

The Private Sector becomes active: The Wolfsberg Process
by
Mark Pieth & Gemma Aiolfi

**Professor Mark Pieth
Gemma Aiolfi
Juristische Fakultät
Universität Basel
Maiengasse 51
4056 Basel
Switzerland
Mark.pieth@unibas.ch
Gemma.aiolfi@unibas.ch
Tel: +41 61 267 25 38
Fax: +41 61 267 25 49**

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There is a tide in the affairs of men, which taken at the flood leads on to fortune. Omitted, all the voyage of their life is bound in the shallows and in miseries. And we must take the current when it serves or lose our ventures.'

(Wm. Shakespeare, Julius Caesar)

1. Introduction

This chapter examines how the Wolfsberg Anti-Money Laundering Principlesⁱ came into being, charts their subsequent development and also looks at what the Group may tackle in the future. The prospects for the expansion of the Group itself are also addressed and some of the possible implications this might have on its workings are posed. But before looking ahead, the first part of this section deals with the placing of this industry lead initiative into its recent historical context. The background to these developments is therefore sketched, as well as the interaction that has emerged between the various legislative and 'soft-law' initiatives that continue to contribute to the growing body of anti-money laundering rules.

2. The private sector gets active - but why now ?

One aspect of the critical discourse on multi-national enterprises has long maintained that conglomerates, major industrial groupings and the financial services industry may have larger turnovers than the GDP of many a small state and wield even greater power, not only within the countries where they operate, but also on the world stage. At the national level the clout of MNE's has traditionally been channelled through lobbyists with the aim of influencing legislative initiatives that impact their businesses. But the question of taking a more proactive approach in influencing regulations and defining their own rules would, given the dynamism of globalisation, certainly be a logical undertaking for the private sector and particularly at the international level. In the context of the development of anti-money laundering initiatives this question however is even more acute: Why did companies only get active in the last couple of years and why, for more than a decade, did they leave the definition of the rules against money laundering entirely to regulators?

It is surprising because in 1988 it was the banks themselves that had requested the movers of G7 countries and others to clamp down on illegal drug markets. US banks in particular had already learned to live with routine cash reporting (CTR)ⁱⁱ which dated back to the provisions of the Bank Secrecy Act of 1970, and were regarded as the acceptable price to pay for being involved in the fight against organised crime. Although 'know your customer' (KYC) policies were not unknown to US securities firms from the New York Stock Exchange Rules, banks were not however, prepared to engage in serious KYC policies and customer due diligence (CDD). These concepts were regarded as both intrusive, costly and over burdensome and also because they were perhaps looked upon more as European notions that did not fit the American banking tradition. It is appropriate to recall in this context, that the original US delegation to the Financial Action Task Force in the Autumn of 1989, had no desire to promote KYC policies or suspicious transaction reporting. At that time their primary interest was focused on creating world-wide control mechanisms over money flows, both in cash and - insofar as it was possible - over electronically transferred funds. And there is nothing to suggest that banks themselves held different opinions to their regulators at this time. By focusing on the transfer of cash the emphasis was placed on the so-called placement stage of money laundering, namely the initial depositing of currency into the financial system. The complexities of the subsequent layering and integration stages were thus not tackled directly. This approach may have been adopted for various reasons, perhaps because measures to counter money laundering in the latter stages were regarded as too costly, or because the tracking of cash would, theoretically at least, solve the problem at source, thereby rendering any further controls at later stages redundant.

The developments in the late 1980s appear to have caught the banking world unawares not least because the supervisors of the UK, France and Switzerland teamed up and managed to strike a deal with the US regulators in the context of developing the FATF 40 Recommendationsⁱⁱⁱ and into which the Europeans introduced their own concepts, which included attaching to the process one of the most rigorous enforcement mechanisms known thus far in international law. The CDD rules in the FATF 40 Recommendations were created by taking a combination of national strategies and an early international Recommendation of the Basel Committee, (the Basle Statement of Principles (BSP) of 1988^{iv}). The KYC provisions in the Recommendations drew on Swiss law and the BSP's increased diligence in unusual circumstances, reporting obligations had their roots in UK guidance notes. In return, the US essentially obtained in the FATF Recommendations, the endorsement of what had been achieved in the Vienna Convention of 1988^v, namely the commitment of the international community to criminalise money laundering, to forfeit ill-gotten gains and the agreement to share information, even though at that time it was still restricted to the topic of drugs.

