What Your Institution Must Know About OFAC Sanction Management

Speakers

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OFAC Sanctions– a global challenge and imperative

"Supervisors should be satisfied that appropriate internal controls are in place to monitor wire transfer activity, that these controls are effective, and that banks are in compliance with supervisory and regulatory guidance.".

Basel Committee on Banking Supervision – Consultative Document

"…conducting a broad inquiry into illegal transactions by Iran"……"There are nine other banks we think are doing this"

District Attorney Robert Morgenthau

"There is no single compliance program suitable for every financial institution…OFAC includes any interest whatsoever, direct or indirect, present, future or contingent"

Office of Foreign Assets Control – Q&A

While the cover variant may be viewed as an update to existing standard, in reality it will have significant operational, cost, risk and regulatory implications for organizations who are active in global settlements ."

Ernst & Young

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Who is OFAC?

Office of Foreign Assets Control (OFAC)
US Department of the Treasury

OFAC administers and enforces economic and trade sanctions against targeted:

- Foreign governments
- Individuals
- Entities
- Practices

>> Who must comply with OFAC Sanctions?

Jurisdiction

Individuals

- U.S. citizens and permanent resident aliens located anywhere in the world
- Individuals, regardless of citizenship, physically located in the United States
- Employees of U.S. corporations located outside the U.S.

Corporations

- Organized under U.S. law, including foreign branches of U.S. companies
- Physically located in the U.S., including U.S. branches, agencies and representative office of foreign corporations
- With respect to Cuba/North Korea sanctions, foreign subsidiaries/ controlled entities of U.S. corporations wherever located

>> What are different Sanctions Programs?

Sanctions Programs

Comprehensive Programs

Counter Narcotics Trafficking
Non-Proliferation (NPWMD)
Anti-Terrorism
Sudan
Cuba
Iran
Burma (Myanmar)

Regime-Based Programs

Former Liberian Regime of Charles Taylor
Dem. Republic of Congo
Cote D'Ivoire
Zimbabwe
Iraq
Balkans, Belarus

Limited Programs

Diamond Trading
North Korea
Syria

http://www.treas.gov/offices/enforcement/ofac/programs/index.shtml

>> Who are SDN’s?

Specially Designated Nationals and Blocked Persons

SDNs

- Individuals or entities all over the globe
- Owned, controlled by or acting on behalf of targeted governments or groups
- May be front companies, high-ranking officials or specifically identified persons
- Designated narcotics traffickers, terrorists, terrorists groups and support networks

http://www.treas.gov/offices/enforcement/ofac/sdn/index.shtml

>> Where and why are organizations at risk?

Where and why are organizations at risk?

- Increased regulatory scrutiny, and higher visibility and scale of sanctions/fines by OFAC and bank regulators.
- Accountability for robustness and quality of technology solutions used to enable the sanctions programs.
- Potential poor management of conflicting sanctions regimes leads to regulatory exposures and potential violations.
- Existing data quality issues, vendor updates or errors in list management can severely diminish a programs quality and sustainability – again leading to unintended violations and penalties.
- Full compliance must be achieved in severely cost-constrained environment.
- Lack of/insufficient training to ensure employees are aware globally.

>> What constituent programs should be part of comprehensive OFAC compliance program?

Compliance Programs

1. Risk Appraisals
2. Internal Controls
3. Internal Testing and Audits
4. Compliance Officer
5. Training

FATF: Manage and mitigate illegal activities through deterrence, detection and record-keeping

>> How can I apply risk based approach to OFAC compliance program?

The Scope for OFAC Reviews is Broad

- International Fund Transfers
- Nonresident Alien Accounts
- Foreign Customer Accounts
- Cross-Border ACH Transactions (IATs)
- International Trade Finance
- Electronic Banking
- Stored Value, Pre-Paid Cards, “Plastics”
- Foreign Correspondent Banking
- Payable Through Accounts
- International Private Banking
- Overseas Branches of Subsidiaries/controlled entities (Cuba/North Korea)

>> How can I better monitor, manage and mitigate OFAC compliance risk?

