IR-RAPPORT TAL-FIAU DWAR PILATUS BANK

Dear Mr Ali Sadr,

Compliance Visit

In the exercise of its functions in terms of the Prevention of Money Laundering Act, the Financial Intelligence Analysis Unit (FIAU) carried out an on-site examination in relation to Pilatus Bank Limited ("the Bank") between 15th March 2016 and 22 March 2016 in order to assess the extent of the Bank's compliance with the provisions of the Prevention of Money Laundering and Funding of Terrorism Regulations (PMLFTR). The on-site eamination focussed primarily on the measures in place within the Bank to deal with clients who are politically exposed clients, including individual clients who are Polically Exposed Persons (PEPs) and corporate clients in which there is the involvement of a PEP either as a director, shareholder, ultimate beneficial owner, signatory or holder of a power of attorney.

Officials of the Enforcement Unit of the Malta Financial Services Authority (MFSA) also participated in the on-site examination in terms of Article 27(1) of the Prevention of Money Laundering Act.

The compliance examination comprised an interview with the Money Laundering Reporting Officer (MLRO) as well as an inspection of all the files involving PEPs at the time of the examination. As part of the examination, FIAU offciails also reviewed the following documentation:

The Bank's Anti-Money Laundering and Counter Funding of Terrorism Policy and Procedures;
The Account Opening Forms (completed by the applicant for business) used by the Bank;
The KYC Form (completed by Bank officials);
The Annual Compliance Report (ACRs) submitted to the FIAU; and
The Internal Audit Report dated July 2015.

The conclusions, findings and recommendations outlined below are based on the information and documentation obtained throughout the on-site examination.

1. Politically Exposed Persons

Section 3.5.3.1 of the Implementing Procedures requires subject persons to obtain information directly from the applicant for business as to whether they are PEPs or immediate family members or close associates of PEPs. FIAU and MFSA officials noted that while the KYC form is either completed by the applicant for business or by the bank officials, it is never signed by the applicant for business. Although the form provides an option to mark whether the applicant for business is a PEP, this document was not being signed by the applicant himself.

It should be noted that since the KYC form does not provide an explantion as to who is to be considered a PEP, the Bank should include a comprehensive definition, in line with Regulation 11(7) of the PMLFTR. It is imperative that all applicants for business have a

clear understanding as to what situations would give rise to a person being classified as a PEP so that the correct information is included in the KYC form. This form should in all cases be signed by the applicant for business.

Upon further inspection of the full client list which was provided to the FIAU following the compliance examination, it transpired that there were a number companies which should be classified as having PEP involvements but were not. In terms of Regulation 11(7)(c), any natural person who has joint beneficial ownership of a body corporate or any other legal arrangement, or any other close business relations with a PEP is also considered to be a PEP. The failure by the Bank to identify these involvements to be a major shortcoming, particularly since this would suggest that the mandatory enhanced due diligence measures were not applied in these instances.

2. **Purpose and Intended Nature of the Business Relationship**

Through an examination of the clients' files, FIAU and MFSA officials noted that information relating to the purpose and intended nature of the business relationship was generally recorded in KYC forms. Furthermore, it was stated that upon receipt of a request for the carrying out of a transaction from the applicant for business, information is invariably obtained in relation to the purpose of the transaction. A sample was provided to the inspectors, however it could not be verified whether this porcedure was carried out in all cases relating to PEPs.

FIAU and MFSA officials were also informed that the Bank's Head of Private Banking obtained information during meetings with the ultimate beneficial owners of the companies concerned.

2.1. Source of Wealth and Source of Funds

From a review fo the Bank's ongoing processes and the information maintained in relation to the purpose and intended nature of the business relationship, it was determined that notwithstanding the fact that information on the source of wealth and source of funds was gathered in the KYC form, the information obtained was too generic and clearly did not meet the minimum requirements laid down in the Regulations and the Implementing Procedures. In particular, an assessment was made of the information obtained by the bank in relation to two principal clients of the Bank that are PEPs in jurisdiction posing higher ML/FT risks (Azerbaijan). A generic description of the source of wealth maintained on file listed three businesses owned by the same indiviudals who, according to the MLRO, are high net worth individuals who own a large number of companies. Nevertheless, it was confirmed that this generic information obtained on the source of the persons' wealth is not backed up by documentary evidence and reliance is only made on open-source web-based information.

Although it is understood that the Head of Private Banking of the Bank is on familiar terms with these clients, the obligation to obtain sufficient proof on the source of the wealth on these clients still remains. Indeed, it is concerning to note that insufficient

information is being obtained on the manner in which the wealth of the clients was accumulated, the extent of their involement in business activities and the profitability of the companies generating the wealth that forms the basis of the investments taking place through the banks accounts.

