edition and look forward to your feedback and comments.

With best wishes

Dennis Cox BSc, CFSI, FCA
Chief Executive Officer

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PLEASE CIRCULATE TO:

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TO THE EDITOR

Do you have risk issues in your organisation or region you would like to share? Email your thoughts to the Editor at DWC@riskrewardlimited.com

Risk Reward Updates, a regular journal covering insights and global risk issues of interest to the banking, insurance and financial sectors in developed and emerging markets.

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Basel III and the Challenges to Bank IT

Graeme Skelly is a member of the Risk Reward Risk Management Faculty since 2007 advising and training banks and financial institutions in emerging markets on topics including Basel II & Risk Management, Basel II Implementation and Compliance, and Measuring and Managing Operational Risk. Graeme offers a brief overview of the latest banking regulations and its impact on IT for practitioners.

The Banking crisis of 2007/08, the so called Credit Crunch, highlighted significant deficiencies within the banking system and the regulations adopted to manage financial risks. The crisis was caused by many factors and has been described by some as "a perfect storm". The U.S. Financial Crisis Inquiry Commission report of January 2011 summed it up: In response to the crisis the Basel Committee on Banking Supervision has released a series of amendments to the existing Basel II regulations to form "a comprehensive set of reform measures... to strengthen the regulation, supervision and risk management of the banking sector". These amendments and agreements are collectively referred to as "Basel III" and are intended to address the globally systemic nature of modern banking and provide a more risk sensitive framework for banks. The regulations address the deficiencies by adopting both a macro and microprudential approach as well as strengthening the risk management, governance, and transparency requirements. One key element is the requirement for banks to take account of 'stress conditions' when calculating their regulatory capital.

The Basel III Framework

The Basel III accord aims to strengthen the regulation of individual banks, micro-prudential, whilst ensuring the stability of the overall banking system, macro-prudential. It also looks to overcome the limitation of Basel II by minimising a bank's ability to benefit from regulatory arbitrage both between local implementations of the regulations and between the trading book and banking book. It also aims to strengthen the regulations for certain types of risks. Basel III framework defines: a simplified structure and improved quality of capital; measures to encourage banks to hold capital that can be utilised in periods of stress; improved risk coverage; improved capital requirements for both the banking and trading book including consideration of the impact of stressed markets; measures to improve counterparty credit risk considerations; the introduction of a leverage ratio to support the risk-based requirements; global regulatory standards to ensure banks hold sufficient liquidity buffers; measures to reduce the pro-cyclicality effect of Basel II; measures to address the systemic nature of important banks; improved governance; and improved transparency and disclosure. All of which will add up to much higher capital requirements for banks.

In November 2010 the set of enhancements were formally endorsed by the G20. Whilst most countries are aiming to ensure their local regulations are Basel III compliant by 2013 not all will do so. The most notable exceptions are in Asia where some countries will adopt Basel II/III in due course. Within those countries who adopt Basel III by 2013, Banks will have until January 2019 to be fully compliant with the new regulations. The implementation timescale for Basel III is phased to ensure that banks are able to fulfil the increased capital requirements whilst not adversely affecting their ability to lend.

Impact on IT

The impact of Basel III on a bank's IT will be far reaching and complex due to the interdependencies of the new regulations. Not only will the risk management systems need to change but banks will also be required to upgrade their balance sheet management and reporting systems. However the key factor will be ensuring there is sufficient data of the required quality to support the analytical and reporting systems. Add to this the resulting requirements for IT and operational governance, and Basel III will pose considerable challenges to banks. Consequently there will be no one-size-fits-all approach as banks will need to configure their implementation of the Basel III framework to the complexity of their organisation and its business.

If the challenge of implementing Basel III on its own is not daunting enough, all of the changes will have to be achieved against a back drop of significant change and turmoil caused by other regulatory changes, national initiatives and economic instability. For the immediate future IT departments will have to carefully prioritise and allocate resources with the right level of expertise, making sure they use them effectively and efficiently.

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Exec Pay – Lining up Reward and Risk

Sandra Quinn is an independent consultant providing consultancy and contract support to businesses and public sector bodies looking to manage their business, people, conduct and ethical risks. A former UK Financial Services Authority regulator, Sandra created an innovative people risk framework for Lloyds Banking Group. As Interim CEO, she founded the National Fraud Authority. She has delivered business reviews for the Attorney General's Office and the FSA, and worked with the Prime Minister's Strategy Unit and the Independent Police Complaints Commission. In this article Sandra answers the questions where do you start when considering getting risk properly integrated into reward.

The Prime Minister's announcement on 8th January 2012 (http://www.bbc.co.uk/news/mobile/uk-16458570) that the UK Government would seek measures including legislating on executive pay raises a number of interesting issues. Subsequent Government proposals went little further than strengthening the hand of investors. But after EU Commissioner Michel Barnier's warning of EU legislation before the end of 2012 on pay and bonuses in banks, the European Parliament is now trying to insert remuneration provisions into the EU's implementation of Basel III.

This creates different challenges for legislators, companies, boards and shareholders. For legislators, how to make this workable. For companies, to have the infrastructure and culture to comply. And for boards and shareholders, to have the information enabling them to challenge and to ask whether mere compliance is enough or whether actually they should use this to contribute to better running of firms.

So what could all this be about in practice?

Let's assume it's right that pay should be about the right amount for the right job. But avoid getting into ethical arguments about relativities between shop floor and senior management or the relative social value of nurses and bosses.

It started with the bonuses

For a start, 'pay' in terms of packages is about salary, bonus, pension and benefits. To date a lot of the focus - especially in financial services - has been on bonuses.