Internal controls

Screening is the foundation of an effective compliance policy

Updating compliance programs and using the most current SDN list

Reporting

Record Keeping

Internal controls – due diligence

Individuals

- Full name (first, middle, last), POB, DOB, nationality, full address (no P.O. Boxes), national ID number, passport number.

Commercial entities

- Full name (not just acronym), location, tax ID number, ownership structure.
- Review for possible affiliation with sanctions targets.

Internal testing and audits - characteristics

- Conducted **independently**
- Completed at a minimum **annually**
- Contain an **audit scope** commensurate with institution's risk profile.
- **Report violations**

Internal testing and audits - purpose

- **Remediate** any deficiencies found through audit
- **Identify** what remedial steps have been taken
- **Assess** the effectiveness of remedial action

Designating a Compliance Officer

- Should be **knowledgeable** about OFAC
- Should maintain **strong lines of communication especially with Senior Management**
- Must develop a **written compliance program**
  - **Should it be a global one, regardless of where the company is located?**
- Should designate a **back-up** officer

Compliance training - tips

- Ensure that **all employees** involved in high risk activities understand OFAC
- Provide **practical** examples of issues that may arise
- Train **new hires** in OFAC compliance
- Conduct training on an **on-going basis**

>> What are the key challenges in managing OFAC Sanctions compliance?

Summary of key challenges

- Heightened governance and oversight
- Global Scope and inconsistent standards
- Customer Data Issues
- Internal Technology Issues
- List management, data and name matching
- Technology implementation and integration
- Other Issues

Heightened governance and oversight

- Institutions must implement programs successfully across multiple business lines in diverse locations
- Constructing a cross-border sanctions program includes:
  - Establishing clearly defined policies, procedures and guidelines
  - Includes both regional and global requirements
  - Developing a system for handling results of screening
    - work instructions
    - guidance on processing “hits”
    - Recordkeeping
    - escalation protocols

Heightened governance and oversight (Continued)

- Instituting the appropriate operating model
  - Selecting suitable technology
  - Conducting staff training
- Ensuring the overall accuracy of the sanctions program components
  - Enhancing and maintaining on an ongoing basis
  - Implementing systems to ensure the controls

Customer Data Issues

- Wide variety of businesses present challenges for screening
  - Data capture issues
    - What is the relevant info you want to screen
    - What do you do if you have the info (name, address, principals/beneficial owners/products)
      - Are you screening appropriately
      - On front end, real time, at SDN updates, periodically, at changes in customer info
      - Must you verify (e.g., beneficial owner)
    - What do you do if you don't have it
      - Need to assess the risk
      - How do you assess it
      - What is a sufficient risk assessment
      - What is sufficient documentation if you transact with SDN

Internal Technology Issues

- Limitations of company database/systems
  - Systems don’t talk to each other
  - Prohibited relationships uncovered in one business are not identified in another
  - Foreign language issues (screening tool screens English data only)
  - Data privacy limitations
    - Corporation’s customer
    - Employee info