Throughout the following decade bank supervisors at the national level struggled with their banking communities (and later on also the non-banks) to implement these regulations. The outcome was the creation of a patchwork of rather diverse rules which had the effect of immediately increasing both regulatory competition and regulatory arbitrage, thus enabling the money launderer to profit from these discrepancies between the various financial centres. The 1990s saw the progressive extension of anti-money laundering legislation to the transfer of proceeds of other serious crimes but in relation to CDD at the international level things quietened down and nothing happened for nearly a decade on this area (almost up to 1999). This was particularly disquieting for internationally active banks because they had to apply all these diverse standards concurrently - and at the same time they constantly risked losing clients to competitors operating under a more flexible regulatory framework elsewhere.

The need for greater harmonisation became ever more apparent, yet banks waited for regulators to make the next move. However, eventually the banks realised that this move would probably not be made for the foreseeable future not least because between 1996 and 2000 the FATF had developed other priorities, and was focusing on offshore centres and specifically on the so called non-co-operative countries and territories (NCCT's) rather than further refining its own standards and its own performance.

It was again the Basel Committee of Banking Supervisors and also to some extent the Working Group on Bribery of the OECD, both of which - independently of the other - increasingly took the view that more work on CDD should be done. Supervisors and central bankers world-wide had become increasingly concerned about the risks offshore havens posed to global financial stability, although concrete evidence for these concerns is difficult to ascertain let alone quantify. The issues were addressed on a macro-level by a specialised group in the Financial Stability Forum (FSF)^{vi}. The BCBS picked up the direction given by the FSF but pursued its analysis on a micro-level in that they looked at the need for the regulated banking area to fend off risky clients. In a sense this initiative mirrors the efforts of the FATF in relation to NCCT's, but gives it a different thrust - cleaning up one's own house and controlling the entry points rather than picking on the non compliant with the aim of getting them to toe the line.

The OECD's Working Group on Bribery - which had just concluded a far reaching Convention on combating bribery in business transactions^{vii} - had started to expand its scope of work by looking at the abuse of financial centres for bribery. This development proved to be important because in the same context the non-governmental organisation specialised in combating corruption, Transparency International launched an initiative with some of the key private banks to recruit their help in preventing the misuse of financial centres for the creation of slush funds, bribe payments and bribe money laundering. The timing seemed particularly apposite as abuses of private banking by corrupt officials had been revealed in the 1990's, with highly placed political officials being found to have laundered large amounts of cash through US and European banks who had displayed a lax attitude to AML. The damage to the reputations of the banks involved was serious as is apparent in the report by the US sub-committee on private banking^{viii} which levied criticism by pointing to specific failings and

weaknesses not only with respect to the banks involved but also with regard to the nature of global private banking. These developments contributed to the creation of a climate of change - with the notable difference that this time the affected banks themselves decided to grapple with the issues.

3. Developing the industry standard

At an early stage in the Wolfsberg process, facilitators talked to key US and European banks to convince them that getting together and defining a common AML standard could be beneficial both for the banks as well as wider society. It was also clear that such a development could help to create a level playing field for banks in competition terms. A common standard could also, if picked up by regulators help reduce the diversity and uncertainties - a net effect of which would be to cut risk management costs. From the perspective of combating corruption and graft as practised by 'potentates' in particular, the banks' effort to review their procedures and internal rules could make it harder for clients to circumvent the new (at that time) anti-corruption laws by engaging in offshore transactions.