The MLRO informed the on-site inspectors that the compliance department of the Bank is notified of any transaction requests of over €100,00 and that supporting documentation is obtained only in those cases where it is considered necessary. Although the MLRO seems to have some understaning of the transactions being undertaken throughout the course of the business relationship, an explanation of complex and large transactions could only be given by the MLRO following private discussions with the Head of Priavte Banking. The MLRO's lack of awareness and understanding of the transactions carried out in the high risk scenarios that were reviewed, clearly reveals that the bank is being exposed to very high risks of Money Laundering and Funding of Terrorism (ML/FT) without basic mitigating measures being applied. Given the high level at risk, the minimum expected in the circumstances would have been the retention of incontrovertible documentary proof of the source of funds of the deposits and continuos scrutiny by the MLRO of all transactions taking place.

In particular, it was evident in the review carried out by on-site inspectors that the Bank failed to gather sufficient information relating to the source of the funds of certain particular transactions. More detail is provided in the paragraphs below, where some examples of evident systemic failures are highlighted:

- In one particular bank account, the quivalent of approximately €1,000,000 was transferred into an account classified as high-risk from the bank account of a third party. No documentary evidence was recorded on file on the origin of the funds and the MLRO could only provide a generic explanation following discussions with the Head of Private Banking. Furthermore, this third party made a number of other significant deposits to different bank accounts pertaining to companies owned by the same UBOs (PEPs in a high risk jurisdiction) within a short period of time. Once again it was noted that no information on the source of the funds was recorded. The MLRO claimed that a check has been carried out on the third party through an internet search and through the SWIFT program itself which runs all details against sanction lists. However, no supporting evidence was found on file.

- The equivalent of approximately € 505,000 was deposited into the same client's bank account from the bank account of a third party. An explanaiton could only be provided to the on-site inspectors once information was obtained from the Head of Private Banking, revealing that the MLRO is not in the habit of asking probing questions as part of the Bank's ongoing processes for high-risk clients. It appeared that questions were being asked for the first time as this was being queried by the on-site inspectors. When asked why no supporting documentation was obtianed on this transaction which involed the repayment of a loan by a friend of bank's client, the MLRO claimed that the culture of these clients is not one where loan agreements are drawn up in writing but one where agreements are reached through a 'hanshake'.

Furthermore, once the income from three particular companies was the main source of wealth of these clients and various large transactions originated from these businesses, it would have been expected that, as a minimum, accurate and comprehensive documentary evidence was in place and kept in file. Nonetheless, the documentation that was found to have been retained on file, while being relevant, clearly did not suffice for the Bank to meet its legal obligations.

The above represent a few examples of certain transactions for which insufficient documentaion or no documentation whatsoever was available to prove the legitimacy of the funds. What is even more worrying is the fact that the MLRO, notwithstanding her knowledge and understanding of the pertinent laws, is confident that the Bank should proceed with a transaction simply on the basis of a general explanation obtained from the Head of Private Banking. Overall, it appears that there has been a glaring, possibly deliberate disregard of the applicable legislative provisions. There is no doubt that the Bank has to obtain further documentary evidence as proof of the legitimacy of the wealth before taking the decision to establish these business relationships. Moreover, a much higher level of ongoing scrutiny is necessary in cases where there are transactions relating to PEPs from high-risk jurisdictions.

It appears that the Bank and its officials have gone to great lengths to protect the confidentiality of their clients. However, this has been done at the expense of carrying out the customer due diligence required by law. Banking secrecy is not an obsolute value and for the purpose of prevention of ML/FT, banks are expected to document the source of the wealth of their clients and they are required to determine and record the source of funds of the transactions on an ongoing basis. This is particularly necessary in high-risk situations such as those examined by the on-site inspectors. It is, in fact, because of the particular nature of the clients, that even more documentary evidence than in normal circumstances was expected to be obtained. Unfortunately, in failing to obtain such information and documentation, the Bank appears to have failed to meet its legal obligations.

3. Risk Assessment and Risk Management

The type of clients that have been on-boarded by the Bank, the high risk jurisdictions of clients, and the business model adopted by the Bank, is clearly indicative of high risk appetite.

In the circumstances, the minimum expected would be that the risk assessment and risk management procedures of the Bank are robust and exhaustive. However, the compliance examination highlighted that the very high risks to which the Bank is exposed are not being mitigated adequately, if at all, and that it is undeniable that there is a pressing need to augment the risk mitigation measures being adopted, particularly in the circumstances PEPs and high-risk jurisdictions.

4. Enhanced Due Diligence

In terms of Regulation 11(1), the Bank is required to apply, on a risk sensitive basis, Enhanced Due Diligence (ED) measures in situations which, by their nature, can present a higher risk of ML/FT.

The Bank, in fact did classify Azerbaija, being the country of nationality of most of the Bank's PEP clients, as a high-risk jurisdiction. This classification necessitated the implementation of EDD measures in order to mitigate the high-risk situations to which the Bank was exposed. During the on-site examination, however, it was discovered that there are no formal procedures indicating what measures need to be applied in such situations other than a generic comment on the Bank's manual that officials are to consider obtaining additional information. It is therefore clear that the Bank did not apply the reasonable measures that should have been applied to mitigate such risks.

Moreover, these clients are not only considered to constitiute a higher risk to the Bank because they are nationals of a jusrisdiction which is considered to pose a higher risk of ML/FT, but at law are also PEPs, family members of PEPs or close associates of PEPs accupying prominent public functions.

