



Third Party Anti-Money  
Laundering (AML)  
Assessment of the Effective  
Implementation of Customer  
Due Diligence (CDD)  
Measures with Regard to  
Cyprus' Deposits and Loans

**Updated Final Report**

**Friday, June 14, 2013**

## 1. Purpose and Structure of the Document

This “Updated” version of the April 24th Final Report has been modified from the original version to: a) reflect the *errata corrige* detailed in the final section of this document (section 9); and c) address some inconsequential formatting and stylistic improvements that could not be made prior to the official submission date because of the limited time available. None of the modifications and improvements contained in this version alter the previously reported overall findings.

Within the context of our engagement with the Central Bank of Cyprus (CBC or Supervisor), Deloitte Financial Advisory S.r.l. (Deloitte Italy) is providing this report on the overall credit sector's level of compliance with the AML legal framework, to CBC, the Cyprus Ministry of Finance (MoF) and the economic assistance program partners (the International Monetary Fund or IMF, the European Central Bank or ECB, and the European Commission or EC). These findings are not meant to and do not contain confidential information with respect to any of the six largest Cypriot banking institutions covered by this review (each a “Covered Institution”) or their customers.

The remaining content of this document is structured as follows:

- Introduction
- Executive Summary
- Background
- Approach
- Considerations and Limitations
- Sector Level Findings
  - Breakdown of Deposits and Loans
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- Banking Institution Level Findings
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  - Level of Compliance with the Cyprus Legal Framework
- Appendices

Please refer to Appendix A of this document for a list of common definitions and Appendix B of this document for anonymous customer level information reported, as requested, for the each of sample customers of the Covered Institutions.

The report is intended to be read in its entirety; careful consideration should be given to conclusions drawn from any one section alone or from a subset of sections of this report, in view of the considerations and limitations set forth in Section 6. Finally, the scope of this report is not intended to include recommendations, which are provided separately.

## 2. Introduction

### 2.1. Confidentiality

All documents, data and information the Deloitte Italy team received from CBC or a Covered Institution, including documents, data and information pertaining to CBC, any Covered Institution or regulated entity and any customer of a Covered Institution or regulated entity, or collected from any Covered Institutions or of which Deloitte Italy became aware in the context of its contractual relation with CBC or which are the results of studies, tests or research conducted during the engagement for the purposes of execution thereof are confidential. Deloitte Italy understands that it is not entitled to provide, publish or disclose such information and data and any other confidential information to any third party.

Deloitte Italy took steps to safeguard that each team member is bound by confidentiality obligations and signed a CBC statement to that extent. All customer level work was performed on the premises of the respective Covered Institutions.

In addition, as per the terms of the agreement with the CBC, Deloitte Italy complied with the provisions of the Cyprus Personal Data (Protection of the Individual) Law 2001 (as amended), the “Data Protection Law”, in the performance of its activities.

## 2.2. Restricted Tender Process

Deloitte Italy was selected to participate in a restricted tender procedure for the award of the contract for “the provision of a CDD review on the Cyprus banking system to be carried out within the framework of the assistance program applied for by the Cyprus Government.”

As prescribed in the tender process, the objective of the review was “the assessment of whether CDD requirements are effectively implemented by banks in accordance with the Cypriot legal framework, that is, the Prevention and Suppression of Money Laundering Activities Laws of 2007-2012 (“AML Law”) and the 2008 (CBC) Directive to Banks on the prevention of money laundering and terrorist financing (“CBC Directive”).”

The review covered the six largest Cypriot banks at the time of the review, namely, Bank of Cyprus Public Co Ltd, Cyprus Popular Bank Public Co Ltd, Hellenic Bank Public Co Ltd, Eurobank Cyprus Ltd, Alpha Bank Cyprus Ltd and Russian Commercial Bank (Cyprus) Ltd.

The contract was awarded by the CBC subject to the agreement of the CBC with the assistance program partners.