List management, data and name matching

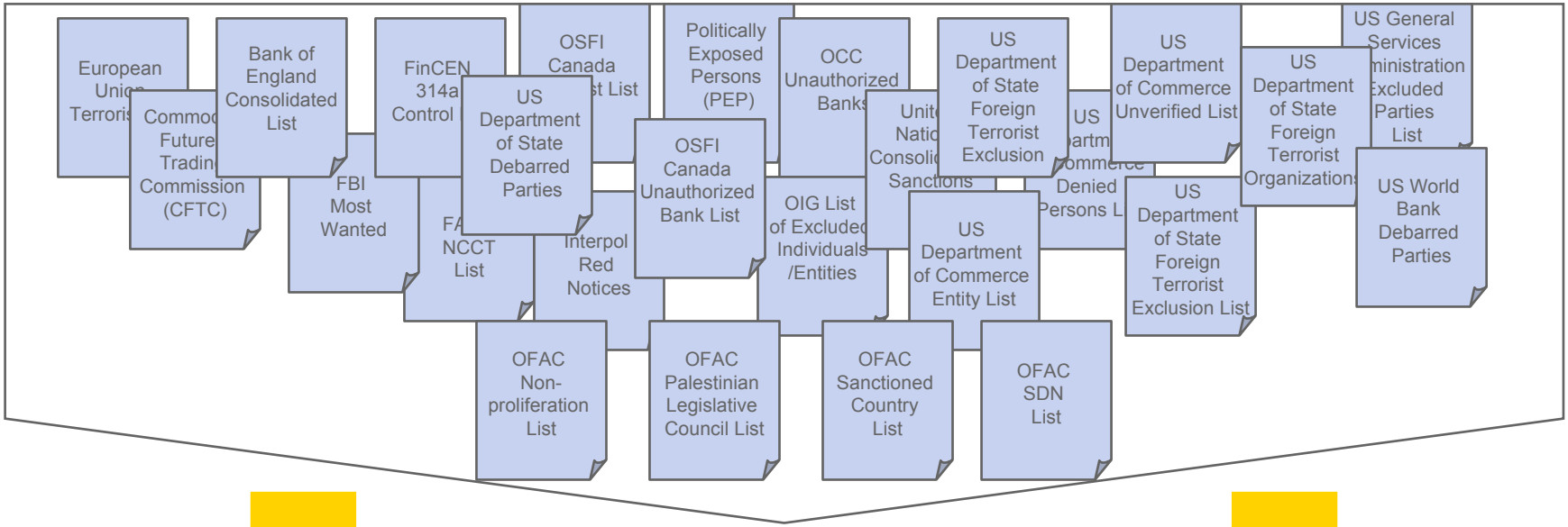
- Errors can occur during list updates, even when using testing vendors solutions
- Timing/frequency of updates can impact screening effectiveness
- All sanctions lists are not the same
  - Lists vary by provider and region
- Constantly changing target lists
  - Requires firms to regularly screen new and existing relationships
- Sanctions lists may not include complete verification information
  - Accurate address or date of birth information may be missing

Other Issues

- Antidote/antidiscrimination legislation
- How far downstream should you screen (e.g., customer's customer)
- Joint venture/partner relationships
  - Can you/should you rely on their compliance processes
  - What about their agreement to OFAC screen: is it good enough?
  - Vendor Screening
- Validating current systems and processes
  - Are you testing sufficiency of sanctions compliance processes
  - Is your screening tool really effective
- Economics of enhancements
  - How far must/should you go?

>> How can list management be rationalized?

Multiple points of failure in list management



How can these be rationalized?

List management, including fuzzy matching, is key to the scanning process because:

- Lists do not have a consistent structure
- The nature of the "sanction" is variable
- Lists are updated at different frequencies; including daily
- Certain entries will appear on multiple lists
- A "match" might require several different actions
- False positives are common in certain languages
- Data on lists can be incomplete
- Entries can be deleted as well as added

List management controls:

- Complete, accurate and timely
- Must be current version in operation
- List dissemination from a central control point, with no local alteration
- Updates should be tested to ensure operation
- The list should be secured to prevent unauthorized access
- Accountability, including attestations and nil-returns, should be in place to ensure control operation

Effectiveness of screening relies on quality of data

- Customer and transactional data must be consolidated, validated and managed to ensure quality and correctness to reduce false positives

Challenges	Solutions or Mitigations
► Customer records and transaction data is inconsistent, invalid, incomplete, and/or out-of date due to varying on-boarding processes, changes to systems and ongoing maintenance	► Define data governance standards and processes to prevent future data issues ► Use data cleansing tools to validate and investigate potential data gap ► Find patterns of gaps and control deficiency for root cause analysis and the development of on-going monitoring
► Effective screening requires imports from multiple data feeds consisting of various formatting standards, such as: negative news, customer Information, and transaction data	► Customize solution to meet various data input and output layouts ► Properly identify data ownership to ensure accountability and authority ► Create data quality check points to validate quality of information flowing through various systems
► Front-office may be resistant to collecting additional information from customers due to concerns about losing them as a result of perceived invasiveness	► Use automatic triggers and workflows to enable the front-office to request customer information as efficiently as possible, or only when necessary
► Customer records and relationships are difficult to match between disparate systems and data sets ► Customers hold multiple, unlinked products with no common identifier	► Use data cleansing tools to normalize data ► Use data analysis and advanced matching capabilities to match linked customer records to third party sources