Because bonuses are essentially about job done, the focus has traditionally been on past performance. How well have you and the firm done in the past year? That was established thinking until RBS and Lehmans forced regulators such as the FSA to require firms to ensure that reward was more aligned with risk and not just with short term financial results. After all, you may have made lots of money but did you create lots of risk which hasn't hit the company yet? The Financial Services Authority's Remuneration Code therefore forced first banks, now investment firms (and soon EU requirements will extend to insurance companies via the Solvency II EU directive) to look at the current/future risk profile as well as the financials in arriving at collective bonus pool and individual bonus decisions. After all, it's that risk profile which will impact on the future financials.

Think sub-prime mortgages and in the UK, Payment Protection Insurance. Lots of money made. Now lots of money lost or provisioned for settling losses, complaints and mis-selling. Which is now leaving HR Directors with tricky challenges about clawing back bonuses paid or holding back those awarded but not yet paid to the people responsible (and who in the good times were bullish about being the 'accountable executive').

Evaluating risk and showing you've evaluated risk

But 'risk aligned reward' is relevant to wider executive pay beyond bonus. You should have to look at the risk profile of the firm if you are going to judge performance 'success' or 'failure' for salary as well as for bonus. Because these roles are about the performance of the company is why there is such political, investor and public frustration with people paid for perceived failure. But that should mean the current and future risk profile and not just the past (past performance is after all no guide to the future ...) if you are not going to fall into the trap which sub prime and PPI exposed.

So what risk profile? Logically it's got to be more than about

Exec Pay – Lining up Reward and Risk

the financials. It's got to be about the key risks the organisation carries because that's where the hidden impact on financials is sitting. And that should cover financials, processes, compliance, people, its conduct and reputation. All of which are inextricably linked. See sub prime and PPI.

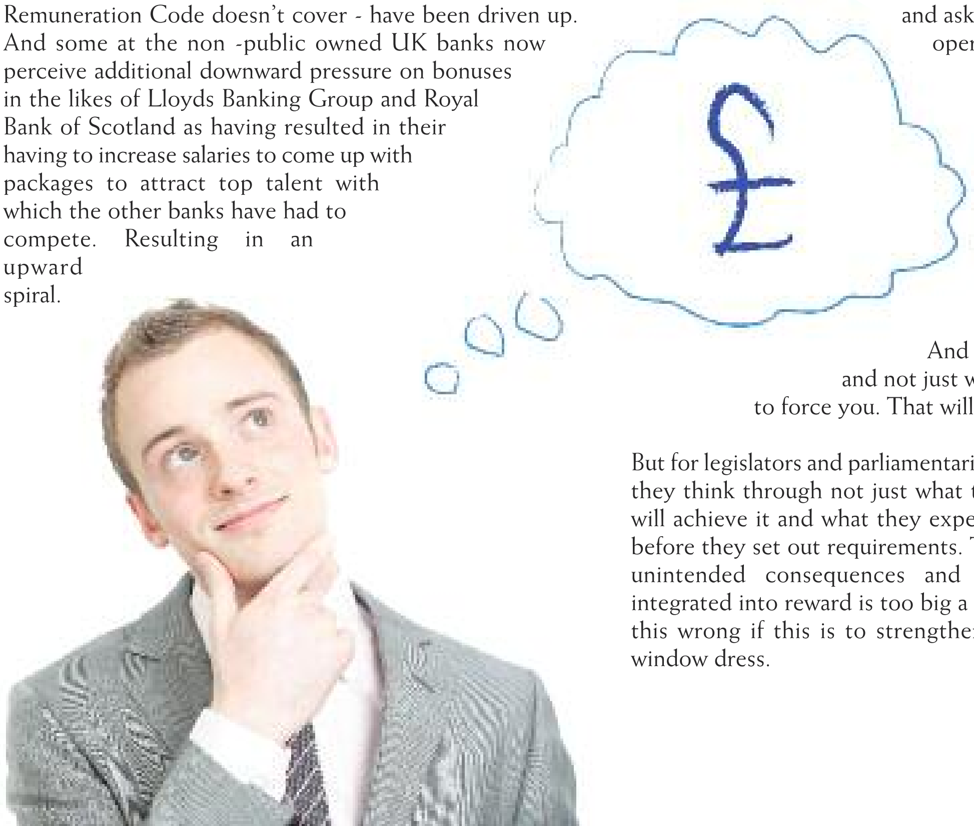
This has big implications for the way firms evaluate pay and the kind of information that Boards and investors should be seeing in terms of risk alignment and critically what they should be demanding and challenging. And big implications for firms to demonstrate their risk alignment, particularly where all their culture, decision-making, processes and information just haven't needed to before. It means HR, Risk, Compliance and Investor Relations working together in a way they won't have had to before. Even in banking where this has been most advanced to date, Investor Relations has not really been in the frame. Anyone in a company who knows any of these functions will confirm that they are often different beasts with divergent skillsets and cultures of their own so just 'working together' will itself take a lot of work. Some firms won't even have a central or strategic risk function to draw on, for example.

But returning to what has happened to date in relation to bonuses and financial services.

The law of unintended consequences

Focussing on one part of the 'pay' construct can have unintended consequences so companies and legislators will need to avoid that.

Feedback suggests that in financial services, restraint on variable pay had the unintended effect of sending employer and employed to look at what could compensate for the holding down of bonuses so the overall 'package' could be sustained. A bit like water looking for an alternative course when it's been frustrated. So salaries - which the Remuneration Code doesn't cover - have been driven up. And some at the non -public owned UK banks now perceive additional downward pressure on bonuses in the likes of Lloyds Banking Group and Royal Bank of Scotland as having resulted in their having to increase salaries to come up with packages to attract top talent with which the other banks have had to compete. Resulting in an upward spiral.