## 2.3. Terms of Reference

As part of the invitation to tender received on March 13, 2013 Deloitte Italy was provided with the document “Appendix 1 Key Elements for a Third Party AML Audit of the effective Implementation of CDD Measures with Regard to Deposits and Loans.” Commonly referred to as the “Terms of Reference” or “ToR” for this initiative, said document was the basis for the objective, scope, and approach to be followed by Deloitte Italy. The ToR was subsequently supplemented to include additional information (e.g., on the specific sampling methodology to be followed, on the report format and content, and on the need to also cover transactional activity and suspicious activity detection and reporting) and represents the detailed “agreed upon procedures” followed by Deloitte Italy in carrying out this engagement.

Per the ToR, the entire effort together with the delivery of the final report to the CBC, the Cyprus Ministry of Finance and the assistance program partners was to be completed within a two week timeframe.

As consistently indicated throughout the tender process the agreed upon procedures do not necessarily represent the scope, approach, and especially the timeframe that Deloitte Italy would have proposed given our understanding of the overall objective of this initiative.

## 2.4. Independence

One of the key aspects of the tender procedure was to be able to demonstrate the ability to preserve objectivity and independence including by disclosing the details of any existing business relationship with the Cypriot government, related agencies, and Covered Institutions.

Deloitte Italy is a private firm which is by nature independent and during the years we have developed a series of strict internal policies and procedures to help prevent both real and perceived conflicts of interest from arising. Accordingly, per our policy, we have performed an internal cross border search for any potential conflicts arising between the work to be carried out and the customers we serve; nothing has come to our attention that, in our judgment, would have impaired our ability to objectively serve on this engagement.

The contracting legal entity is Deloitte Italy; as agreed to during the course of the tender process, the Deloitte member firm in Cyprus and its practitioners have not been involved, in any capacity, in this engagement.

In addition, Deloitte Italy agreed for the course of this engagement to manage the financial and investment relationships, should any exist, between its partners and members of staff and as applicable partners and members of staff of its subcontractors, with the Covered Institutions and/or personal relationships with individuals employed by such Covered Institutions.

### 3. Executive Summary

#### 3.1. Overview

Appreciating the broader context of the economic assistance program for Cyprus in which certain readers might approach this report, we have approached its drafting with a view towards providing data and insights that might be useful to policymakers seeking to formulate options for the future. Careful consideration should be given to the conclusions that can and should be drawn from this report, including the range of limitations on the scope of the review under the agreed upon procedures, the limited time period for review and analysis, the limited customer sample, and the requested elements to be reported. Deloitte Italy has attempted to apply a rigorous and consistent analytical methodology, and to present relevant facts and data while protecting the confidentiality of bank and customer information. That notwithstanding, in many cases it would be more prudent to utilize the data or reported numbers not as a conclusion with respect to a specific value or degree of compliance or omission. The report will likely be more useful to inform the reader as to relative areas of risk and relative strengths and weaknesses in relation to efforts to mitigate those risks. When considered together with policy priorities, we hope that this might help inform on practical steps where improvements could or should be made, as well as the relative costs or tradeoffs involved in such efforts.

The purpose of this summary section is to attempt to reflect in a balanced and weighted way the general picture on the effective implementation of CDD and other measures in the Cypriot banks covered by this review. More specifically, following in this section are the high level findings for the analysis of the *Breakdown of Deposits and Loans* as well as for the analysis of the *Level of Compliance with the Cyprus Legal Framework*. The findings need to be measured within the context of the critically important considerations and limitations described in section 6 of this document. In addition, please note the context of the customer level information in Appendix B, which is included in response to the specific requirement to “provide an individual report listing customers in the sample (allocating a number by customer in order to preserve confidentiality)” for each Covered Institution. Said customer level information is not summarized in this section given its detailed nature. However, the findings in the right most columns of Appendix B, which are provided for comparison purposes only, do relate to comments found in sections “3.4.1.3. Determination of Customers Subject to Enhanced Due Diligence” and “3.4.1.1. Client Acceptance” of this document.