Name matching challenges

- Name matching is imperfect and error prone
  - Updated lists need to be checked for accuracy, format and completeness
    - Abbreviations
    - Short names
    - Initials
    - Family name order
  - Names often come with multiple translations
  - Non-roman alphabets
  - Common names (e.g., John Smith)
  - Phonetic spellings
  - Transcriptions
  - Inconsistent conventions by the media
  - Short vowel, long vowel, diphthongs, doubled consonants, digraphs and visual representation
  - Capitalization

>> How technology can help in improving OFAC Sanctions management?

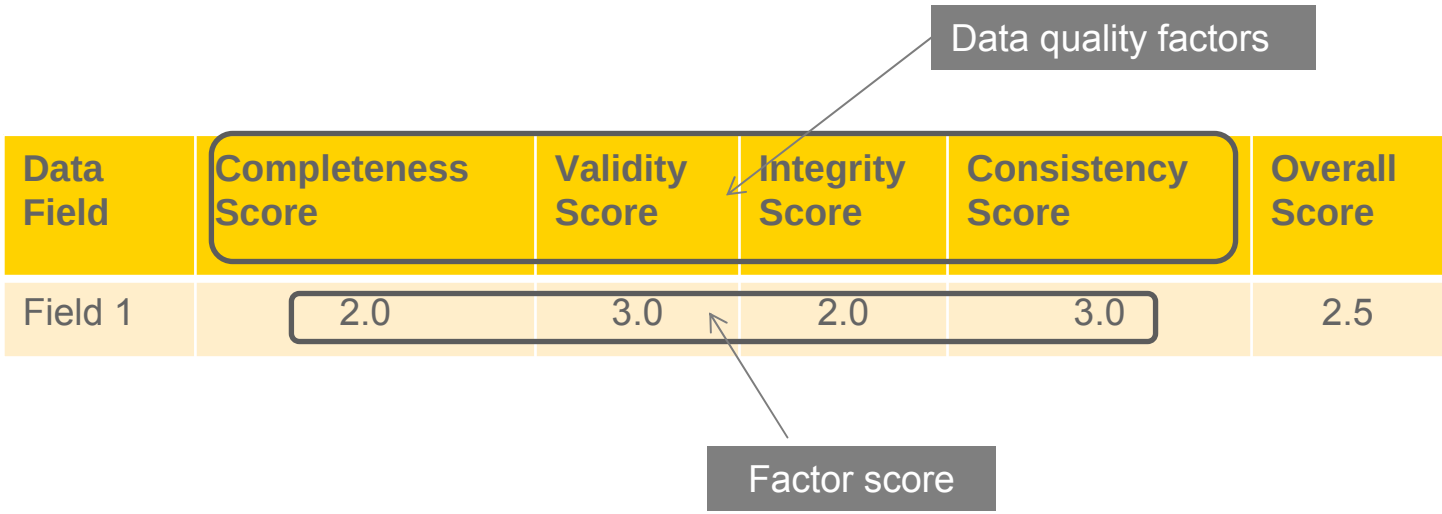
Effective technology enablement

- The challenge in electronic screening is to correctly flag records involving sanctioned parties while minimizing the number of false positive matches
- If the optimal system is not implemented, or the adjudication process is not clearly defined, analysts are quickly overwhelmed by the considerable workload
- Firms struggle with selecting the appropriate technology and integrating various components into a cohesive and effective AML surveillance system:
  - Sanctions screening
  - Know your customer
  - Transaction monitoring
- There is no one size-fits all; may require different technology solutions

Data quality remediation

Data quality assessment

- Data quality matrix can help assess the data quality and identify remediation control



Data quality matrix (Illustrative)

Data quality remediation (continued)

Data remediation techniques

- **Data profiling** tools to investigate data gaps and match linked customers
- **Data cleansing** tools to normalize data
- **Data quality checks** to prevent invalid, incomplete, inconsistence data

Data remediation process and controls

- **Data governance standards and process** to prevent future data issues
- Identify and establish **data ownership and stewardship** to ensure data accountability and authority

>> How can false negatives can be prevented?