Does Risk stop at Exco?

And how far do you go through the firm? The impact of bonus requirements in financial services has affected the top couple of tiers of senior staff - those at senior levels and others in 'equivalent' roles in terms of their potential risk impact on the firm.

Currently the PM's thoughts seem to affect Board and Executive Committee type roles. But will it stay there? Should it stay there? Arguably that is where the FSA started with the Remuneration Code. If you are building risk into reward structures then why just stop at the Executive Committee? Why not look at other key roles which drive and impact on performance?

Preparing for the future

So what started in financial services is now showing signs of spreading to other industries.

Focus is likely to be on strengthening the role of RemCos and the challenge and role of investors who are the people and bodies (often our pension funds) who take the hit when it goes bad. Which means recalibrating pay decision making, tougher challenge, better MI and analysis which links risk to reward. And firms and their functions having to re-gear their thinking on all this.

So where do you start? A good place is to have a good tough look at how you evaluate risk in relation to pay and ask yourself if your decision making and the criteria you use really would stand up to external scrutiny. Chances are it won't. So how will you make it stand up and give it integrity. Look at what risk information you give your Remuneration Committees and what links you have between your Risk (if you have them) and your Remuneration Committees. Then project your primary investors and Investor Relations into the equation and ask how they would/should operate.

Inevitably a lot of busy firms are going to groan with this prospect. While potentially painful, it could be good management and good for the company. If you get it half-way right. And that will take preparation and not just waiting for the legislators to force you. That will be the trick.

But for legislators and parliamentarians, I would recommend they think through not just what they want but how they will achieve it and what they expect firms will actually do before they set out requirements. There have already been unintended consequences and getting risk properly integrated into reward is too big a prize for business to get this wrong if this is to strengthen business and not just window dress.

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People Risk

Richard Sargent is an international management and sales training consultant with over 25 years experience in the Financial Markets. He has worked in over 60 countries worldwide and specialises in high energy, practical training delivery that catalyses immediate and lasting behavioural change. In this article Richard asks what does people risk mean in the real world and offers insight into creating more effective sales and management teams.

To what extent is business success driven by technical expertise alone?

It is well known that the majority of failed company mergers are down to a lack of due diligence. But this is not attributed to the lack of analysis of underlying financial performance or contractual / legal issues but rather to under-developed employee personal competencies in relation to leadership, team working and conflict handling. In other words, a lack of due diligence when it comes to **People Risk.**

Professor Malcolm Higgs and Vic Duelwicz conducted research into the performance of top executives in 15 global organisations, including IBM, PepsiCo and Volvo. They concluded that the key personal and social competencies as defined by Emotional Intelligence (EI) were twice as important as cognitive (intellectual) or technical skills when developing exceptional job performance.

Further research concluded that owner-managers in small to medium-sized enterprises held back their companies' growth by trying to hold onto control - such managers displayed high independence, low trust, low empathy and high aggression as well as abnormally high stress levels! The one characteristic they all shared? Low Emotional Intelligence!

So, what is Emotional Intelligence and is it a valid predictor of **People Risk?** According to Daniel Goleman, the author of much of our more recent EI theory, it is defined by 5 personal and social competencies.

These are Self Motivation, Self Regulation, Self Awareness, Social Awareness and Relationship Management (Social Skills). These include such behavioural competencies as achievement drive, initiative and self confidence, communication and building relationships.

It is these competencies, or lack of them, that we believe define the "People Risk" in any organisation.

When we think of risk, we think of complex mathematical analysis using mathematical instruments and sophisticated software systems. The significant investment in time and money that has been made to control and mitigate risk in the financial markets in which we operate is plain to see - but can the same be said about how we mitigate our **People Risk?**

What does **People Risk** mean in the real world? What we do know is that it has an impact at every stage of employee engagement – from their recruitment and induction, through their ongoing development and promotion right through to the point that they may exit from the company.

Let's look at the recruitment risk first of all. How much involvement do our operational managers have in the recruitment interview process? Enough to allow them to make the right hiring decision? Most importantly, is the whole process legally compliant? In other words could we justify each and every selection or rejection decision if we were asked to do so? What about our HR team – is their recruitment process defined and consistent across the business and is it competency based?

People Risk

Whilst the majority of organisations have now installed behaviourally-based competency frameworks, many of them are found to be over-complex and unworkable operationally. Even worse, they are often perceived as an HR system designed to cause the operational team as much pain as possible! Sadly, the competency framework should be seen as the mechanism that drives the entire **People Risk** Management Process.

Then let's think about our induction process – it's such a pity to be able to attract the cream of the crop to the business only to lose them within 3 months. Is the message becoming clear? The huge investment we make in underwriting technical risk is not matched when we start to think about our **People Risk.**

Employee development in the real world is often sporadic, unstructured and discretionary – in other words is often left to their line manager. In spite of HR's best efforts, career paths are more like crazy paving, a journey that is often negotiated without maps, compasses or indeed a destination. How would this same approach work if we were to apply it to our currency or exchange rate risk strategy!!

Succession planning is a critical part of the promotional process but the foundation – once again, the competency framework – is often littered with subjective measures of performance or even worse, giant voids where operational managers have failed to log assessment data because they failed to see the bigger picture.

Our 80:20 rule probably applies here– 80% of organisations have a failed or failing performance review system in spite of HR's best efforts to administer and police them. How did the other 20% get it right? Because they invested in their **People Risk.**

People Risk is about capturing our workforce's hearts and minds and motivating them to provide peerless service to colleagues, customers, stakeholders and shareholders.

From the evidence presented, had their employer won their hearts and minds?

