



ÆGIS e-journal

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1. Due Diligence — Due diligence for profit in private banks and trusts

Under the *International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001* there is a lot of confusion as to what constitutes appropriate exercise of due diligence. The confusion is more than theoretical, since there is, in this case, no established “safe harbor” that allows you to feel comfortable. A bank might make every reasonable effort to do what they thought best – or even what they thought of – and find themselves in trouble.

While this is a serious and obvious problem for all financial institutions and financial gatekeepers, it causes particularly strong concerns as well as provides big opportunities for private banks and trust companies.

The special concerns are the result of the wider range of services provided by private banks and trusts versus commercial banks, thereby expanding the number of areas in which they can get in trouble. In addition, while they deal with a smaller number of customers, these customers have a lot of money, a lot of clout, and a lot of ideas about how they want their wealth managed on their behalf. This means that the bank has to be willing to stand up and do the right thing, which in this case means they should do nothing that will result in them, the bankers, ending up in the slammer. Included on the list is appropriate discretion in selection of clients, particularly those that fall into the *politically exposed persons* category, as well as particular caution in knowing their client, and where the funds are being invested.

In other banking environments this is actually somewhat easier to do, as much of the initial due diligence can be handled by formula, with little need, in terms of the number of exceptions, for much beyond the initial screening.

In addition, because the sums associated with any given account are likely to be relatively small, it is not much of an emotional difficulty to tell someone you don't want their business. As an example, we were in a bank last year when a young French girl, just beginning her college studies, came in to open an account, and was refused because she didn't already have an account. The loss of the small amount of income she would generate was simply not worth the effort for them to investigate further. Even adding in the loss of our account after having watched this (and having been asked to fill in a full-page form to change five twenty dollar bills for a single hundred dollar bill as a birthday present for a child), a strong case can be made from the point of view of the bank that the risks associated with pushing the envelope don't justify the costs. The number of potential wealthy customers

for a private bank, however, is much smaller, and it is therefore more difficult to turn one away.

However, vetting a new customer appropriately is only half the battle. For American citizens, it is a relatively straightforward process to find out if there is any legal impediment to taking in a specific customer. Then the bank has to deal with the issue of risk to reputation risk to decide if they want the customer, or, if undesirable, whether they can be excluded. Thus, while banks no longer tend to be so quick to exclude someone directly because they are Black, Irish, Jewish, or Native Americans, they can decide that they don't want to deal with, for example, pornographers, on the theory that respectable folk wouldn't want their money in the same place as Playboy keeps its money.

When dealing with funds from overseas, or investments overseas, however, none of these issues is quite so straightforward. First, if you are not from the region, you may not be equipped to handle the most basic of the Know Your Customer requirements. You are unlikely to recognize whether the person is a politically exposed person, where the funds came from, or whether the funds represent a risk to you. In many cases, institutions simply take a conservative approach and turn away these accounts.

Other companies, however, see this as an opportunity, and have turned to companies such as LUBRINCO to exercise the appropriate due diligence in geographical locations in which they have no expertise or reliable contacts. Thus, while other private banks and trust companies feel forced to shrink their foreign-customer pool, others are empowered to expand it by recognizing their limitations, and surmounting them with outside help.

By the same token, globalization has opened up investment opportunities for wealth managers some of which offer good prospects, but hide lot of dangers. Within LUBRINCO's geographical area of economic expertise (Central and Eastern Europe, the offshore financial centers, Beijing and Shanghai, and Latin America) we are constantly astonished at the number of firms who go in to do business with the expectation that everything works in much the same manner as it does in the U.S., and come out wiser but poorer for the experience. Some prudent companies decide not to venture too far afield from their comfort zones. Others, more prudent still, recognize that both the opportunities and the risks are great, and bring in outside help to deal with the risks in areas where there is great potential for profit for those willing to go after them, and great potential for loss if there is not an appropriate exercise of due diligence.

2. OPSEC, Economic Espionage, and Competitive Intelligence — Protecting customer lists in private banks and trusts

The average cost of a single incident of economic espionage to a non-manufacturing company is \$500,000.00. At \$300 billion total annual loss, this would mean that there could be upward of 600,000 incidents. Since there are also losses in manufacturing companies (the average loss there, for those interested, is \$50 million), the number of incidents is less than 600,000 a year, but still more than will fit in a cigar box.