The participating banks were very cautious in the early days of the initiative, and after all it was a novel process, the outcome of which was not certain. The criteria for extending invitations to banks to join the group were on the basis of the significance of their private banking activities and also to ensure a geographic spread as far as it was possible. Some banks needed intensive convincing to join the process - especially by their peers. The initiative really took off after the two leading banks at the first meeting in October 1999, decided that as a first step they would exchange their internal corporate AML compliance rules. Working from this basis the Group subsequently decided to extract a common denominator on which to build a standard. The original 'Wolfsberg Principles' are the result of these early efforts. The first revision of the Principles was published in May 2002 and came about partly as a result of the usual internal updating that Group members had undertaken in the intervening period, as well as in response to new developments at the international level such as the Basel Committee's 'Customer Due Diligence for Banks'^{ix}. This process indicates that the development of the Principles was clearly not an end in itself, and that further evolutions in the Principles are to be expected. The working dynamics of the Group have similarly progressed as the expeditious drafting of the Wolfsberg Statement on the Suppression of the Financing of Terrorism showed: The Statement was published in early 2002. An integral part of the process has also been the Group's efforts to make the Principles accessible and practical to other financial institutions who may want to apply them. To assist these institutions, the Group has tackled some of the details of the Principles in the 'frequently asked questions' section of their web site, these guidance texts and commentaries are formulated by sub-working groups composed of experienced and senior personnel drawn from the participating banks.

To round off the initial process, the Wolfsberg Group held a media conference in October 2000, to publish and publicise the Principles. The international press was intrigued and many journalists as well as regulators not surprisingly asked, 'so what's new? And will these Principles defeat money laundering?' It also raised - and continues to raise - questions about the message this Group is sending to regulators: In taking the initiative are the banks reacting against further regulation in an already highly regulated industry, or is it a move by the private sector to complement the regulatory framework?^x

4. What is the reasoning behind this initiative?

As a voluntary code of conduct that focuses on private banking the Principles are specific to this business segment - at the same time however - they are also broadly drawn and in certain areas downright vague. It is also correct that the first version of the standards does not revolutionise CDD, it builds on some advanced but well established concepts of identification, and increased diligence in unusual cases. It addresses the issue of how to identify beneficial owners, remains however hazy on the matter of delegating CDD to third parties, be it to agents or other financial institutions (especially correspondent banks).

Whilst they are not a panacea for combating money laundering, the Principles do have the potential to bridge the 'transatlantic gap', bearing in mind that up until quite recently the US had a hard time

toughening up its AML laws: Proposals by President Clinton to tighten the regulatory regime were rebuffed by the republican dominated Congress who were opposed to meaningful change at the time^{xi}.

The real strength of the Wolfsberg Principles however, lies in the fact that the participant banks commit to apply the rules to all their operations at home and abroad, including in offshore centres. If it may be assumed that the Group members make up more than 60% of the world market in private banking, with perhaps 50% of the market share in each key offshore destination - these rules in practical terms - have great potential for becoming the leading principles throughout the industry.

Although it is difficult to second guess the motivation of the individual participants to join this initiative, there can be little doubt that the various risk elements (that are actually described in the Basel CDD paper^{xii}) must have been uppermost in the minds of the bankers invited to attend the initial sessions. It should moreover, be remembered that the requirements set out in the Basel CDD paper and the FATF Recommendations are aimed at national supervisors and are guidelines for minimum regulatory standards. But the implementation of rules takes time, and any subsequent amendments often even longer. This time lag was perhaps one factor that prompted the banks to get active on their own behalf: The need to counter risk in a comprehensive manner had become a paramount question of credibility for some banks, and they could not wait for piecemeal legislation. It is also the case that although the aforementioned guidelines are essentially aimed at regulators the banks also recognise that influence can be exerted at the national level, because governments will always look at what has been going on in terms of self-regulation. And given that the private sector have adopted best practice whilst drawing on a variety of traditions, the Principles will almost certainly impact any proposed legislation at national level in this area.

It has also been correctly observed by critics that these Principles lack a specific enforcement mechanism. However, monitoring is indirectly provided by Supervisory institutions, with whom the Wolfsberg Group meet on a regular basis: The standards have provoked regulators, if not into action then to be substantially more specific than they had been over the last decade.