In considering the findings related to the level of compliance with the CDD requirements of the Cyprus Legal Framework, it is worthy of note that these requirements are generally more detailed, and to a certain extent

prescriptive, than in many other jurisdictions, including other EU Member States that similarly have implemented the requirements of the Third Money Laundering Directive. For example, the enhanced due diligence conducted by the Cypriot banks in obtaining passports and verifying addresses of ultimate beneficial owners, including in cases involving Politically Exposed Persons (or PEPs) down to a 10% ownership level, is more thorough than the EU standard of 25% ownership. This seems to be a recognition of the unique risks in the jurisdiction, and thus an effort to tailor requirements to mitigate those risks.

The sector level findings with respect to the *Breakdown of Deposits and Loans* appear to indicate that the Top 100 borrowers and depositors are prevalently legal persons having Cyprus as the country of residence but that their country of origin is Cyprus to a lesser degree and that of the ultimate beneficial owners' country of origin is Cyprus to an even lesser degree, with the decrease more evident for deposits than loans. Foreign national customers and beneficial owners tend to be from Russia, Greece, the Ukraine, and the British Virgin Islands, among other countries. Note that the quantitative data underlying the analysis of the level and breakdown of deposits made by and loans granted, which was provided by the six Covered Institutions, appeared to be generally reliable, with some inaccuracies noted.

With respect to the analysis of the *Level of Compliance with the Cyprus Legal Framework*, the findings indicate that from a comparative perspective, certain Covered Institutions appear to fair better than others across most of the relevant assessment areas. Bearing in mind the limitations of the sample and of using an un-weighted average, aggregating the results across the Covered Institutions appears to indicate a generally solid level of compliance with the Cyprus Legal Framework, across the six banks, with a few specific areas requiring further attention (e.g., aspects of the Client Acceptance requirements, aspects of the Ongoing Monitoring requirements, and aspects of the Reliance on Third Parties requirements). Also at the sector level, the adequacy of the rationale for the small number of suspicious activity reports submitted within the retrospective scope of this review is self-evident. Lastly, although the framework requirements appear to be sufficiently implemented, the identification of unusual transactions and the reporting of suspicious activity to MOKAS appear to be lower than could be expected under the Cyprus Legal Framework, whether applying CBC typologies or as compared to practices in other jurisdictions.

### **3.2. High Level Findings on the Breakdown of Deposits and Loans**

The analysis of the breakdown of deposits made and loans granted to foreign nationals, by country of residence and by country of origin, for both customers and beneficial owners is based on information provided by the Covered Institutions and subsequently cross-checked with respect to reliability on the basis of our review of key information.

The charts depicting the findings of this analysis, which are found later in the document, use simple un-weighted averages to provide aggregate results for the six Covered Institutions.

The sector level findings with respect to loans show that with respect to the "Top 100" borrowers, 95% are legal persons and thus practically the totality of cases, with Cyprus as the country of residence in 70% of cases. The country of origin is also Cyprus in 70% of the cases, followed by Russia for 10% of the cases and then Greece, the British Virgin Islands, and Serbia. In comparison, for the ultimate beneficial owners of these legal persons the country of origin is Cyprus in 50% of the cases, Russia in 20%, and the Ukraine in 5%, followed by the UK, Serbia and the Marshall Islands. This trend seems to be generally true whether measured by the count of borrowers or the value of the loans.

The sector level findings with respect to deposits show that with respect to the “Top 100” depositors, 90% are legal persons, having Cyprus as the country of residence in 40% of cases, followed by the British Virgin Islands in 25% of cases, Russia at close to 10%, followed by Belize and the Seychelles. In comparison, for the ultimate beneficial owners of these legal entities, the country of origin is Russia in 35% of the cases, Cyprus in 25%, followed by Greece, the Ukraine, the British Virgin Islands and others. Again, this trend seems to be generally true if measured by the count of borrowers or the value of the loans.

A manual review was performed to validate key information for each Covered Institution. The number of incorrect instances of Customer (country of origin, country of residence) and UBO (beneficial owner, country of origin, and country of residence) information as compared to the size of each institution’s sample was used as a proxy for a more comprehensive validation of all of the underlying information used in this analysis.