Why is this of interest to private banks and trusts? Because they have a lot of information that is desirable to steal, starting with customer lists and their associated account contents.

This information is important to many sets of players. For example, customer lists are of value to competitors, because it gives them names of people to whom they can sell their competing services. They are also of value to bad people, who may be looking for new victims. In some cases the information would be of value to political enemies, or even to the press.

This information becomes even more valuable if you have good detailing of the assets being managed. Again, this information is of value to competitors, adversaries – political or criminal – and the media (how pleased would the tabloids have been to have gotten this information about Princess Di, or any other person in the public eye).

How likely is this to be a problem in your organization? There is a very high probability – approaching unity – that there is nobody in your organization tasked to deal prevent and deal with economic espionage, so more likely than not that you are already a victim. And spies steal your information, not for fun, so they usually have a client for the information before they steal it, so once it has been stolen it will quickly be in use.

How badly can this hurt you? If you accept the figure of \$500,000.00 lost in each incident, the question is really how many hits of this size can you take before it causes you problems. If you are a really big company, you might never really be aware of it: People will lose accounts, you will fire them, and go on without even knowing that you had been victimized.

The good news is that losses from economic espionage can be significantly reduced. The bad news is that economic espionage doesn't reduce itself spontaneously, and someone has to be specifically tasked with preventing and dealing with it, and who is empowered to bring in people like us who know the espionage business and how to help deal with it.

3. Executive Protection — On the invulnerability of traveling bankers

A banker friend of ours recently mentioned that he was going to Mexico City. Mexico City is a wonderful place, filled with exciting shops, restaurants, parks, and museums. It is also arguably the most dangerous city in the world.

Our friend had three psychological issues to overcome.

First, he was a former Peace Corps Volunteer, and, as such, like others who have shared this experience, he is oddly trapped in his past. Former Peace Corps Volunteers somehow assume the level of safety we experienced staggering through the bad neighborhoods where they served somehow adhere to them as businessmen. This is not an issue faced by people who served in an area when it was a combat zone, or by those who worked as undercover agents in these areas.

Second, many people in senior positions of responsibility remember places from their youth, when there was, in fact, a much higher level of safety.

Finally, even more than with most other groups, many of the bankers we know assume that they are not potential targets, and that they do not have to take special precautions when visiting foreign lands. This, by the bye, is a reasonable assumption if someone known to you is meeting you at the airport, and is under a protective escort during your entire trip.

Unfortunately, this paradigm fails as soon as you are on your own.

And that was the case here. What with one thing and another, our guy assumed he could fly in, grab a cab at the airport, and go to his hotel, then grab a cab the next morning to go to his meeting. We finally convinced him that this plan was fraught with potential danger, and that he had to change his plan. In this case we recommended that the people he was going to see arrange for safe transport, and that someone known to him should be at the airport to pick him up. If there was nobody he knew, there should be an exchange of photographs so he would be able to identify the person who was to pick him up, and they would be able to identify him without holding up a sign with his name on it. Or at least not with *his* name on it: A fake sign with the name of a tour company, or of the driver, would be more acceptable.

While we tend to do this sort of thing wherever we go, it really is important to make some judgment as to how dangerous a place may be, and put into play whatever plans are necessary to ensure your security, in a manner appropriate to the level of danger you are likely to face. The amount varies from none to a whole lot, depending on who you are, where you will be going, and what you will be doing there.

4. Technical Issues — When everything goes wrong, asset recovery

A bank cannot make 100% of its investment decisions correctly, unless it makes no decision at all. Banks try to make conservative investments, with the term conservative varying from institution to institution, depending on a number of factors not germane to this article. Whatever the decision was, however it was arrived at – eventually a wrong decision will be made and your firm will be out money. What are you going to do about it?

First, find out what was done wrong. Lose the money, but don't lose the lesson. Is the problem a one of a kind situation or is it more systemic? Is it policy, lack of policy, or too much enthusiasm for the wrong type of deal?

As an example of the wrong type of deal, we remember a number of bankers we knew in Arizona going around town telling everyone who would listen – and a few who would not – how they did a deal with the governor. Governor Fife Symington was a land developer and had an active business. Several years later he was bankrupt and under indictment for fraud, a case he lost (but for which he was ultimately pardoned by an outgoing President Clinton).