5. Playing 'Ping-Pong' with regulators: establishing a 'risk based approach'

Even if the CDD rules prepared by the Basel Committee were already well advanced in their preparation when the Wolfsberg Principles were published, and even though the CDD paper makes only brief mention of Wolfsberg in terms of it being a voluntary code of conduct that may underpin regulatory guidance but is no substitute for it, it is nevertheless virtually certain that these papers mutually influence each other^{xiii}. The Wolfsberg Group is continuing the self-critical process in the light of the Basel Committee text and will make further amendments to the Principles in due course. This reciprocal process could also be ascertained in subsequent meetings between the banks and regulators in the years following the publication of the Principles. And this 'dialogue' is perhaps most apparent in the final paragraph of the Wolfsberg Statement on the Financing of Terrorism. The list of areas for further discussion with governmental agencies is not only a response by the banks indicating what they consider as feasible to assist in the fight against terrorism, it also takes the offensive by highlighting areas where regulators themselves should be active and taking responsibility - a role that would normally be associated with rule makers themselves. For example, the requests that regulators ensure that national legislation be in place to permit financial institutions to play their part in the fight against terrorism. There is no question that the banking community is committed to fighting terrorism although this open 'lobbyist' approach may in part also have been a reaction against the apportioning of responsibility in the aftermath of September 11th, and it reveals the level of confidence the Group has developed when it comes to interacting with regulators.

In some areas there are tensions between the views of regulators and bankers: The banks are increasingly uneasy about the extension of rules, which, whilst they may make sense in private banking may not be appropriate to retail banking or other sectors of the industry. To counter this tendency to generalise, the banks are trying to indicate to 'Basel' what is realistic and where a more flexible risk management approach would be more effective. It could be said that one of the main

achievements of the banking industry during these last two years has been to win the regulators over to follow a 'risk based approach' when developing their norms, as opposed to one that is rule based^{xiv}.

What though are the differences between these 'risk' and 'rule' approaches? The latter is the preserve of the State acting autonomously at national level, be it in response to international obligations or in self interest. The risk management concept also involves the making of rules and procedures but at the micro-level of the individual company although they too may also be in response to legislation or international recommendations - so thus far there appears to be common ground between the two approaches. But the rule based approach deploys abstract, prescriptive norms and is reactive in the sense that it takes account of past failures in the system. Risk management on the other hand tends to be practice based and is rooted in both past and ongoing business experience. Thus one of the characteristics of risk management is its flexibility: Whilst there are internal compliance procedures to be followed, there are also systems that enable the risk parameters to be altered by the individual company - and this can manifest itself in clashes between those at the business front-line and those responsible for the management of risk, particularly in highly competitive markets. This sort of tension may be the downside of the risk based approach but at the same time it seems that those companies that actively promote and develop their risk management systems are also typically in the top quartile in performance terms and exhibit the best in class governance and control capabilities^{xv} - perhaps the traditional view of compliance as a costly burden may gradually be revised.

Other characteristics of risk management in this context take into account the components of business risk and certain aspects of operational risks in an inter-linking strategic and policy network. This means that the management of risk has fully evolved from a back office function into a CEO concern: The strategy aims to ensure that risk management is embedded in the organisation through a framework that is specifically designed and implemented in which risk is identified, quantified, controlled and reported^{xvi}.

In terms of outcome there are also differences between the two approaches. Following the rules may still leave the onus of the outcome on the State, because those that comply with the law cannot be held responsible for shortcomings that were not envisaged by the regulations. This though is not particularly constructive in the changing environment in which private banking operates. Traditionally risk management has focused on controlling large losses which have historically been associated with credit and market risks. Whereas it is increasingly the case that large losses come from business and operational failures (and private banking is particularly exposed to certain types of operational risk)^{xvii}. Thus it is not an adequate response for banks merely to comply with legal obligations; strategies that address the risks have to be adopted - and here the banks take the responsibility upon themselves to meet this challenge.