The findings of our manual review indicate that for deposits, overall the instances of incorrect information are not insignificant and relatively more relevant to customers than to ultimate beneficial owners while for loans, that overall the instances of incorrect information are not pervasive and balanced when comparing customer and UBO information. Although certain covered institutions fared worse than others, and bearing in mind the limitations of this focused validation exercise, generally, the quantitative data underlying the level and breakdown of deposits made by and loans granted appears to be reliable.

### **3.3. High Level Findings on the Level of Compliance with the Cyprus Legal Framework**

#### **3.3.1. General Takeaways Regarding Compliance with the CDD Requirements**

As a general matter, when reviewing any assessment of compliance with AML requirements, whether at the level of a specific financial institution, at a sectoral level, or at a jurisdictional level across multiple regulated sectors, it is important to keep in mind that globally recognized AML principles are meant to be preventative and are aspirational in nature, and, as such, are constantly evolving to addressing constantly changing areas of risk. The practical impact is that in our extensive experience, no institution can be expected to have a 100% perfect compliance record. In fact, on the basis of our experience, it is uncommon to find institutions in any jurisdiction that achieve 100% compliance across all customers, especially in jurisdictions where the AML legal framework has been enhanced relatively recently. Another key component of AML requirements is that they are meant to be “risk based” to allow a financial institution to focus on mitigating areas of greatest risk as determined by each institution’s range of products and services, as well as unique customer base.

In the review for compliance with the customer due diligence requirements of the Cyprus Legal Framework, it is worthy of note that these requirements are more detailed, and to a certain extent more prescriptive, than in many other jurisdictions, including other European Union Member States that similarly have implemented the requirements of the Third Money Laundering Directive. As shown throughout this report, this level of detail appears to reflect in part the recognition by the Cypriot authorities of the unique risks in the jurisdiction, and efforts to tailor requirements to mitigate those risks. For example, we noted among the many sub-elements of the customer due diligence requirements of the Cyprus Legal Framework that in the case of a bank’s reliance on third persons, such as professionals or alternative service provider introducers for customer due diligence purposes, the bank should promptly obtain and subsequently maintain copies of the document duly certified by the third person as a true copy of the original. That said, the review of customer sample files also identified some omissions in terms of the file documentation being certified as true copies. Notwithstanding such omissions, the customer sample files reviewed consistently contained legible copies of passports and statements of utility bills

used to verify addresses of persons identified to the bank (but unidentified to the public) as ultimate beneficial owner, including in cases involving PEPs and/or owners down to a 10% level (below the EU standard of 25%).

While detailed requirements can target certain risks, a natural tension exists in that a formalistic approach to compliance at the micro level can draw compliance resources and attention away from risks at a more macro level. Activity that is rather common in Cyprus as witnessed through the customer sample in terms of a combination of high-risk factors including foreign investors, introducing third persons, and cross-border transactions, would in many other jurisdictions be quite rare and thus such a customer profile at any given financial institution might be the focus of compliance attention as a high-risk outlier. This was not the case with respect to the sampled files.

As per the agreed upon procedures, Deloitte Italy performed an analysis of the overall credit sector's level of compliance with the Cypriot Legal Framework on CDD, by aggregating the results obtained from the six Covered Institutions, with respect to their 390 sampled customers.

Bearing in mind the limitations of the sample and thus the ability to extrapolate from it, certain key themes could be inferred from the results. From a comparative perspective, certain Covered Institutions appear to fair better than others, across most of the relevant assessment areas. Further, some of the Covered Institutions appear to have more customers for which assessment areas such as "Reliance on Third Party Introductions", and/or "Simplified Due Diligence" (applicable in limited cases), and/or on "Natural Person Not Residing in Cyprus" apply. Most importantly, and again bearing in mind the limitations of the sample and further of using an un-weighted average, aggregating the results across the Covered Institutions appears to indicate a generally solid level of compliance across the six banks with the following areas requiring further attention: (1) Client Acceptance (certain key aspects such as Customer Business/Economic Profile and others), (2) Ongoing Monitoring, and (3) Reliance on Third Parties. Within this context we noted as a credit sector level general trend that more recently established client relationship appeared to have more complete due diligence files than accounts opened a number of years prior and especially before 2008.

