The risk-based approach of the new Swiss customer due diligence rules

by Eric Stupp, Bär & Karrer

The Swiss Banking Commission as well as the Swiss Bankers Association have issued new customer due diligence rules. Financial intermediaries such as banks and securities dealers have to undertake an assessment of all their business relationships in order to single out those which may pose increased reputational risks. Furthermore, financial intermediaries are required to implement an electronic system which allows an ongoing monitoring of transactions. Finally, financial intermediaries must ensure that their branch offices or subsidiaries outside Switzerland comply with the principles laid down under the new rules.

Supervisors around the world are pushing their banks to have adequate controls and procedures in place so that they know the customers with whom they are dealing. These know-your-customer-rules originated from the fight against money-laundering and are nowadays also seen as a tool to limit reputational, operational, legal and concentration risks of financial intermediaries. The Swiss authorities are committed to fully complying with the standards of the Financial Action Task Force (FATF), the Bank for International Settlements and other international institutions and have revised the rules concerning customer acceptance, customer identification and ongoing monitoring of high-risk accounts. These new rules will come into force on July 1, 2003.

As a result, financial intermediaries such as banks and securities dealers in Switzerland are in the process of modifying their internal compliance programmes in order to meet the revised rules and regulations.

The basic regulatory concept

The new customer due diligence regime is split in two distinct parts. On the one hand, the Swiss banks' code of conduct with regard to the exercise of due diligence has changed. It contains, as did the previous code of conduct, detailed rules on how the identity of a new client and the beneficial owner of the assets must be documented. On the other hand, the Swiss Banking Commission passed an ordinance concerning the prevention of money laundering. The ordinance sets standards with respect to organisational measures which have to be taken by the banks, as well as the duty of care to be applied for a certain risk category for the full duration of a business relationship with a customer.

The Swiss banks' code of conduct which is focused on the account opening process of a financial intermediary, is based on a "one size fits all"-concept and does not allow any deviation from the formal and specific rules. The ordinance of the Swiss Banking Commission follows a different path. It is not as specific as the code of conduct, leaving some discretion to the banks (together with their auditors) on how they implement the risk-based approach for their institution. In other words the depth of an investigation of a customer relationship may vary depending on the risks typically involved with certain business relationships.

It is to be expected that the new rules will be rather costly to implement, as the basic principles laid down in the ordinance and the code of conduct have to be applied throughout the group of a financial institution for which the Swiss Banking Commission is the home regulator, irrespective of whether branches or subsidiaries are located in Switzerland or abroad. At least did the Swiss Banking Commission abstain from imposing a duty to establish a centralised data base of all business relationships throughout the group of the financial intermediary. It is sufficient if internal control bodies and external auditors at group level have access to information within any of the group companies.

Hurdles for electronic banking and wire transfers

The code of conduct complicates the entering into a business relationship by way of correspondence. It requires individuals to provide a copy of a passport or any other identification document to the bank, independently of whether they reside in Switzerland or abroad. The veracity of the copy must be confirmed either by a notary public, or a financial intermediary instructed by the Swiss financial intermediary based on a written contract, to issue such confirmations. These requirements make it more

burdensome for individuals to open an account with banks which do not have an extensive network of representative offices. On the other hand, under the new rules the requirement that pure internet banks have to meet larger customers in person has been dropped.

Swiss financial intermediaries will have to include the details of the remitting party in all cross-border wire transfers. This means that, e.g. a wire transfer only mentioning "in the order of one of our customers" will no longer be permissible. However, the identity of the beneficial owner does not have to be included in the wire transfer orders. Especially since the terrorist attack of September 11, 2001, Swiss banks have already experienced that correspondent banks refused to execute wire transfer orders because the customer was not properly disclosed.

The classification of the customer base and IT-based transaction monitoring system

Banks have to categorise each business relationship. In order to achieve such a categorisation, they have to undertake an assessment of the abstract risks involved with each customer and must define the appropriate criteria in order to make such an assessment. Such criteria could be, e.g. the domicile of a client or the type and the expected volume of transactions. Such a categorisation of the customer base is an ongoing obligation. As a consequence, banks have to systematically monitor all transactions effectuated on behalf of customers. In order to achieve such an ongoing monitoring of transactions, banks must develop IT-based solutions which automatically alerts the financial intermediary whenever a risk criteria is encountered. Financial institutions must have carried out the classification of their entire customer base by the end of June 2004; the same deadline applies to the ongoing transaction monitoring.

Politically Exposed Persons (PEPs) constitute a risk category where it is mandatory for banks have to exercise heightened scrutiny. The regulatory treatment of PEPs have to be viewed in the light of past scandals, such as Abacha, in which "potentates" abused their position and embezzled funds of the state. Such cases put financial institutions and the Swiss financial market as a whole at a high reputational risk. PEPs

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may be defined as individuals who have been entrusted with prominent public functions, including heads of state or military officials. The most senior executive body of a financial institution has to decide whether the financial intermediary shall enter into a business relationship with a PEP. Furthermore, the most senior management level of such institutional must reconfirm annually whether the business relationship may continue.

Heightened scrutiny for correspondent banking

The ongoing monitoring of business relationships also applies to correspondent banks. This means, e.g. that Swiss financial institutions need to know what business the correspondent banks are active in, what purpose the account of the correspondent bank with the Swiss financial intermediary serves, who manages the banks and what kind of measures it has taken to prevent money-laundering, and whether they are subject to meaningful supervision. On the other hand, Swiss banks are not required to establish the identity of beneficial owners of an account of a correspondent bank, except if signs of abuse exist. Finally, Swiss banks may not maintain business relationships with banks which do not maintain a physical presence in the country of origin (so-called "shell banks").

Additional investigations

As soon as it becomes evident that a business relationship entails higher risks, financial intermediaries must undertake additional enquiries. The goal of such enquiries may, e.g be to check whether the contracting party is the beneficial owner of the assets, what the origin of the assets are or what purpose of withdrawals or large deposits of assets is. Financial intermediaries may appoint a third party to conduct such investigations if:

- a written agreement exists;
- the third party will exercise the same standard of diligence as the financial intermediary;
- the financial intermediary issues specific instructions to such third party; and
- the financial intermediary is in a position to verify that such investigations are carried out diligently.

Expected amendment of the Criminal Code

The Swiss Parliament is expected to amend the Swiss Criminal Code shortly. The envisaged amendment will – similar to many other jurisdictions – make organisations and legal entities subject to criminal sanctions. Financial intermediaries will therefore have an additional reason to introduce and maintain a systematic recording of business relationships and to undertake in-depth investigations into business relationship, namely to escape criminal sanctions.

Final remarks

Great efforts are being made by international organisations to ensure that regulation at the national level does not lag behind international standards. It remains to be seen whether there will not only be a convergence of rules, but also of daily practice in the major financial centres of the world, such as the UK, US, Switzerland or Singapore. If a levelling of the playing field is not achieved, regulatory arbitrage will be unavoidable and thus disadvantage financial institutions with strict home country regulators such as the Swiss Banking Commission, which pursue the fight against money laundering and the avoidance of scandals as a top priority.

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