In terms of Regulation 11(6) of the PMLFTR, in addition to senior management approval, as an EDD measure, the Banks was also required to take adequate measures to establish the source of wealth and funds involved in the business relationships and transactions. The Bank was also required to carry out enhanced ongoing monitoring on the transactions as explained in Section 3.5.3.2 of the Implementing Procedures. Nonetheless, it has resulted that the only enhanced measure from those required by law that was actually undertaken was the obtaining of senior management approval. With regards to the other two mandatory measures, the Bank could not provide evidence that these were actually being carried out up to the level required by law.

5. Ongoing Monitioring of the Business Relationship

In terms of regulation 7(1)(d) {as further explained in Regulation 7(2)(a)} of the PMLFTR and Section 3.1.5 of the Implementing Procedures, subject persons are required to scrutinise transactions undertaken throughout the course of the business relationship and to ensure that these are in line with the customer's business and risk profile, including the source of funds. It has transpired that in most of the cases examined by the inspectors, the intended purpose indicated by the applicant for business was to invest in and hold immovable property in specific parts of the world. However, a review of the bank statements revealed that in the majority of cases, the final purchase of property had not yet been carried out. When questioned about this, the MLRO stated that if the intended purchase is in line with business profile of the applicant for business and that purchase was not made within the year, the matter would be brought to the attention of the Head of Private Banking who would then ask the client for an update. Proof of actual purchase was rarely, if ever, obtained.

Moreover, FIAU officials noted that many transactions in the bank statements consisted of inter-company transfers. It was explained that the client generally deposits funds that

are idle in one company's bank account into another company's bank account in order to fund a particular project. However, for various reasons which are undocumented, the final purchase of property is not always made. FIAU and MFSA officials also noted that the Bank had given loan facilities to these same clients.

In respect of ongoing monitoring, which should be of an enhanced level in view of the type of clients concerned, the negative media information available on the clients and the jurisdictions concerned, it was concluded that not enough questions are being asked and insufficient monitoring is being carried out. The concerns are amplified when one takes into consideration that fact that the documentation kept on file is sparse.

6. Systemic and Governance issues

The Bank was found not to have sound AML/CFT policies established by the board of directors for clients who classify as PEPs. Even though the MLRO is a director of the Bank, it appears that the Bank is lax in its adoption of AML/CFT measures and very little regard appears to be given to the Bank's ML/FT risk exposure. Rather, a lot of attention is given to ensuring that the Banks' high net worth clients, including those who are PEPs from PEPs from high-risk jurisdictions are given assurances that their banking operations are treated with utmost secrecy. Contact with certain clients is only possible through one bank official who is, according to the MLRO, a trusted acquaintance of the clients concerned. I.T. applications have been created for contact with such clients and knowledge of the identity of these clients is restricted to very few bank officials. Although attention given to the confidentiality of the clients may appear to be commendable, it seems that the veil of secrecy that has been created is in actual fact making it easier for banking transactions to be carried out by PEPs, their family members and their close associates without the level of scrutiny required by law.

The way in which certain accounts opened for PEPs, their family members and close associates are being operated is particularly problematic. The lack of adequate scrutiny gives the impression that a blind eye is being turned for these individuals to be able to invest their funds without appropriate questions being asked. Assessments as to the legitimacy of the funds are weak and particularly accommodating while ongoing monitoring is practically inexistent, a far cry from the enhanced monitoring required by law.

These failures highlight systematic issues of grave concern that also reveal that the business model of the Bank concentrates on accommodating clients who value their secrecy above everything else. Such concerning revelations also question the soundness of the governance structures of the institutions and whether the checks and balances that are necessary to ensure that the Bank does not lend itself to being misused by criminals conforms with internationally accepted standards.

By way of conclusion, the compliance examination revealed that the Bank has a number of serious shortcomings. This not only places the Bank in breach of several provisions of the PMLFTR, but also exposes the Bank and the jurisdiction as a whole to a high level of risk,

which is not being mitigated by any other process. Furthermore, the serious deficiencies are compounded by the fact that the Bank's profitability depends to a large extent on a few select clients who are PEPs.

The bank is therefore required to review the requirements emanating from the PMLFTR and Implementing Procedures and ensure that its processes and client records are brought in line.

Pilatus Bank Ltd is hereby being invited to provide any clarifications it deems necessary on issues raised and stated in this letter which may not be factually representative of the situation resulting of the understanding of the FIAU. In this eventuality, the Bank is kindly requested to do so by not later than 8th June 2016.

Additionally, Pilatus Bank Ltd is requested to take into consideration the above findings and recommendations and to notify the FIAU in writing as to how it intends to rectify its position. Where the Bank is unable or not in a position to do so, it should submit its reasons, also in writing, to the FIAU. Such notifications should reach the FIAU by 18th July 2016.

The FIAU would like to make it clear that the contents of this letter are without prejudice to any other regulatory action that may be taken against the Bank for breach of the PMLFTR and the Implementing Procedures.

We remain available for any additional information or clarification that might be required in relation to the issues raised.