People Risk is about ensuring employees provide service in a committed and consistent way, with focus, energy and open-mindedness. That they see the organisation as their business and that they can influence it's success whole-heartedly and positively in spite of any external or internal resisting forces or events.

So why do organisations fail to invest sufficiently in managing their **People Risk**? The principles that are exercised when investing in technical risk controls don't seem to apply to the softer issues of **People Risk**.

For example, credit risk training is a compliance requirement policed by the regulatory authorities with some vigour. In addition, when we invest in this type of training we know that if we start at a default rate of X% and can potentially reduce this to Y% using the proven tools and techniques, we can make a saving of Z$, a clear ROI or Return On Investment which can be easily validated.

People Risk is NOT a compliance issue NOR can we easily or quickly see a return on the investment in a management skills programme for instance. Hence the primary drivers for investment in training would appear to be missing!

Then there is the question of training quality – is all "soft skills" training behaviourally-based and structured around the key competencies necessary to develop high levels of Emotional Intelligence? The simple answer? Usually "No!"

Many soft skills programmes are based around a typical technical skills training template – 00's of PowerPoint slides, lectures and highly theoretical content. According to Mager "behavioural change will only result after the training if it can be observed and assessed during the training" How can 300 PowerPoint slides achieve that?

The People Risk Sales and Management training team believe there is a better way to develop the core Emotional Intelligence Competencies we have highlighted. Our soft skills training programmes are based around effective, model behaviours which are known to work in the real world – from giving negative performance feedback through to persuading clients to buy, from managing a project from inception to completion to building a complete new business development strategy.

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What Risk Managers need to Know about ISDA® Negotiation[1]

Abigail Harding is Managing Director of Derivatives Documentation Limited, a consultancy and training company established 15 years ago and specialising in OTC derivatives and securities documentation. In this article she provides practical guidance for credit risk officers involved in negotiating ISDA® Master Agreements.

When a risk manager is approached for instructions on the terms to include in a draft ISDA Master Agreement Schedule it can be tempting for them to respond "Standard terms". Unfortunately in the world of ISDA negotiation there is no such thing.

Running a search on "Risk Management and ISDA" on a well-known internet search engine I stumbled across an Australian site for the International Self-Defence Association and I could not help but think that it was rather apt for the two organisations to share an acronym– given that self-defence is arguably the main aim in negotiating an ISDA Master Agreement.

How then can a risk manager use the ISDA Master Agreement to enhance credit protection and pre-empt potential hazards?

Taking the advice of Fraulein Maria in The Sound of Music "Let's start at the very beginning" by asking the simple question - Who is my counterparty?

By focusing on the counterparty type concerned a risk manager can immediately gauge the relative bargaining power of the two sides (e.g. a triple A rated supranational and a lesser rated bank) and differentiate between the terms that are essential (need to have) versus those that are merely desirable (nice to have).

They might then consider who owns or controls the counterparty. If their creditworthiness depends on the continued support of a powerful parent company a risk manager would look at ways to reflect this in the documentation and incorporate possible exit provisions should an adverse change in control or ownership occur. These may take the form of Additional Termination Events covering a downgrade in the parent company's external credit rating (typically by one or two notches) or the failure to maintain (directly or indirectly) a certain level of ownership – 51% or 75% are commonly chosen trigger levels for this.

If the counterparty is part of a wider group rather than a standalone entity, it is possible to join other of its group members as "Specified Entities" to certain Events of Default and one Termination Event in the ISDA Master Agreement. This would mean that if a Specified Entity was to be impacted by one or more of these events (e.g. derivatives cross default, debt default, insolvency or financially adverse merger) it would trigger a default under the ISDA Master Agreement even though such an event did not affect the counterparty directly. To determine which group members are to be nominated as Specified Entities (if the catch-all "Affiliates" definition is not used) a risk manager would look at where the group's assets are located and seek to tie-in asset rich or financially significant subsidiaries.

Alternatively where a third party guarantee is provided, the guarantor can be referenced as a Credit Support Provider in the ISDA Master Agreement Schedule and be joined automatically to many Events of Default and Termination Events.

Once the risk manager's requirements have been incorporated into the initial draft Schedule they will be reviewed by the counterparty's negotiator, who will inevitably respond with various changes to the proposed terms.

At this stage the risk manager is likely to be approached again for guidance on the proposed modifications and for this reason it is useful for risk managers to be familiar with commonly negotiated amendments. It may well be the case that many such changes are provided for in an institution's documentation or credit policy (as they tend to be variations on a theme) but it clearly makes sense for risk managers to understand what a given counterproposal is intended to achieve and any disadvantages that agreeing it would entail.

Examples of credit provisions which may be negotiated include:

Specified Entities: You may have requested all Affiliates but your counterparty may only want to include certain named entities (or none at all!).

Additional Termination Events: For example, with hedge

1 ISDA® is a registered trademark of the International Swaps and Derivatives Association, Inc.

2 A very good place to start.

What Risk Managers need to Know about ISDA® Negotiation

funds a decline in net asset value (NAV) termination event may be required but the parties disagree on what level the NAV trigger should be and whether total NAV or NAV per share should be used.

Grace periods for certain Events of Default: You may want shorter grace periods than the ISDA standard and your counterparty may want longer ones.

Cross Default vs. cross acceleration: Whether defaults under other agreements between the parties can lead to a default under your ISDA and the timing of when this Event of Default can be triggered. This can be a major sticking point in some negotiations if the parties want differing terms.

Threshold Amount: This is the trigger at or above which a Non-defaulting Party can terminate all Transactions under the ISDA Master Agreement's Cross Default clause. The level of this is often negotiated and whether it should be measured as a fixed money sum or a percentage of shareholders' equity.

