HORIZON

from
SKADI

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February 2022 Edition

HIGHLIGHTS

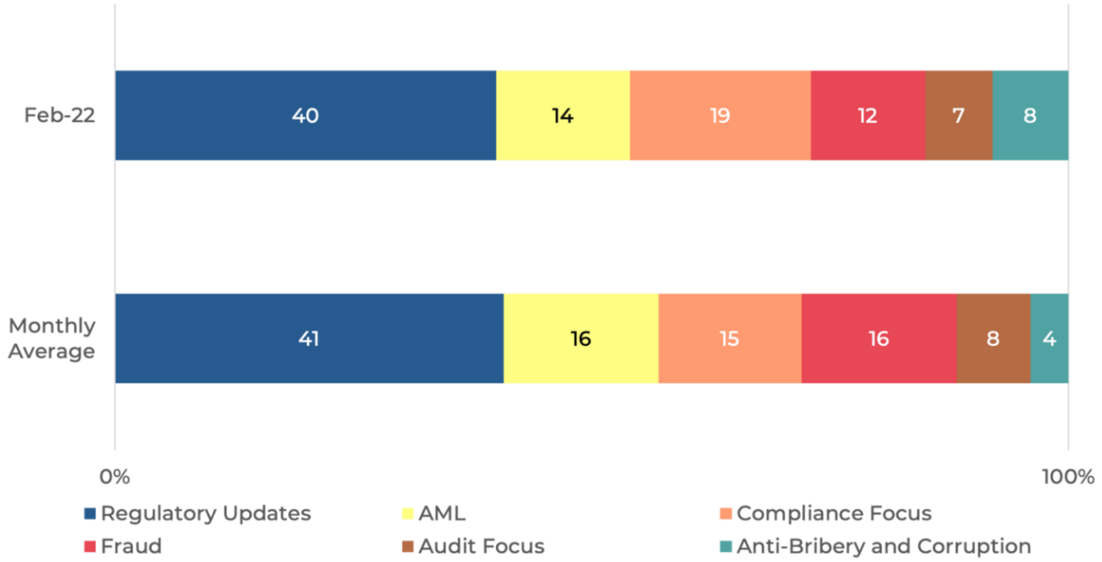
- Given the tragic events unfolding in Ukraine as we go to press, it is no surprise that there was a large increase in ***Sanctions*** headlines last month.
- February was a record month for ***ESG*** related stories, with multiple articles raising the issue of 'greenwashing'.
- This month's Key Story looks at concerns over staff turnover at the Hong Kong and UK Regulators.

CATEGORY OVERVIEW

The Category breakdown for February showed minimal deviation from the HORIZON monthly averages (we have been collating data for over 5 months now so hopefully the baseline data is starting to stabilise). As shown in Figure 1 below, ***Regulatory Updates***, ***AML*** and ***Audit Focus*** were all within 2% of their long-term average.

Fraud headlines accounted for only 12% of stories in February, up from 8% in January, but still substantially below the 4-month average of 16% since October 2021, and well below the 19% in Q4 2021. As we wrote in last month's Horizon, the high prevalence of ***Fraud*** articles in the last 3 months of 2021 resulted from several large, unrelated cases. ***Compliance Focus*** accounted for almost a fifth of the SKADI Sammendrag stories in February, largely due to the compliance implications of Russian sanctions, as we explain in more detail below. Finally, ***Anti-Bribery and Corruption*** doubled its share of articles last month from 4% to 8%. These included problems at the Serious Fraud Office (SFO) which we think will continue to occupy headlines over the coming months.