In practical terms the banks have been given the green light to start monitoring customers with simple (and relatively cheap) means, unless risk indicators are detected. Once risks manifest themselves the financial institutions can activate a highly differentiated and graded approval of further investigation - a system that is far more efficient than the standardised ticking of boxes of the early days of AML compliance. Just as an illustration of this 'risk based approach' are the new procedures applied in cases of so called 'PEPs' (politically exposed persons), identifying officials, legislators members of the government, high ranking military and their entourages and establishing bona fide / legitimacy of the acquisition of their funds.

On the other hand banks need to be ready to do more on the identification of beneficial owners, which would include understanding the structures related to corporate entities that may be used by natural persons to open anonymous accounts^{xviii}. To date banks did enquire and take note of the information they received, rarely did they, however require documentary evidence for the beneficial ownership. As part of the risk based approach - the Basel CDD paper encourages the banks to go beyond their current standard - here Wolfsberg needs to be adapted to the Basel recommendation which states that a banking relationship should only be established once the customer's identity has been satisfactorily verified^{xix}. Of course as mentioned above, the contents of the Basel paper are not automatically law

but are recommendations to supervisors of member states that might still be watered down at a national level. Therefore it is crucial what the Group defines as best practice.

The convergence by regulators and bankers on the risk based approach has resulted in the empowerment of financial institutions to develop far reaching new concepts in areas such as correspondent banking and agents, and these are briefly previewed at the end of this chapter.

6. Recent Developments

Of course the Wolfsberg Group has not been left untouched by the events of September 11th 2001. It was impressive to realise how quickly the Senior Compliance and risk officers of the key banks grasped what the impact of the terrible events could have on their institutions. Already on the evening of the fateful day their systems were in a position such that they were ready to hunt for names. Although searching on the basis of lists of names and organisations is part of the pattern of preventing and tracing the finances of terror, it is not an area that would typically come within the domain of private banking. The focus of terrorists has not usually been comparable to large scale economic crimes - and far smaller sums are involved. Such amounts typically fall in the sphere of retail banking rather than private banking. This has implications for the standards of awareness that banks should maintain - by necessity they have to be lower in routine business - the example of payments to 'students' who perpetrated the attacks in the US, is only one of the most striking to illustrate the difficulty. Therefore expectations that banks may autonomously be in a position to detect funds primarily destined to finance terrorist activities should not be high. This difficulty is accentuated by the unwillingness of many national regulators to define 'terrorism', leaving banks without abstract guidance, rendering it difficult for them to translate such concepts into risk management mechanisms. As has already been mentioned this problem clearly has influenced the Wolfsberg Statement on terrorist financing, and whilst the banks have unequivocally pledged co-operation, they have also requested information - similar to the way in which they are used to dealing with embargo cases.

7. Future Moves

a. Wolfsberg as a key partner in developing the new FATF recommendations

The most significant current text - apart from the Basel paper - is without doubt the Consultation Paper of the FATF^{xx}. Much of what has already been addressed has been picked up by the FATF review: And the FATF is once again ready to discuss the range of entities covered by its CDD rules. It is also interesting that for the first time it concentrates on actual CDD procedures including such issues as the reliance on third parties to perform identification and verification obligations.

It is to be expected that the Wolfsberg Group will be a valuable contributor in the consultation process since it can credibly argue which measures are practicable. On top of this the Wolfsberg sub-working groups have developed some very original concepts in specific areas, especially on 'correspondent banking' and on 'agents and introducers'. The major contribution lies in its concrete elaboration of what risk based due diligence means in these areas, namely what questions need to be asked about 'respondent banks' in relation to the status of their supervision which may differ greatly according to company domiciles.

b. Will Wolfsberg Grow?

The Wolfsberg Group currently comprises twelve banks, all of which have a significant private banking business segment. There are obvious advantages and attractions of being part of a small group - and to name a few - include the way the decision making processes function, the practicalities of drafting, the development of trust amongst the participants and ensuring active participation in the meetings. The down side of remaining a small group is that accusations of elitism and exclusivity may

be levied - although a place in the Group is not a prerequisite for an institution to adopt the Principles and to implement them within their own organisation. Also if the scope of topics that the Group examines in the future overlaps into other areas of business that their banks are engaged in, then this may also have implications both for existing and potential members.