As well as the ISDA Master Agreement itself, you may want to enter into a collateral document - e.g. the ISDA Credit Support Annex under English Law (the "CSA") - to reduce your counterparty risk exposure further. Terms for consideration include whether the CSA is one-way or two-way, the unsecured Threshold you are willing to give your counterparty before trade exposure needs to be collateralised (i.e. secured), what types of collateral are acceptable to you and whether the parties will be allowed to re-use (or "rehypothecate") the collateral they receive. Over 90% of collateral in the OTC derivatives market is cash in mainstream currencies and G7 government bonds.

So, as you can see, there are many issues to consider when you first review a company which is looking to enter into OTC derivatives under an ISDA Master Agreement and certain points you may need to concede in order to get your "need to haves" in the document. "Standard terms" are a complete myth.

The Lexicon of PEP Risks in Global AML Framework

Danny Sanhye (FCCA, CFE, CAMS), is a financial crime specialist and an accredited expert witness. He is a former World Bank Mentor and has also consulted for the UNODC and Commonwealth Secretariat on anti-money laundering and anti-corruption matters. He has worked in various jurisdictions evaluating country's anti-money laundering legal framework. In this article he looks at the recent development around Politically Exposed Person (PEP) in the new set of recommendations issued by Financial Action Task Force and considers the difficulties of PEP screening and the gaps in legislation.

The Financial Action Task Force (FATF) pile up the pressure on financial institutions to crack down on crime by issuing a revised set of anti-money laundering (AML) recommendations in February 2012, but despite this effort there is still huge gaps in AML international standards. Financial institutions operating globally will still face the challenge of getting their due diligence right because of the lack of harmonisation in the global AML framework.

The revised FATF recommendations include among others an obligation for financial institutions to identify domestic customers who are politically exposed and to treat them in the same manner as the foreign customers who are classified as politically exposed persons (PEP). This revision is supposed to assist in the identification and repatriation of assets associated with corruption before they reach global financial capitals. But this effort would achieve very little as long as there is no similarity in the interpretation of PEP.

Politically Exposed Person: a public official, who by dint of their position could potentially have opportunities to appropriate public funds or take bribes; or their family members of close associates. The anti-money laundering regulations require that bank accounts belonging to PEPs or companies controlled by them should be subjected to extra scrutiny.

Many countries have modelled their AML legislation on United Nations Convention against Corruption (UNCAC) or on EU Directives. Both standards take different approach on PEP. The variation in AML law creates opportunities for corrupt individuals and companies to launder the proceeds of their crime by moving money from one jurisdiction to another or by cutting deals to ensure that corrupt money stays offshore. In many reported corruption cases where PEP is involved, we found that intermediaries (most often a family connection with PEP) would launder their ill-gotten gains. So how deep and how far should the screening of domestic PEP go; the challenge for financial institutions in these circumstances is to spot the transactions which are hiding the proceeds of crime by understanding PEP's source of funds and wealth in the enhanced due diligence (EDD) process.

In the UK, the Financial Services Authority (FSA) reported last year that three-quarters of the banks reviewed failed to take adequate measures to establish the legitimacy of the source of wealth and the source of funds, and "around a third of banks, including the private banking arms of some major banking groups, appeared willing to accept very high levels of money laundering risk if the immediate reputational and regulatory risk was acceptable."

Effective scrutiny of transactions with proceeds of crime is a major challenge, given the high level of sophistication in money laundering techniques. For financial institutions with branches overseas, the level of corruption in some countries could frustrate their anti-money laundering and anti-bribery measures they have in place.

PEPs present a multi-dimensional risk to financial institutions

The enhanced scrutiny process that financial institutions need to develop is complicated by the fact that in many jurisdictions PEP screening is not performed adequately. In addition, non-PEP customers can become PEPs, sometimes without a financial institution's knowledge through marriages (legal or cultural marriages) with a PEP family member, or promotions within government to a "senior" position. There is currently no definitive list of PEPs which leaves financial institutions to rely heavily on commercial companies that research and provide lists of PEPs and their associates, along with information about business dealings, court cases, corruption allegations and appearances in the press. To bridge the gap in due diligence, domestic financial services regulators should be required by FATF to assess the effectiveness of commercial databases of PEPs on which financial institutions rely to carry out their customer due diligence or governments should be called to compile lists of domestic PEPs and provide a definitive basis against which to apply EDD measures. There are also important gaps in connection with ensuring sufficient transparency over beneficial ownership of assets and the time limit of PEP after leaving office.

The Lexicon of PEP Risks in Global AML Framework

Both the FATF recommendations and the UNCAC now advocate the identification of domestic PEP, but unlike the UNCAC, FATF can use its black list of "high-risk" and "non-cooperative" jurisdictions to put countries under pressure to comply with 'domestic PEP' identification.
Most European Countries and the U.S. have no requirement for financial institutions to scrutinise accounts held by domestic political figures. Domestic PEPs have not been a priority in many countries and the theory that politicians will pass legislation that may incriminate them remain to be seen.

The lack of a coherent approach in international standards can be seen in the table below.

