WORLD-CHECK™

REDUCING RISK THROUGH INTELLIGENCE

MARCH 2009

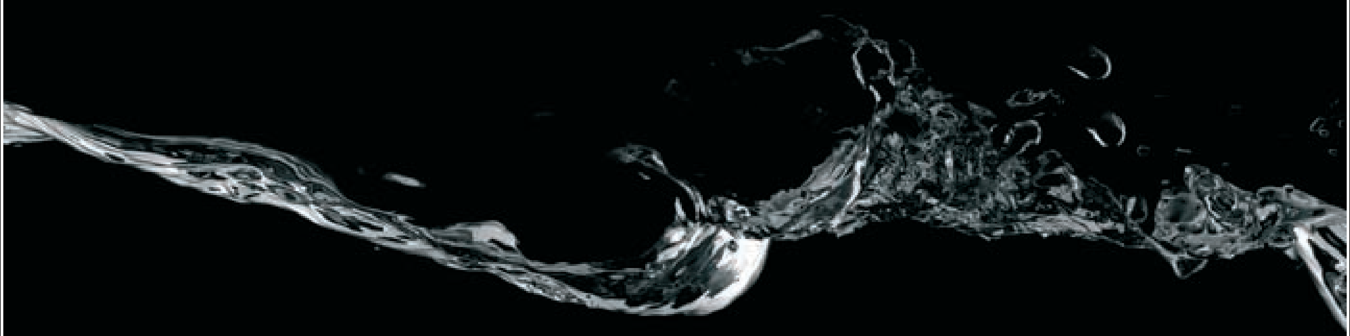
Expert Talk

Dangerous riptide threatens financial institutions

by guest contributor Dennis M. Lormel (IPSA International Inc.)

Newsletter by World-Check, the recognised authority on reducing risk through intelligence.

www.world-check.com/experttalk



A riptide or rip current is caused after waves coming in from the ocean hit the beach. The receding water is referred to as a backwash, causing a rip current on the surface. The bigger the waves, the more dangerous the riptide becomes to swimmers. In a strong riptide, swimmers are at greater risk of being caught in the backwash. The ultimate consequence is drowning.

Riptides occur on the surface and swimmers trapped in them have a chance to survive by relaxing and swimming across the current, parallel to the shoreline. Unfortunately, the natural tendency is to swim against the current directly toward shore. This places the swimmer at higher risk of tiring and drowning.

More harrowing is an undertow. Undertows are currents along the bottom of the backwash. They pull their victims down beneath the surface. A strong undercurrent can knock a swimmer down and drag that individual out to sea on the bottom of the ocean. This makes the risk of drowning far greater.

"Although financial institutions are being forced to downsize staff and budget because of the losses they are sustaining, it does not relieve them of their Bank Secrecy Act (BSA) compliance and reporting obligations."

What is the relevance of this information to financial institutions?

Many financial institutions are currently treading water in an ocean of economic uncertainty. They are having enough trouble staying afloat without having to worry about riptides, or worse yet undercurrents. Regrettably, the waves hitting the banks attempting to stay afloat are growing larger and more violent making it more difficult for those institutions to tread water. Consequently, the resulting riptides and undercurrents are gaining momentum and becoming extremely dangerous.

As the financial crisis worsened over the last six months, many thousands of bank employees have lost their jobs. As this situation continues to grow bleaker, the layoffs will continue. In addition to the alarming number of layoffs, institutions have had to slash budgets dramatically. These overwhelming resource reductions are placing institutions at greater risk of falling prey to dangerous riptides or worse, a fatal undertow.

Although financial institutions are being forced to down-size staff and budgets because of the losses they are sustaining, it does not relieve them of their Bank Secrecy Act (BSA) compliance and reporting obligations. Many of the people being retrenched are compliance professionals. The loss of talent and experience, coupled with likely diminished compliance capability, could well be the next crippling blow causing one or more financial institutions to drown.

The BSA requires financial institutions to establish and maintain robust Anti-Money Laundering (AML) programmes. An AML programme has four mandatory requirements:

1. Development of internal policies, procedures and controls
2. Designation of a Compliance Officer
3. Ongoing employee training programs
4. Independent audit function to test programs

Essentially, financial institutions must have the ability to assess and mitigate risk.

They must have the ability to monitor their systems for risk and to establish controls to ensure they meet all BSA reporting requirements, the most important of which are suspicious activity reporting and Know Your Customer policies and procedures.