Please refer to the "Institution Level" section of this document for further findings for each of the Covered Institutions as these are too detailed and specific to be summarized here.

#### 3.3.1.1. Client Acceptance

Generally, the Covered Institutions do not seem to have a suitable degree of accuracy in gathering and documenting relevant information from customers in order to understand the purpose of the account, to define the customer's business economic profile and to evaluate the expected pattern and level of transactions (examples of required information observed missing from or insufficiently detailed in customer files include: too generic descriptions of customer's business activity and purpose of opening the account, documentation regarding the expected origin of incoming funds and the expected destination of outgoing transfers and payments, and the customer's source and size of wealth and annual income).

This missing or insufficiently detailed documentation is primarily evident in accounts, which represent a large part of the sample, that have been established for passive investments and apparent tax minimization purposes as distinct from operating entities (e.g., the incorporation documents provide for the investment powers, perhaps with limited geographical or sectorial specialization, and target investment values).

The timing of customer identification was at times inadequate as there seemed to be a practice of collecting information and documentation after the business relationship was established, reportedly because of perceived familiarity with the customer.

Procedures adopted by the Covered Institutions in order to identify the UBO via reliance on third parties showed some weaknesses (e.g., at times the UBO is identified through a non-certified declaration; the control chain between customer and the UBO is not always easily traceable, etc.).

Covered Institutions were generally not considering as a higher risk factor the nature of offshore exposure, as well as multi-layered and less transparent ownership and control structures for their legal person customers.

### **3.3.1.2. Ongoing Due Diligence - Updating Information Throughout the Business Relationship**

Periodic monitoring and verification of customer and UBO identity are performed on a “risk based” approach and according to each Covered Institution’s specific internal policy (e.g., yearly for high risk customers; every 3-5 years for normal/medium customers; over 5 years for low risk customers). Even in cases where a foreign customer’s business was brought to the bank through an introducer and the customer due diligence carried out via third persons, in some cases the bank would subsequently arrange an in-person meeting with the ultimate beneficial owner. Nevertheless, within a customer’s file (with specific reference to high risk customers), even where there were summary forms or customer transaction statement showing updates, there has been observed a general lack of traceability of controls performed (for example, specific customer review forms and/or documentation/proof of information obtained over time).

### **3.3.1.3. Determination of Customers Subject to Enhanced Due Diligence**

The Covered Institutions have generally adopted procedures in order to determine whether a customer/UBO is a PEP and/or is involved in bribery, corruption or other financial crime, or otherwise requires enhanced due diligence, including regular checks of commercially available databases or the Internet, upon account opening. Those controls were generally not consistently/programmatically performed during the course of the business relationship, on a risk based approach, according to each institution’s specific internal policy. As such, the Covered Institutions appeared exposed to the risk of not promptly identifying and managing a change in a customer’s status (e.g., customers/UBOs who subsequent to account opening have been identified through commercially available sources as becoming a PEP or having negative indications with respect to money laundering and/or other financial crime activities).

### **3.3.1.4. Reliance on Third Parties**

In general, third parties or persons that play an important role in the onboarding CDD process (e.g., a business introducer, shareholding nominee, secretary, or director) have been observed in a number of cases to be interconnected with one another through ownership relations so as to weaken the premise that Covered Institutions can reasonably rely on third parties as an independent source; this is particularly the case in multi-layered and less transparent ownership and control structures.

The Covered Institutions may rely on third parties for updating customer due diligence information, such as through certifications and verifications, but the Covered Institutions appear to have been

overly reliant on third persons in providing such information in the absence of risk based verification of the underlying information provided, in particular in multi-layered and less transparent ownership and control structures involving foreign jurisdictions, which are generally considered to be of higher money laundering risk.

More guidance on appropriate practices for the banks vis-à-vis not only such third parties based in Cyprus, but also in other jurisdictions might promote more consistent compliance in this area.