Figure 1: SKADI Sammendrag Articles by Category



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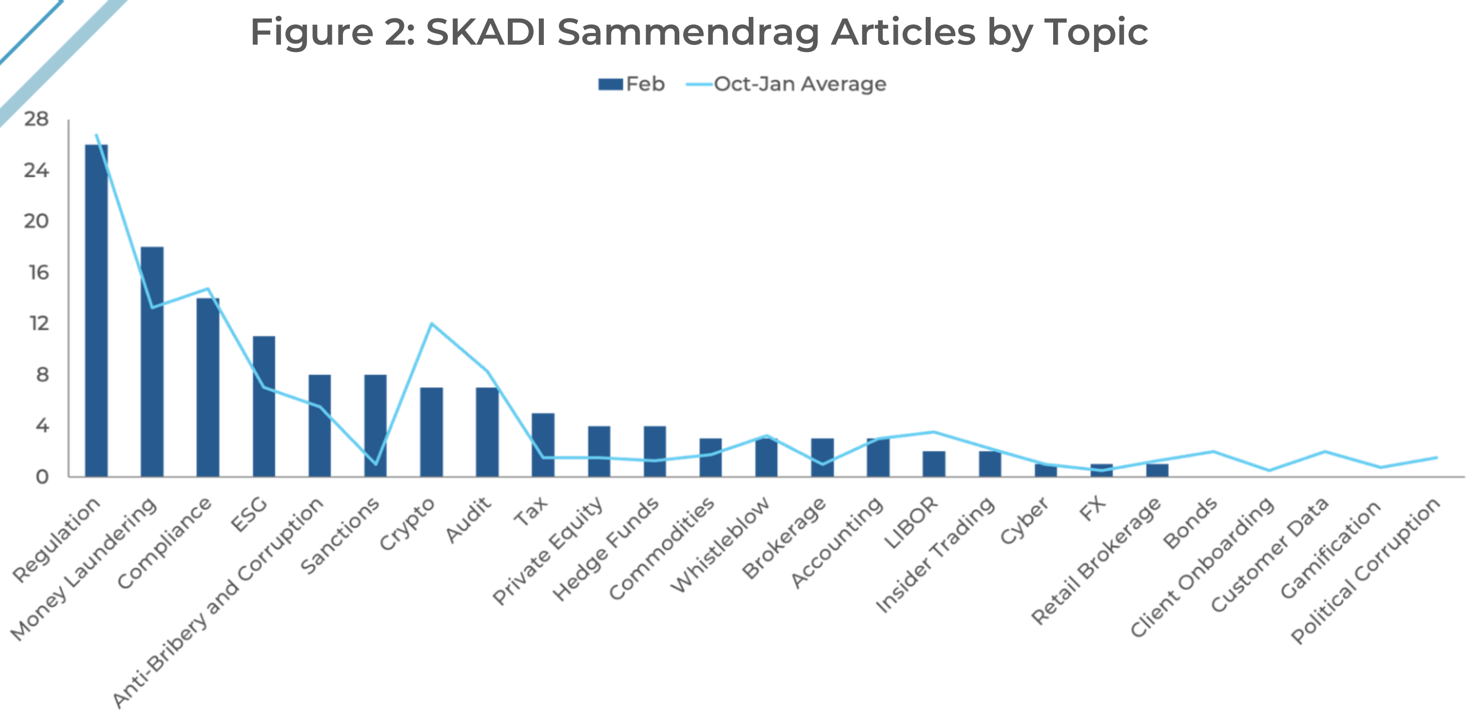

<u>TOPIC DETAILS</u>

Sanctions

All of the ***Sanctions*** related stories reported last month appeared in the final week. With only one exception ("EU targets Myanmar's lucrative energy sector in latest sanctions"), 7 out of 8 stories all related to Russian sanctions following the invasion of Ukraine on 24-Feb. Prior to February, only 4 stories since the launch of the SKADI Sammendrag in Oct-21 featured sanctions news. Unfortunately, we anticipate sanction stories to continue to dominate news headlines for the foreseeable future.

As of the time of writing (02-Mar-22), US, UK, EU and Canada have agreed for a number of Russian banks to be cut off from SWIFT, the main international payments system.

How will this work in practice internally within financial institutions?

- Specialist software will continue to capture updated lists from global regulators including...
    - Keyword and key-phrase searches
    - Embargoed individuals
    - Embargoed entities
    - BIC's (Bank Identifier Codes) related to the above
- Systems will automatically scan SWIFT payment messages against these updated lists and block any suspicious transactions.
- Payment Control Teams will have to balance additional payment exceptions against releasing legitimate funds prior to cut-offs.
- Strong focus on payment sanction controls will therefore be crucial over the coming days and weeks.

As an example of what can go awry if SWIFT payment controls are not kept up to date, back in 2008 KfW, a German bank, paid EUR 300 mln to Lehman Brothers after it had gone into bankruptcy as an automated payment, apparently unwinding a currency swap. This led to the suspension of three senior executives; two from the Management Board, and the Head of Risk Control.

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What are Russia's alternatives?

Since 2014, they have been using their own domestic system for authenticated financial communication called SPFS (System for Transfer of Financial Messages). SPFS accounted for approximately one fifth of Russian internal messaging traffic last year, with the vast majority still being processed by SWIFT.