Fuzzy matching is key to effective matching

Fuzzy matching

- Matching software uses fuzzy logic to match data fields and generate the confidence score depending on the closeness of the match
- Higher the score, closer is the match. Score of 100 is considered to be perfect match

Match Criteria	Record 1	Record 2	Match Result
First Name	John	Jonathan	No Match
Last	Smith	Smith	Match

Exact Match (Illustrative)

Match Criteria	Record 1	Record 2	Match Result
First Name	John	Jonathan	Partial Match Score = 95
Last	Smith	Smith	Match

Fuzzy Match (Illustrative)

Identification of potential matches

Current matching process only identifies exact matches. **Fuzzy logic** can be used to identify **potential matches** where exact match is not possible

Match matrix is most critical part of the matching solution

Match matrix

- It is a set of rules defining which fields will be scanned, match priority and what is the tolerance when the match is not exact
- The hits generated are as good as match matrix

Matching rules

- Matching rules are match conditions used to match data extract against the watch list
- Purpose of the match rule is to identify the matches between target list and watch list

Rule priority

- More correctly the rule can identify an entity, higher is the rule priority
- Match results can be improved by setting the correct rule priority and exclusions

Match tolerance

- The tolerance used to generate a potential match
- Matching software generates match confidence score for potential match. It should be analyzed and calibrated in order to maximize the effectiveness of the screening process

Match matrix – example

Matching Criteria				Match Confidence Score	Matching Rule
Name	Address	SSN	Date Of Birth		
				90	Match Name
					Match Valid SSN
					Match Name and Address
					Match Name and Address
					Match Name, Address, SSN and Date of Birth

High Priority Medium Priority Low Priority

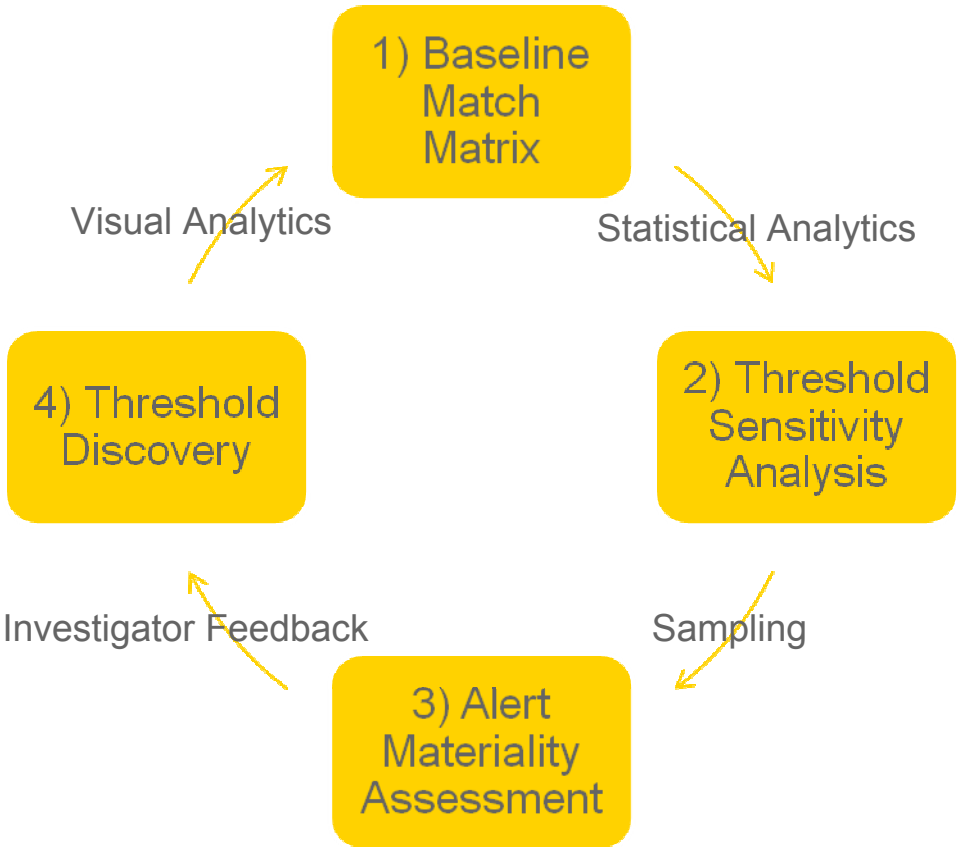
Match Matrix (illustrative)

