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HABIB BANK TO PAY $225M FINE AND CLOSE ITS NEW YORK BRANCH FOR ANTI-MONEY LAUNDERING AND SANCTIONS COMPLIANCE FAILURES

On September 7, 2017, the New York State Department of Financial Services ("**DFS**") issued a consent order (the "**Consent Order**") against Pakistan's largest bank, Habib Bank, pursuant to which Habib Bank consented to pay a civil money penalty in the amount of US $225 million and to close its New York branch (the "**NY Branch**"). The Consent Order alleges that Habib Bank and the NY Branch failed to comply with New York laws and regulations designed to combat money laundering and terrorist financing, failed to maintain true and adequate books, accounts and records in violation of the New York Banking Law, conducted their business in an unsound and unsafe manner, and violated multiple provisions of a 2006 Written Agreement and a 2015 Consent Order.

The AML and sanctions compliance failure alleged in the Consent Order are described as egregious, but nonetheless, the Consent Order is a stark reminder that the DFS continues to aggressively pursue AML and sanctions compliance deficiencies and will not hesitate to institute an enforcement action that could threaten an institution's banking license should it deem that such an action is necessary. Further, as described below, this is the second DFS enforcement action this year involving charges based principally on a bank's failure to take adequate steps to manage AML and sanctions compliance risks. It also is notable that the DFS has once again acted separately from the Federal Reserve, the Office of Foreign Assets Control and other US enforcement authorities that typically have an interest in these matters.

The NY Branch of Habib Bank was established in 1978 primarily to offer dollar clearing services. In 2006, the NY Branch and Habib Bank entered into a Written Agreement (the "**2006 Written Agreement**") with the DFS and the Federal Reserve in connection with "significant deficiencies" identified in Habib Bank's program intended to ensure compliance with applicable anti-money laundering ("**AML**") and sanctions laws. The Consent Order alleges that since 2006 the NY Branch has "struggled to comply" with the 2006 Written Agreement and the requirements of New York Banking laws and regulations, and that violations of the 2006 Written Agreement and/or New York Banking law have occurred almost every year since 2006.

In 2015, the DFS found that Habib Bank's compliance efforts had deteriorated further. Specifically, the DFS identified "significant breakdowns" in the NY

Branch's risk management and compliance with Bank Secrecy Act ("**BSA**")/AML requirements and with regulations of the Office of Foreign Assets Control ("**OFAC**"). As a result, in December 2015, Habib Bank entered into a Consent Order (the "**2015 Consent Order**") under which the Bank was obligated to implement a series of reforms to its policies and procedures, including:

- Implementing a system of internal controls designed to ensure compliance with BSA/AML requirements, including those relating to correspondent accounts for foreign financial institutions;
- Conducting a comprehensive BSA/AML risk assessment that effectively determines inherent and residual risks;
- Appointing a qualified compliance officer to manage the BSA/AML compliance program with full autonomy, independence, and adequate resources;
- Independent testing for compliance with BSA/AML requirements; and
- Effective training for all appropriate personnel and affiliates in all aspects of the BSA/AML requirements.

The Bank also agreed to implement a governance framework that requires upper-level management of compliance functions, and to hire independent consultants to review and report on the effectiveness of the compliance program, as well as any activity involving high-risk customers or transactions.

In 2016, the DFS conducted a compliance examination, exercising its authority under the 2015 Consent Order to expand the scope of an independent review of Habib Bank's operations. The DFS ultimately determined that the NY Branch should receive the lowest possible rating due to continued "severe" weaknesses in the branch's risk management and compliance with BSA/AML and OFAC laws and regulations. Specifically, the DFS found that, despite repeated criticism, the Bank had failed to implement effective controls to mitigate and manage BSA/AML and OFAC risks, including:

- Insufficient BSA/AML compliance;
- Insufficient compliance training;
- Insufficient customer risk ratings, including insufficient risk based foreign correspondent due diligence;
- Insufficient documentation for enhanced due diligence customers;
- Insufficient senior management and head office governance, oversight, and documentation;
- Lack of evidence for adequate OFAC and sanctions screening;
- Weaknesses in BSA/AML independent testing and the NY Branch's audit program, including weaknesses in the internal audit program's rating methodology; and
- Weaknesses in data mapping and integrity.