Other countries have developed potential alternatives to SWIFT due to increasing concerns over the "weaponization" of the US dollar. Notably in 2015, the People's Bank of China (PBOC) launched the Cross-border Interbank Payment System (CIPS). The payment system enables clearing of cross border transactions in Yuan, and participants include domestic and foreign banks. In 2020, 17.5% of trade between Russia and China was settled in Yuan, according to Reuters.

If other messaging systems are to be used as an alternative to SWIFT, we envisage potential issues around resilience testing. By way of example, CIPS processed around 12,000 transactions per day in 2021, and SPFS handled 5,500 messages. Both these numbers are dwarfed by the 42 million messages processed daily in SWIFT. Adapting to an alternative payment system would also require potentially any number of SWIFT's 11,000 participants to adapt systems and controls.

Other Topics

February saw a record month for ***ESG*** articles featured in the SKADI Sammendrag, surpassing the total we saw around COP26 in Nov-21. Unlike last month, all but one of the articles concerned environmental, rather than social or governance, issues. Nearly half of these referred to 'greenwashing' concerns as highlighted, for example, in the Financial Times story "Green investing: the risk of a new mis-selling scandal". They reference claims made by industry insiders who predict green investing could be the next mis-selling scandal similar in scale to Payment Protection Insurance (PPI). One of the main issues has been that the rapid growth of green investing has outpaced auditors' framework for checking companies' sustainability credentials. This could take years to develop and is something for control staff to be aware of the potential risks.

There was a drop-off in ***Crypto*** news last month for the first time since we started this report, largely driven by a reduction in regulatory headlines. However, concerns over money laundering and sanctions evasion are bound to keep crypto in the headlines in the coming months, and we see this as a temporary blip.

There were eight articles last month on ***Anti-Bribery and Corruption***, ranging from corporate corruption in South Africa to South Korean Telecom being sanctioned by the SEC over bribe allegations. The former concerns widespread corruption that occurred during President Jacob Zuma's tenure and is likely to continue occupying headlines over the coming months.

Finally, ***Tax*** appeared more times than usual in last month's financial news. A couple of these stories surrounded HMRC's first ever seizures of NFT-backed works. This was a very eye-catching development and will likely be an area of focus for HMRC following their success last month.

KEY STORY: REGULATORY STAFF TURNOVER IN HONG KONG AND THE UK

One of the stories that caught our attention last month was the Bloomberg opinion piece: "Hong Kong's Brain Drain is Causing Real Pain". The article was in response to the Hong Kong Securities and Futures Commission's (SFC) annual budget statement which warned that the watchdog was under enormous pressure. This echoed a statement made earlier in the month by the SFC CEO Ashley Alder, where he told lawmakers that the high turnover of staff was affecting their work. More concerningly, the budget statement also warned "...without the appropriate number and mix of staff, the Commission will not be able to deliver on the various initiatives underpinning Hong Kong's development as an International Financial Centre."

Since the imposition of China's national security law in 2020, the Special Administrative Region has lost nearly 90,000 residents (1.2% of the population). Alongside this loss of talent, recruiters have stated it has become almost impossible to attract foreign workers to immigrate to the city.

Whilst the political pressures are distinctly unique to Hong Kong, the UK's Financial Conduct Authority (FCA) is also facing staffing struggles. Since the appointment of chief executive Nikhil Rathi, four of seven top executives have left, as have 49 senior employees and the FCA is also facing potential industrial action. The grievance for most staff is changes to pay, including the abolition of annual bonuses, which were drafted before Rathi took over. In a recent staff survey, over 50% stated that these changes "would not support the FCA in meeting its regulatory objectives".

So, what are the consequences of these staffing struggles in Hong Kong and the UK?

A strong, well-resourced, and well-staffed regulator is crucial to the smooth functioning of the financial system. A regulator is constantly having to adapt to changing conditions (think sanctions), ever more complex financial products, and even completely new products (here's looking at you crypto).

If regulators continue to be under resourced, they will look to shift more work onto institutions' internal control teams – the 2nd and 3rd Lines of Defence (2LOD, 3LOD). If resources continue to be stretched, more review work will have to be conducted internally, with FCA staff only becoming involved at the end to verify their findings. This will add pressure to already busy control staff and will further the demand for compliance staff that we have seen over the past few years.

Postscript: As we go to press, the FCA have announced a 20% rise to their lowest-paid staff.

What is it we're doing here?

Released every morning, the SKADI Sammendrag covers headlines to assist Compliance, Internal Audit and control teams. In this monthly research document, HORIZON, we collate and analyse these 100 or so articles, finding themes and areas of focus for control functions.

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