INTERNATIONAL STANDARDS	APPROACH TO POLITICALLY EXPOSED PERSONS
FATF	• List the individuals who are PEP. For example, Heads of State or of government, senior politicians, senior government, judicial or military officials, senior executives of state owned corporations, important political party officials. Business relationships with family members or close associates of PEPs involve reputational risks similar to those with PEPs themselves. • Silent on companies that are related to PEP's close associates. • Focuses on those "entrusted with prominent public functions in a foreign country" regardless of their country of residence. • No distinction between domestic and foreign PEP (prior to February 2012 domestic PEP was not covered).
3rd EU Directives	• PEPs are defined as "natural persons who are or have been entrusted with prominent public functions and immediate family members, or persons known to be close associates, of such persons". • It does not distinguish between domestic and foreign PEPs, but requires that firms identify and apply EDD to PEPs who reside outside the jurisdiction. As a result, the Directive does not require EDD for PEPs who reside inside the jurisdiction even if they were entrusted with a prominent public function overseas. • Has time limit imposed on PEP. • The degree of relationship focuses on immediate family members, which may not be sufficient in cultures and jurisdictions in which the extended family maintains very close ties. • PEP covers joint beneficial ownership of legal entities or legal arrangements.
UNCAC	• Does not distinguish between foreign and domestic PEPs, which mandate the application of EDD to both foreign and domestic PEPs. • Includes as close associates both persons and companies that are related to the individual entrusted with the prominent public function • No time limit for PEP (once a PEP, always a PEP)
Wolfsberg	• Referring to individuals holding or having held positions of public trust, such as government officials, senior executives of government corporations, politicians, important political party officials, etc., as well as their families and close associates. • PEPs potentially represent higher risk because they either are in a position to exert undue influence on decisions regarding the conduct of business by private sector parties, or have access to state accounts and funds.

Conclusion

Due diligence by financial institutions will vary in depth, but as the Arab Spring brings regime change across Northern Africa and the Middle East, financial institutions should review the robustness of their ABC and AML/CFT system with PEP and to treat those that pose "higher risks" of corruption in the same manner as their foreign counterparts and seek senior management approval for the accounts transactions; determining the source of the account-holder's funds and monitor their accounts closely. If initial background checks fail a more specific and detailed inquiry will be needed. This process may also require forensic auditor to review financial and other records to substantiate source of wealth and source of fund.
Financially Exposed Persons (FEP) holding important position in the private sector should go through a similar monitoring process to PEP, as they are no less vulnerable to corruption.

Disclaimer - This article is intended to provide commentary and general information. It should not be relied upon as legal advice or any sort of formal advice.

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Radical Transformation of the Turkish Banking Sector

Dr Botan Berker is a banker and risk management specialist, and CEO at Merit Risk, Istanbul, Turkey and former managing director of Fitch Ratings. In this article she takes a critical review of the more than ten years of dramatic change within the Turkish banking system and holds it up as a reference to paths which other markets may follow.

The Turkish economy had suffered a long lasting high inflation period since the late 1970s which resulted in distortions of the several aspects of economic activities, mostly of the intermediary institutions such as banks. There had been several attempts of the government with the support of the International Monetary Fund (IMF) to tackle the vulnerabilities of the public finances that continuously fed into the inflationary dynamics. However, despite to several relatively milder crises during 80s and 90s it was not up until the year 2001 that the economy really hit the wall and all of the problems of the banking sector became visible by all and a radical change became a requisite?

During the late 1990s Turkish banking sector could be characterised as an overly banked system with small institutions that lacked institutional ownership thus partly owned by some individuals somewhat distant to any corporate governance guidelines. Moreover the banking system was deemed to be highly profitable with respect to the banking systems of other OECD countries due to the fact that banks were overly investing in high yielding Turkish government papers which seriously exposed them to market risk. Furthermore Turkish banks were able to earn large returns by maintaining net open foreign exchange positions. They were funding themselves through lower cost foreign exchange markets and lending in Turkish lira to capture the high risk premium on government debt. The real interest rates on Turkish government securities were around twenty percent and the open position of the banks were more than one hundred percent of their equity in most cases. The lack of prudent supervision played a significant role in alleviating the systemic weaknesses.

The Turkish government had launched a disinflation program in late 1999 and adopted a crawling peg exchange rate system incorporating an exit strategy to the peg in almost two years. This exchange rate system led to underestimation of currency risk by the banking sector. Eventually the accumulated weakness in public finances coupled with an extraordinary mismanagement, the economy collapsed. The immediate consequence was to switch to a free float of Turkish lira which had devalued sharply leaving the banks to realise their losses stemming from their exposures to a very serious currency risk.

With the economic activity coming to a halt and the ongoing IMF Standby program being suspended the Turkish government had approached the IMF to resume and enhance the programme. By May 2001 the Standby Programme for Turkey at an amount of 19 billion USD had been approved by the fund incorporating structural policies aimed at correcting the distortions in banking.

At the heart of the programme was the provision for a fully functioning, newly established independent Banking Regulatory and Supervisory Agency (BRSA). The BRSA stepped in and changed the rules of the game immediately.

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As a starting point to maintain adequate capital the supervisor asked for the triple audit of all the banks which had been reduced in number following the consolidation. Following the audit process that more accurately reflected the banks' financial conditions a recapitalisation scheme for the sector has been introduced and the capital base has been strengthened. Since 2001 the Turkish Banks' regulatory capital ratio had been set as 12% minimum if they wanted to open any new branches. All cash dividend distributions have been suspended until the capital adequacy ratios had been restored and maintained. In order to enhance the transparency administrative and regulatory steps have been taken to improve the reporting required by the banks. The state banks that had the legacy of distorting the markets, have been restructured and their relative advantages have been wiped off to provide a level playing field for all the banks.

Private banks, especially those with common owners, were encouraged to merge. Tax laws were further revised to make mergers of banks and their subsidiaries tax neutral. Loan loss provisioning rules have been strengthened. An enhanced monitoring system for the liquidity position and interest rates in all banks has been introduced to make sure that unviable banks are not allowed to engage in unsound practices and that corrective actions are taken early. To address the problem of connected lending, a regulation defining related parties for purposes of limits on banks' exposures to owners and other parties has been introduced. A capital charge on foreign exchange exposures has been introduced in line with the new market risk regulations. Accounting standards for banks were brought in line with international standards which included bringing all repurchase agreements on to the banks' balance sheets. Furthermore there has been some renewals on the foreclosure and bankruptcy laws.