- SSN match rule has the highest priority since if we have a perfect match on the SSN then we don't have to think further. We know that two people can't have same SSN
- Name match rule, name and country match rule are assigned low priority as it is highly likely that you can have people with same names
- If we have exact match on name, SSN and address then we have a perfect match. This rule is also assigned the highest priority

Tuning can help reduce false positives

Tuning

- The modification of match confidence score threshold values to identify potential matches while reducing the number of false positives is considered rule tuning



Tuning (continued)

1) Baseline Match Matrix

- Decide matching fields, initial matching rules and default match confidence threshold

2) Threshold Sensitivity Analysis

- Apply statistical analysis to determine different threshold value and its impact to alert volume

Match Rule : An alert is triggered if name or SSN or address match between a customer and a suspect is above match confidence score of X

The threshold sensitivity assessment measures the impact of modification of threshold values on the total number of potential alerts being generated

Threshold		Step Down	Baseline	Step up	Trend	Sensitivity
Match Confidence Score (X)	Relative	80	85	90	O(X)	Moderate
The match confidence score should be greater or equal to this score in order to generate an alert.		1262	975	694		

Generate alert estimates for variation of threshold values.

Provide sensitivity rating for threshold based on potential alert estimates

Threshold Sensitivity Analysis (illustrative)

Tuning (continued)

3) Alert Materiality Assessment

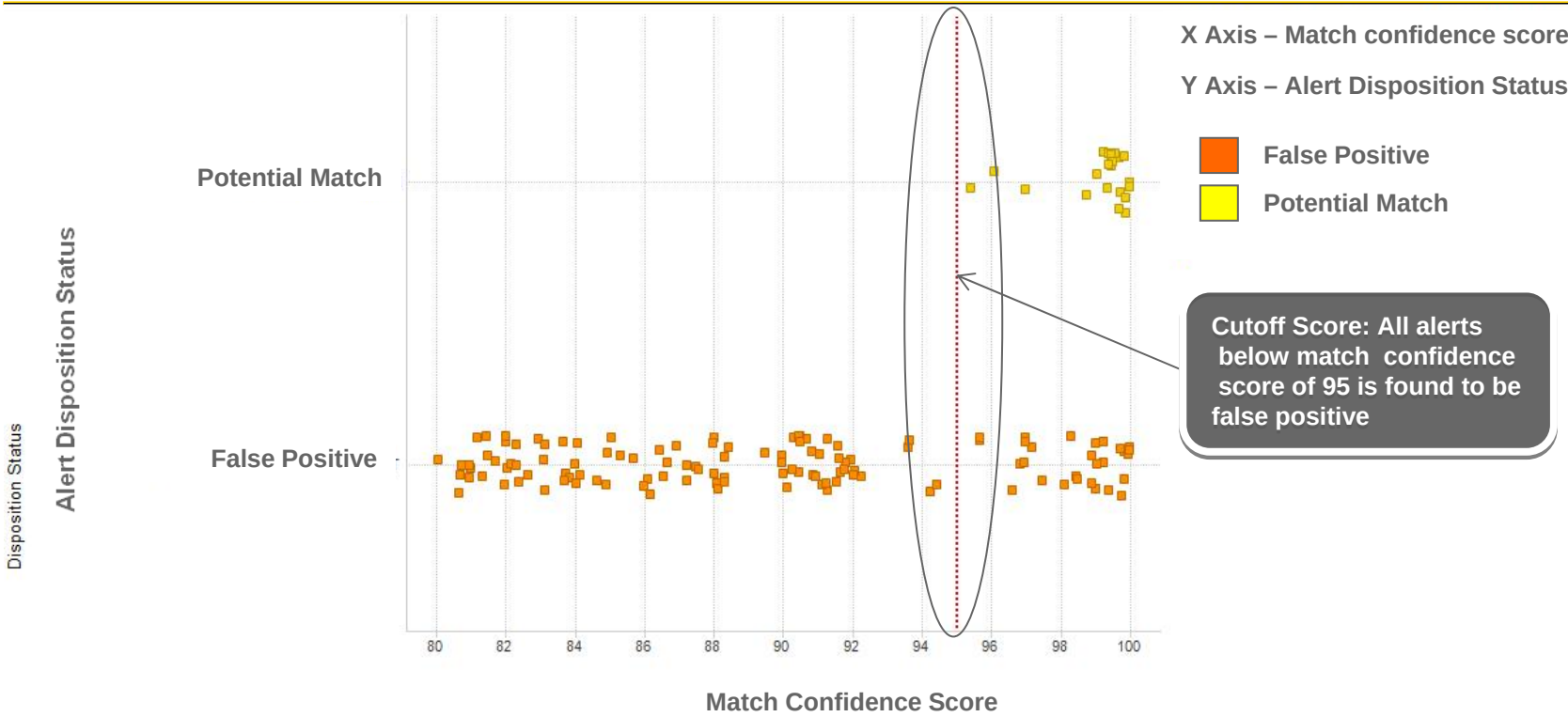
- Select alert samples using sampling tools
- Record investigator feedback and decision on these alerts