The 2016 exam also discovered 855 "batch-waived" transaction alerters that were cleared summarily by NY Branch staff without review or rationale. In addition, the

2016 exam identified a range of control deficiencies in the documentation and administration of the Bank's customer due diligence program as a whole and in particular for its existing correspondent accounts, including with respect to a correspondent account maintained for a Saudi bank, Al Rajhi Bank, with reported links to Al Qaeda. The Consent Order further alleges that Habib Bank facilitated billions of dollars in transactions with Al Rajhi Bank without adequate AML and counter-terrorist financing controls and without information about Al Rajhi Bank's customers or a thorough review of Al Rajhi Bank's expected versus actual activity.

These allegations are particularly significant as they exacerbate the uncertainty about the need for banks to conduct due diligence with respect to the customers of their correspondent bank customers (commonly referred to as "know-your-customer's-customer" or ("KYCC")), and fly in the face of efforts by international bodies such as the Financial Action Task Force to dispel the confusion caused by the term KYCC and address the so-called "de-risking" phenomenon.

The Consent Order alleges that through unsafe “nested activity," Habib Bank enabled sanctioned entities to anonymously channel funds through the NY Branch. The Consent Order also alleges, among other things, that Habib Bank:

- Allowed for at least 13,000 transactions to flow through the NY Branch that potentially omitted information adequate to properly screen for prohibited transactions or sanctioned entities;
- Improperly used a “good guy” list—a list of customers who supposedly presented a low risk of illicit transactions—to permit at least $250 million in transactions without any screening, including transactions by an identified terrorist, an international arms dealer, and other potentially sanctioned persons and entities;
- Allowed a customer to send funds through the NY Branch to a person who was blocked from using the U.S. financial system, while intentionally omitting the prohibited party's name; and
- Did not identify and report numerous instances of suspicious activity.

The DFS's allegations against Habib Bank focus principally on the bank's failure to properly assess and manage its AML and sanctions compliance risks. In at least one other enforcement action against a major non-US bank earlier this year the DFS imposed a significant fine and required the appointment of a monitor in connection with compliance failures allegedly due to compliance control deficiencies. These actions are indicative of the DFS's increasing enforcement focus on compliance program and risk management deficiencies, which is particularly remarkable in the wake of the recently enacted Part 504 of the DFS regulations mandating specific AML transaction monitoring and sanctions filtering program requirements.

It appears that Habib Bank was initially unable to reach a resolution with the DFS and on August 24, 2017, the DFS issued a Notice of Hearing and Statement of Charges ordering Habib Bank to appear for hearing on September 27, 2017, and seeking to impose a civil money penalty in the amount of $629,625,000. The Statement of Charges set forth more than 53 alleged separate violations of New

York law and regulations committed by Habib Bank and/or the NY Branch from 2007 to the present.

On August 24, 2017, the DFS also ordered an expanded transaction review by an independent third party (the "**Expanded Lookback Order**"), as well as an order regarding the surrender of the NY Branch license. Apparently, in connection with the DFS investigation, Habib Bank had expressed an interest in surrendering its NY Branch license. Accordingly, the DFS issued an order which provided that Habib Bank may notify the DFS within 30 days of its intention to surrender its NY Branch license and set out the conditions for the license surrender. On August 31, 2017, Habib Bank notified the DFS of its intention to surrender its NY Branch license.

It appears that further negotiations followed the issuance of the Notice of Hearing and Statement of Charges, which led to a settlement memorialized in the Consent Order. It is notable that the Consent Order does not dispense for the need for Habib Bank to conduct an expanded transaction review as provided under the Expanded Lookback Order, and that the DFS could potentially seek further penalties on the basis of new findings identified through this expanded transaction review. Also, the 2006 Written Agreement and the 2015 Consent Order will survive the license termination and would apply to any future re-establishment of a branch, agency, representative office, or a banking subsidiary by Habib Bank within the State of New York.

The Consent Order is another cautionary tale for banking organizations operating under the jurisdiction of the DFS. Lack of affirmative and prompt attention to compliance deficiencies identified by the DFS and/or other regulators carries a significant enforcement risk that could threaten an institution's banking license. DFS-regulated institutions should take with utmost seriousness and promptly remediate any compliance deficiencies identified through regulatory examinations, internal audits or otherwise. The Consent Order underscores that being responsive to compliance enhancements needs and demonstrating a commitment to a culture of compliance and cooperation with the regulators are indispensible for the adequate management of regulatory compliance risks.

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