So they did a deal with the governor of the state. So what? Was it a good deal or a bad deal? We asked many of those bankers this very question. They didn't answer yes or no they just repeated the mantra “ I did a deal with the governor!” Fiscal Zombies – yikes! Most of these bankers lost their jobs because the deals they did with the governor were very bad deals, and many of the policies the lenders had in place to prevent bad deals were ignored since they were dealing with the governor.

Once you have identified the loss and its cause, does it make sense to mount a recovery effort? By this we mean do you go to the police if the loss of funds involved a crime? Odds are that unless the crime is so blatant and so egregious law enforcement will not be interested. Most law enforcement agencies are not prepared to deal with financial investigations of any sort. This type of crime often does pay.

If is a civil matter, discuss the paths to recovery with an attorney. You will need to litigate and obtain a judgment. What are those costs? You may need professional assistance from independent experts to determine the magnitude of the damage. What are the costs and the time to do this?

Now we are in the realm of business decision. Is better to take the loss, or to pursue a recovery effort? While getting the judgment maybe straightforward, does the subject of your litigation have the wherewithal to pay the

judgment? Were third parties involved in the action such that they have become “pregnant” with a portion, or all, of the liability?

This is the point at which LUBRINCO is generally brought in: As financial investigators we can help make an assessment of the assets available and how to identify them *before* litigation. This is important for two reasons.

- The more information available, the better will be your decision making process. And yes, sometimes a decision is made not to proceed if there are no funds remaining to be recovered.
- When a judgment is obtained you have a baseline of assets, and if any of these assets have been transferred to avoid garnishment a fraudulent conveyance can end up with other parties partially responsible for the debt.

The sad truth is that no matter how careful an institution may be, it will eventually face the likelihood of being victimized. If you exercise appropriate due diligence before the fact, your exposure will of course be greatly lessened.

But if you are victimized, take your time and meet with your professionals to develop the necessary information for your asset recovery requirements.

5. Real Stories from the Field — Going the extra mile in trust transactions

We were recently involved in a transaction where the government of a large country wanted to buy some rolling stock from a manufacturer in another country. As it happened, the manufacturer wanted to sell the vehicles: That is, after all, why they are in business. The problem was that the two countries have, historically, distrusted each other, generally for good reason. The buyer had no confidence in the probability of getting exactly what was being ordered, in good working condition. The seller, on the other hand, had serious doubts as to whether the money would appear.

It might appear that a Letter of Credit would do the trick, but an LC is like a certified check, and can be cancelled or challenged. There have been enough problems with LCs in cases of mutual distrust that, in this case, it was simply not the appropriate tool.

Our solution was to put the money in trust, and accompany the shipment to its delivery point, where it would remain in the custody of the manufacturer. Each day our trustee would work with an inspection team from the purchaser. At the end of the day some certain number of vehicles would be inspected

and accepted. We would then authorize the release of funds to cover that many vehicles, the money would be transferred, and the vehicles released.

This approach provided both sides of the transaction with a lot of comfort. No funds would be released until there was reasonable assurance that the merchandise was as it should be. No bad merchandise would be foisted off on the buyer. The seller would be getting money as soon as the merchandise was inspected, with no chance of a loss. The incremental cost for the inspections – and the trust company representative was negligible.

All worked well until the last day, when one of the vehicles wouldn't start. A close look at the vehicle by the inspection team indicated that some sharp-toothed creature on the ship had eaten through the gas line.

The trust company representative, who had grown up on a farm in Nebraska, sent into town for a new gas line, which he himself installed. The vehicle started, and was inspected and accepted. The last of the funds were transferred, and all parties were happy.

The bottom line here is that with a little imagination, even difficult transactions, taking place in hostile environments among distrustful participants, can, with a little imagination, come off flawlessly.

6. Book and Product Reviews

Critical Issues in International Financial Reform

Albert Berry and Gustavo Indart.

Transaction Publishers ISBN: 0-7658-0177-9 386 pages \$49.95

<http://www.transactionpub.com/1-732-445-1245>

For those who must understand why national economies work and don't work, this compilation offers a fascinating insight to many different aspects of national economies and ideas on reform. Reform meaning the policy approaches of the Washington Consensus, and the generally offered advice for developing nations by the international financial institutions.

These conference notes, concentrating largely on Latin America, are not for the casual reader. They are, however, good read for academics, policy makers, and thoughtful international investment bankers.

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