Match Confidence Score	Total Number of Alerts	Number of Sample Reviewed	Number of "False Positive" Alerts	Number of "Potential Match" Alerts
80-84	292	30	30	0
85-89	283	30	30	0
90-94	322	33	33	0
95-99	127	20	13	7
100	238	29	14	15
Total	**1262**	**142**	**120**	**22**

Alert Materiality Assessment (illustrative)

Investigators reviews the alert and decides if alert is "false positive" or "Potential Match"

Tuning (continued)



Threshold Discovery (illustrative)

4) Threshold Discovery

- Apply visual analytic methods to analyze investigation result and feedback
- Based on the analysis recommend match confidence threshold and match matrix changes

>> What are the leading practices for successful OFAC compliance program?

Leading practices for enterprise level OFAC success

- Formally and fully consider your organization's risk profile and vulnerabilities
- Conduct a comprehensive gap assessment against that risk profile/vulnerabilities
- Establish a sanctions policy; consider supplementing with a business prohibition and ethics policy
- Define a clear operations architecture and systems topology for compliance
- Establish clear accountabilities for governance, oversight, list acquisition and deployment supported with attestation process for list loading
- Establish handling procedures for "hits" and "matches" and a clearly defined escalation plan for notifications
- Deploy a screening system which is operationally and architecturally appropriate for the organization

Leading practices for enterprise level OFAC success (continued)

- Operate an awareness program for client take-on to payment release areas
- Examine specific high risk activities such as message repair, STP and correspondent relationships
- Establish program Key Risk indicators to identify system issues
- Reconcile country, jurisdiction and payment interfaces to ensure full coverage
- Consider technical issues such as:
  - Interoperations with payments systems
  - Security of message queues and system configuration
  - Volume and business continuity
  - List integrity and installation
  - Workflow and case management
  - The ability to extract supporting data including KYC data
  - Version control and patch management
  - English language screening tool and foreign languages

Summary / next steps

- All public news sources point to a future increased application of penalties and criticisms for financial services institutions
  - Evaluate your current governance and oversight
  - Consider and document your risk profile when validating the robustness of controls
  - Don’t rest on your laurels if you have not had control breakdowns in the past: test, test, test
  - Recognize the pressures of the current financial environment ob your program effectiveness
  - Challenge your current technology solutions for consistency and “doing what you think they are doing
  - Revisit current metrics and reporting
  - When issues arise, consider historical implications as well