### **3.3.2. Other General Takeaways**

#### **3.3.2.1. Tax Optimization – Generation of Alerts**

Many of the files in the customer sample could be interpreted as evidencing account relationships established either primarily or in significant part driven by tax considerations. As a general matter, the customer files do not provide information as to the tax implications of the customer relationships or transactions, but often evidence services provided to the customer by accountants, lawyers and company service providers.

As part of the review for potential unusual or suspicious transactions related to the customer sample, many of the transactions alerts generated through the application of standard AML compliance methodologies (in particular, as related to transfers of large, round number values or a wire transfer in to an account followed by wire transfer out to a related party) upon review appeared to be in connection with investment activities. However, this should be considered within the context of the only very recent addition in the FATF standards (February 2012) of serious tax crimes constituting a predicate offence for money laundering and as far as Cyprus is concerned, a relevant amendment of the law only very recently enacted (December 2012).

Where the documentation was generally consistent with the transactions (e.g., the file indicated a loan agreement as the basis for the outgoing principal and the subsequent repayments with interest) no determination was made related to potentially unusual or suspicious activities unless information was omitted from the file or the document was significantly incomplete or otherwise inconsistent with the activity.

#### **3.3.2.2. Complexity of Legal Persons / Intermediary Beneficial Owner Structures**

The results of a targeted analysis conducted to assess the complexity of intermediary beneficial ownership structures, which is based on a subset of the sampled customers, across all the Covered Institutions, and not only in relation to higher risk customers, should be viewed in the context of the very detailed requirements of the Cyprus Legal Framework (not required or applied in most other jurisdictions) possibly reflecting the intent of the Cyprus authorities to mitigate the enhanced risks related to such phenomena.

The complex structures observed are characterized by the presence of nominee shareholders, on average three levels or layers of intermediary beneficial owners, four or more individuals involved in the ownership structure and an average of three countries of residence or incorporation.

For the most part, the complex structure observed in the sample did not have the UBO identified through original independent sources but rather through certified declarations by third parties,

which at times were not certified. Briefly, whereas UBOs identities were almost always verified through certified true copies by an independent source (e.g., a Passport) the intermediate and ultimate beneficial owners in an ownership structure were typically not verified via original documents from independent sources (e.g., certificates of official registry from a foreign country such as of incorporation or incumbency).

### **3.3.3. Level of Compliance by Key Elements to Assess the Adequacy of Transaction Monitoring Procedures and Suspicious Activity Reporting**

The AML review uncovered a number of transactions at each of the Covered Institutions that were viewed as unusual or suspicious, when independently applying factors including the customer profile and the AML transaction typologies identified by CBC. The uncovered transactions resulted from both a manual review of account activity as compared to customer profiles and a programmatic review of transactional data, for each of the customers in the selected sample.

The Deloitte transaction monitoring rules adopted were selected on the basis of their alignment with the specific requirements of the agreed upon procedures and were programmatically run against the electronic data gathered. This generated 10,173 alerts to be investigated, from a sample of 570,000 transactions. Said alerts as well as other potentially unusual activity stemming from the manual review were investigated by the project teams and either cleared as not representing unusual activity or warranting further investigation. Deloitte identified 536 instances of potentially suspicious activity that required further investigation, out of which 29 appeared to be potentially suspicious. Said potentially suspicious activity is contained in the main body of this report and has been referred to the CBC to determine if reporting to MOKAS is warranted.

Caution should be taken in relying on these numeric findings. In some cases, with more time available, further investigation, including in some cases obtaining additional information from the customer, could have led to determine that the transaction or activity had a reasonable explanation and was not suspicious. Conversely, with more time available additional transaction monitoring rules could have been run and most likely would have produced more alerts and more potentially suspicious activity to be investigated and reported.

A general finding nevertheless can be made that at the sector level the identification of unusual transactions and the reporting of suspicious activity to MOKAS appears to be lower than could be expected under the Cyprus Legal Framework and specifically in applying the CBC typologies, as well as compared to practices in other jurisdictions.