The Turkish regulator had addressed the issue of quality and quantity of capital at an early date. Besides the requirement of 12 percent regulatory capital they urged the banks to reduce permanent assets through outright sale and/or conversion to interest bearing assets.

A risk management structure had an area of great importance for the regulator and it introduced the required model to the system with immediate effect. Accordingly banks had to establish an audit unit, an internal control unit and a risk management unit which should be carrying out their functions independently of other bank activities.

Separately each bank had to establish an Executive Risk Committee to prepare management strategies and policies. As a critical part of the internal control function, the bank's operations had to be functionally separated from each other (i.e. separation of banking and trading, separation of marketing and credit review). In order to comply with these requirements banks had installed state-of-the art technology information systems. Risk Management units started to function independently and the head of the unit became responsible to a Board director in charge of risk management. Over the years the system proved effective which had closely been supervised by the BRSA through conducting on-site and off-site supervision.

The banking sector showed a rapid growth performance during 2002-2008 periods and had an asset growth of 258 percent up from USD 130 billion to USD 465 billion.

The Turkish banks have encountered the global financial crisis in a relatively comfortable position with high capital adequacy ratios, low NPLs, strong funding base mainly through deposits and a well-established risk management culture. During 2009 when the economy contracted due to the decline in external and domestic demand the banking sector had been affected mildly as shown in the increase in impaired loan ratio from 3.3 and 3.4 at the end of 2007 and 2008 respectively to 5 percent by the end of 2009. That ratio had come down to 2.7 by the third quarter of 2011. At the end of 2010 the Turkish banking sector had 49 banks. Its assets stood at USD 653.9 billion with an average regulatory capital ratio of 19 percent and return on assets and equity at 2.4 percent and 18 percent respectively.

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Global Taxation Rules – the New Imperialism, the New Risk, the New Madness

David Millar is an independent risk management journalist and consultant and trainer. As a process and operations expert with 40 years experience in banking and financial markets, he has provided advisory services to banks, financial institutions and central authorities. Until recently he was Chief Operating Officer at the Professional Risk Managers' International Association, PRMIA, a trade association focussed on improving financial risk management through professional membership events, training and certifications. In this article David asks if the new FATCA rules are worth the impact on international trade and investment.

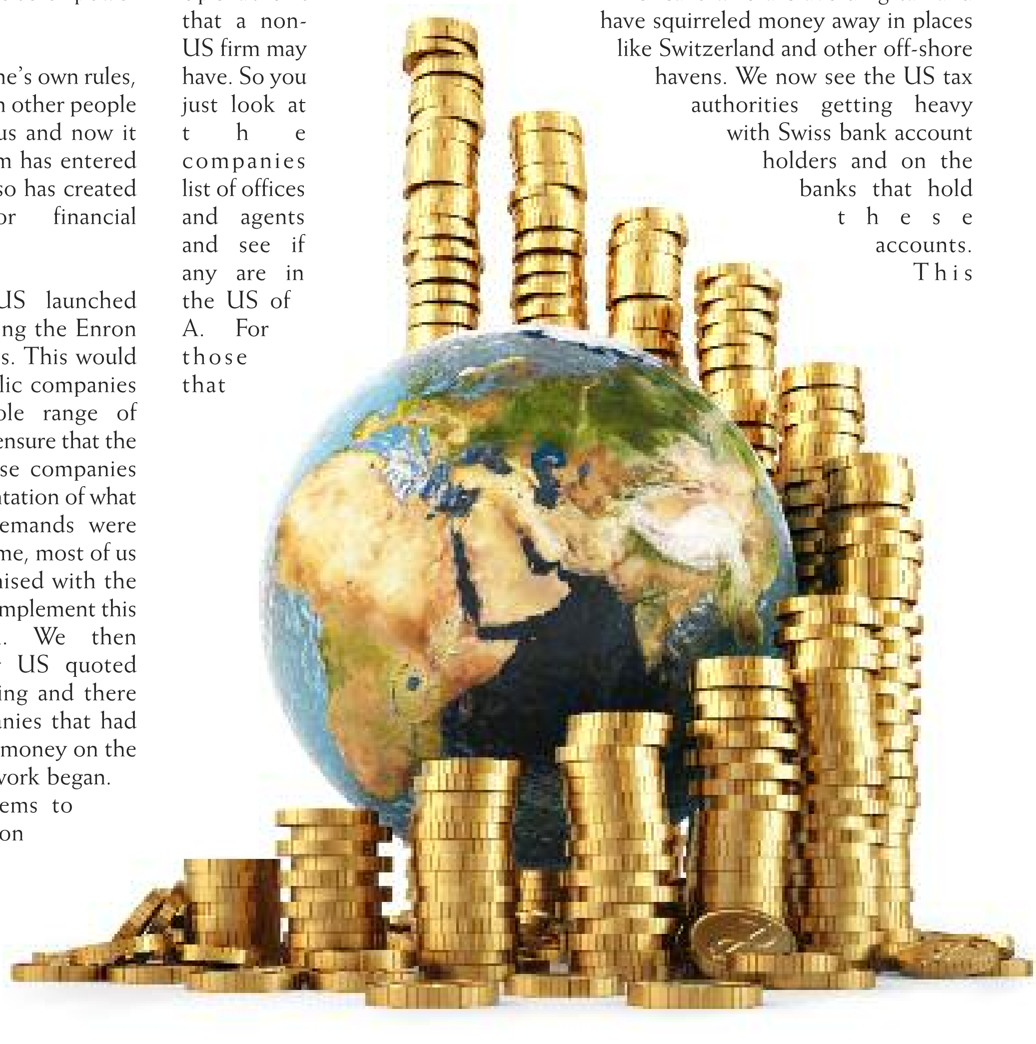
Imperialism is now a derogatory word in any language or vocabulary. From the military conquests of Ancient Macedonia, to the trade-driven acquisition of foreign lands in the 17th and 18th centuries, to the outright commercial "Coca-Cola" conquest of the world by large global firms in the past 50 years, imperialism has been seen as the unjust exercise of power over unwilling subjects.