One commentator, in looking at the potential of the Wolfsberg Principles, has picked up on their global application, and has suggested that the disbursement of funds by international financial institutions (such as the World Bank) should be given to financial institutions that are transparent and apply the very highest standards of AML policies and procedures. This 'white listing' of banks that impose standards on their operations world wide would combat the problem of regulatory arbitrage and draw on the best features and practices of the FATF, the Basel Group and the Wolfsberg Principles^{xxi}.

The role of facilitators and consultants who played a pivotal role in the early part of the process in getting the initiative up and running will continue to be important - not least to counter anti-competition regulations. Moreover, in a situation where there is no formal monitoring mechanism the presence of civil society does at least provide an external presence that increases the Group's credibility in the wider world. On the question of expansion, the non-governmental organisations that chart the developments of the Group would like to see the Principles as widely adopted as possible and would perhaps therefore prefer to see some sort of expansion plan. On the other hand they may take the view that now that the banks have shown their willingness to confront the risks of money laundering, then why not address other areas of concern as well - and thus regard expanded membership as less of an issue than the fact of having established an entrée into the senior echelons of some of the largest banks.

ⁱ See www.Wolfsberg-Principles.com for the full text of the Wolfsberg Principles and the Wolfsberg Statement on the Financing of Terrorism. The original Principles were made public on October 30 2000 in Zurich, Switzerland.

ⁱⁱ In the period 1987-1996 US banks filed 77 million CTR 's leading to 3000 money laundering cases with 7,300 people charged; of which 2,875 were found guilty.

ⁱⁱⁱ <http://www1.oecd.org/fatf/>

^{iv} Bank for International Settlements: Basel Committee on Banking Supervision: Prevention of Criminal Use of the Banking System for the Purpose of Money Laundering, Statement of Principles, December 1988.

^v UN Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances, 1988 concluded in Vienna on 20 December 1988.

^{vi} Financial Stability Forum, Working Group on Offshore Financial Centres Report, April 2000.

^{vii} Convention on combating Bribery of Foreign Public Officials in International Business Transactions, 21 November 1997, signed on 19 December 1997, in force since 15 February 1999.

^{viii} Minority Staff Report for Permanent Subcommittee on Investigations; Hearings on Private Banking and Money Laundering: A Case Study of Opportunities and Vulnerabilities (see www.senate.gov/gov_affairs/110999_report.htm)

^{ix} Bank for International Settlements: Basel Committee on Banking Supervision Working Group on Cross-border Banking, Customer Due Diligence for Banks, October 2001.

^x For examples of press comment see; The New York Times, editorial 11.6.2000, American Banker, 11.6.2000, Financial Times, 23.10.2000, The Banker, 01.10.2001, for further references see also the press comments section of the Wolfsberg Principles web site.

^{xi} See International Counter-Money Laundering and Foreign Anti-Corruption Act 2000, House of Representatives Report 106/2728, Committee on Banking and Financial Services, Chairman Leach.

^{xii} Ibid. Paras. 8-17.

^{xiii} Ibid. P.5 footnote 4.

^{xiv} Ibid. Para. 20.

^{xv} PA Consulting Global 'IRM' Survey 2001.

^{xvi} Ibid.

^{xvii} Tim Shephard-Walwyn, Operational risk Management in Private Banking, Association of Foreign Banks in Switzerland, Zurich 21 June 2002.

^{xviii} Basel Committee on Banking Supervision, paras. 32-33.

^{xix} Ibid. Paras. 21-23

^{xx} Financial Action Task Force on Money Laundering : Review of the FATF Forty Recommendations Consultation Paper 30 May 2002.

^{xxi} Jonathan M. Winer, Globalization, Terrorist Finance, and Global Conflict Time for a White List?, EJLR Special Edition on Terrorist Financing, 2002 forthcoming.