The loss of highly qualified compliance professionals and the potential of decreased monitoring make it extremely challenging for financial institutions to adequately meet their reporting requirements. In many institutions, compliance professionals are not considered revenue generators, only cost centers. Therefore, a mindset could easily exist among senior business executives that compliance professionals are more expendable. This rationale is pervasive in the industry and incredibly flawed. Compliance professionals may not be revenue generators. However, given the opportunity to perform and meet their obligations, they are revenue savers and/or loss preventers. If business executives follow their natural instinct and opine to cut compliance professionals because they are merely considered cost centers, then they will find themselves swimming against the riptide and will be more likely to drown in unnecessary business risk.

In today's monetary crisis, many financial institutions are taking responsible steps to reduce unnecessary overhead. There are a number of internal institutional redundancies, where reductions are justified. This is particularly true where fraud, security and/or AML programmes overlap by virtue of having been stove-piped or having been duplicated as the result of mergers or acquisitions. In those instances, compliance resource reductions are generally more justifiable. However, compliance staff reductions must be assessed for the potential risk of inability to adequately meet BSA reporting and monitoring requirements.

"How can compliance professionals continue to learn about the nuances of money laundering, emerging trends, and to adequately understand terrorist financing, if they do not receive appropriate training?"

The two elements of the AML programme mandatory requirements that are most susceptible to budget cuts are training and internal controls. Training budgets have probably been sliced to the bone. How can compliance professionals continue to learn about the nuances of money laundering, emerging trends, and adequately understand terrorist financing if they do not receive appropriate ongoing training? Likewise, internal controls and monitoring capabilities have likely been reduced to more minimal levels. Any reduction in controls and/or monitoring capabilities place financial institutions at greater risk of vulnerability.

How much compliance risk is your institutions willing to accept in order to meet budget reduction demands?

A troubling reality exists. Budget cuts have not escaped the attention of fraudsters, money launderers, and terrorist financiers. The best of these bad guys know how to identify systemic weaknesses and exploit them for their illicit purposes.

On 12 February, 2009, Director of National Intelligence (DNI) Dennis C. Blair appeared before the Senate Select Committee on Intelligence. He testified that instability in countries around the world caused by the current global economic crisis is the primary near-term security threat to the United States. DNI Blair expressed the concern that the financial crisis could cause high levels of violent extremism, which could lead to regime threatening instability if the situation persists.

When discussing terrorism during the hearing, DNI Blair advised that al-Qaeda and its affiliates and allies remain dangerous and adaptive enemies. In view of the tenuous state of financial firms and the resultant resource reductions, which could cause compliance shortfalls, will al-Qaeda and/or regional groups demonstrate their adaptability and exploit the financial system to facilitate new terrorist attacks? This is a serious concern with national security implications.

Given the massive problems the financial crisis is causing financial institutions, and in consideration of both the economic and National Security risk, there are three questions financial institutions should answer:

1. How far are they willing to cut their compliance programmes and risking non-compliance with BSA reporting requirements?
2. Do they have a belief that the regulators will give them a pass from BSA reporting requirements because of the perilous position they are already in?
3. What are the consequences they are willing to risk?

Before answering these questions, financial institutions should come to the realisation that they could be swept up in a dangerous riptide or undertow. Will they swim across the tide and reach safety, or will they swim against the tide and drown? It will be interesting to see the choices made as this unprecedented financial crisis plays out.

About the author

Dennis Lormel joined IPSA in July 2008 as a Managing Director of the Northeast region.

In this role, Mr. Lormel focuses on Anti Money Laundering (AML) and Combating the Financing of Terrorism (CFT) issues, fraud and financial crimes affecting IPSA's clients globally.

He retired from the Federal Bureau of Investigations (FBI) in 2003, following 28 years of service as a Special Agent. Mr. Lormel served as Chief, Financial Crimes Section, and during his FBI career amassed extensive experience directing numerous high-profile investigations, particularly in complex, document and labour intensive financial cases.

In addition, Mr. Lormel developed, implemented and directed the FBI's comprehensive terrorist financing initiatives following the September 11th attacks, which evolved into a formal division of the FBI known as The Terrorist Financing Operations Section.

He is the recipient of numerous commendations and awards to include the Department of Justice, Criminal Division's Award for Investigative Initiatives and the Central Intelligence Agency's George H.W.Bush Award for Excellence in Counter terrorism. Mr Lormel currently serves as Advisor to the Congressional Task Force on Combating Terrorist Financing.

Visit www.ipsaintl.com