But the will to impose one's own rules, cultures and practices on other people seems to still be with us and now it seems a new imperialism has entered our lives; and in doing so has created significant risks for financial institutions.

Back in 2003 the US launched Sarbanes-Oxley following the Enron and Worldcom collapses. This would impact US-quoted public companies and presented a whole range of regulations designed to ensure that the public accounts of these companies was an accurate representation of what was going on. The demands were significant and, at the time, most of us looked on and sympathised with the US managers having to implement this gargantuan legislation. We then discovered that being US quoted covered secondary listing and there were few global companies that had not at some time raised money on the US exchanges. So the work began. Thankfully the US seems to have given up on Sarbanes-Oxley, at least for small firms, and it remains something that large multinationals only have to cope with.

The US has now gone for us again with Dodd-Frank, and its love-child, FATCA. Dodd-Frank, although even more complex that Sarbanes-Oxley, is easier to cope with as it impacts any US operations that a non-US firm may have. So you just look at the companies list of offices and agents and see if any are in the US of A. For those that tick this box there will be significant compliance work and the subsequent risk of failed processes.

FATCA, though, is something else again. The US needs cash to pay for job stimulation schemes (and the cost of Dodd-Frank) and is looking to tighten the screws on all those Americans who are avoiding tax and have squirreled money away in places like Switzerland and other off-shore havens. We now see the US tax authorities getting heavy with Swiss bank account holders and on the banks that hold these accounts. This



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is all because, differently from most (all?) of the rest of the world, US citizens are taxed on their worldwide income and assets – a citizenship-based taxation system, whereas the rest of us are taxed on the basis of where we are and where our assets are at any one time.

FATCA goes further than simply insisting that Americans declare and pay tax on their worldly good. It assumes that these assets are not hidden underneath the bed and are managed through a financial institution. FATCA requires that all financial institutions, American or not, both inside and outside the USA, who have clients who may be US tax payers, either declare these persons, or companies if US controlled, to the US tax authorities. If these clients cannot show that they are paying their US taxes, then the institutions that hold their accounts or assets must deduct a 30% withholding tax and send it to Uncle Sam.

If you, the financial institution, do not do this, then the US authorities will place obstacles in the way of any payments from legitimate US business reaching you. So effectively, the USA is asking overseas companies who may have no US presence to act as unpaid tax collectors on the behalf of the US government. The only way out is to stop taking on client business with any US individuals, or US-owned firms, and to ensure that you do not have any counterparties who are US-controlled.

This is probably not feasible and certainly commercial suicide so you have to start introducing processes to check clients, decide whether they are American and discuss the practicality of getting them to agree that they disclose their affairs to the US taxman, or deducting 30% straight off the top. Neither option makes the salesman's life any easier, and the increase in process and reporting complexity is significant. And, by the way, this becomes effective at the end of this year, despite the fact that the details were only finalised this February.

Unsurprisingly there was a lot of protest at these rules and one of the issues was that it just was not legal in many countries to send personal financial details to a foreign organisation. Rather than back down, the US have reached agreements with their foreign tax counterparts so that the overseas firm will divulge the necessary information to their own national tax authorities who will then pass it to the US. Currently the UK, Italy (this is amazing seeing they seem to have trouble collecting taxes from their own citizens), France, Germany and Spain have signed up and we assume that the Americans are in negotiation with other countries to achieve this.

Apart from the amount of effort involved in setting up and running this, the operational risks in this process will have many and varied impacts – fines, loss of business, reputational risk – and these will, I believe, be a key issue for risk management in the year to come. Every client, subsidiary and counterparty will have to be evaluated for its US liabilities and processes set up to monitor future business. Any attempts by clients at hiding their status will have to be tracked down. New business will have an extra risk issue on which to be assessed. The operations will be complex and the new risks are many.

And believe me this operation will not be easy. Every client will have to be looked at and that alone is complex. Is he an American citizen, yes or no? But what about those with dual nationalities? I personally carry two passports. And what about those who are entitled to US citizenship but have never taken up a passport? Most of us in this multicultural world have multiple entitlements descending from parents or grandparents. I can come up with two more from my grandparents. US tax requirements cover all of the above cases. And it is not just individuals that have to be checked; one must also look at beneficial ownership of companies that are clients.

Every financial institution that pays interests, holds assets, or manages funds will be effected. Only those who have no US offices, no US-based counterparties and make a positive decision not to take on any US clients (and close down all their existing ones) can escape the dreaded FATCA. The Empire strikes back, FATCA is the sword and the financial institutions of the world are being made its agents. You are to become an unpaid tax collector, your government is becoming an unpaid tax collector so that unemployed Americans in Detroit can receive their benefits.

Having filled you all with gloom at all the extra effort that will be required of you, I was going to finish this article at this point. But I just wanted to throw in an extra thought.

All governments need extra funds and all are concerned that their citizens may be less that squeaky clean about what is tucked away overseas. What will happen if other governments move to a citizenship-based taxation system and equally start demanding that financial institutions start reporting and withholding taxes from their own citizens? Could that be why the FATCA agreements with foreign tax authorities are said to be reciprocal? Apart from the effort on your firm, think of the impact on trade, investing and travel!

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