KNOW YOUR CUSTOMERS FOR THE PURPOSE OF PREVENTING AND COMBATING MONEY LAUNDERING

Artur GOLBAN[1]

e-mail:golban.artur@yahoo.com

Abstract

It is very important for a financial institution to know its customers: their main type of activity, the countries where they conduct business, their links with politically exposed persons, their partners, etc., in order to avoid the implication of the Bank in schemes of money laundering which can cause reputational risk and fines from authorities. The purpose of this scientific research is to highlight the importance of the process of „Know Your Customer" (KYC) for financial institutions during the stages of money laundering process, to identify the risks of non identification the customers, to present the risks connected to the customers from sanctioned countries in order to elaborate a strong anti-money laundering (AML) program, adopting prudent and healthy banking practices.

Key words: know your customer; identification, anti-money laundering risk, sanctions, AML program.

Combating money laundering became an international problem. Countries from all over the World are meeting at different forums, round table to discuss about this negative phenomenon proposing ways of combating money laundering.

Financial Action Task Force (FATF), who is the „policy- making body", which sets standards and promote effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats to the integrity of the international financial system defines money laundering as „*the processing of criminal proceeds (money, other assets) to disguise their illegal origin*".

In other words, money laundering is the process by which criminal groups try to hide the origin and real possession of income from their criminal activities. In order to enjoy the results of illicit activities, be it drug, arms trafficking, smuggling, fraudulent bankruptcy or fraud in the financial and banking spheres, etc., criminals need to find a way to hide or conceal the illicit nature of their earnings and put them in the legal financial circulation.

The purpose of a large number of criminal activities is to generate profit for the individual or group that commits the offense. Money laundering is the processing of these crime outcomes in order to hide their illegal origin. This process is critically important because it offers to the criminal an opportunity to enjoy the proceeds of crime without revealing their origin and thus without the offender facing trial for the offenses committed.

In this sense, it is very important that the financial institutions to know their customers, their sources of incomes, which type of activities they perform in order to be sure that the flows of money which come to the financial institutions from these customers are from legal activities, not from ilegal activities (primary offences), such as:

- *Drug trafficking*
- *Terrorism*
- *Abduction of minors*
- *Sexual abuse of minors (child prostitution)*
- *Corruption*
- *Fraud, misappropriation of public subsidies*
- *Counterfeiting or falsification of seals, stamps, hallmarks or trademarks*
- *Theft*
- *Abuse of trust*
- *Fraud and deception*
- *Tax crime*
- *Breach of the law concerning water protection and management, etc.*

Thus, in this scientific research will be analyzed: the importance of the process of "Know Your Customer" for financial institutions, the reasons why financial institutions perform this process of identification the customers, the ways of identification the customers, the risks which may be faced by the financial institutions, in case when non proper identification measures of customers are applied within financial institutions.

[1] The State Agrarian University of Moldova

MATERIAL AND METHOD

This scientific article is realized after the research of the specialized economic literature in the field of anti-money laundering, the Moldova's National Money Laundering and Terrorist Financing Risk Assessment for 2017.

In the same time, the legal regulations (both local and international), taken into consideration at elaboration this scientific article include but are not limited to:

a) Law on Preventing and Combating Money Laundering and Terrorist Financing no. 308 of 22.12.2017

b) Directive (EU) 2015/849 of the European Parliament and Council of 20/05/2015 (the "IV Directive") on prevention of use of the financial system for the purpose of money laundering or terrorist financing, which amends (EU) regulation no. 648/2012 of the European Parliament and Council, and which revokes directive 2005/60/EC of the European Parliament and Council and directive 2006/70/EC of the Commission;

c) Order no. 15 of 08.06.2018 regarding the approval of the Guidelines on the Identification and Reporting of Activities or Transactions Suspected of Money Laundering

d) Order no. 17 of 08.06.2018 regarding the approval of the Guidelines on the Identification and Monitoring of Politically Exposed Persons

e) Regulation No. 200 of 09 August, 2018 on requirements for prevention and combating money laundering and terrorist financing in the activity of banks;

The research methods which were used at elaboration this scientific research are: analysis and synthesis, induction, deduction.

RESULTS AND DISCUSSIONS

The fight against money laundering has a double motivation. On the one hand, this is motivation to combat organized crime and its expansion on a global scale. On the other hand, this is preservation of integrity of financial markets and market economy.

The financial institutions shall enter into business relationships and provide banking products and services depending on the client quality, which is assessed based on the Bank's risk appetite correlated to the reputational risk.

The acceptance of clients is based on the principle, according to which the financial institutions enters into business relationships only with persons that carry out legal activities and that make known the nature and purpose of the banking transactions, which they carry out (Cox D., 2014).

Only after the financial institution knows very well the customer, understands the customer's activity, the source and destination of funds, then the financial institution can initiate the business relationship with the customer.

The process of Know Your Customer is a continuous process, which means that the financial institutions need to update on regularly basis the documents related to the customer during the whole business relationship (Sullivan K., 2015).

The identification process need to be applied to the whole database of customers, beneficial owners as well as to the occasional clients.

The measures of identification shall be applied under a risk-based approach, taking into account the type of client, business relationship, products and services requested.

According to FATF guidance published on October 2014: **"Risk Based Approach for the Banking Sector"** - *"Risk Based Approach to AML/CFT means that countries, competent authorities and financial institutions are expected to identify, assess and understand the ML/TF risks to which they are exposed and take AML/CFT measures commensurate to those risks in order to mitigate them effectively" (*FATF, 2014*).*

The concept of risk based approach also was reflected by the Wolfsberg Group, in 2006, when was published the **„Wolfsberg statement. Guidance on a risk based approach for managing money laundering risks"**, which stipulates that: *„A reasonable designed risk based approach will provide a framework for identifying the degree of potential money laundering risks associated with customers and transactions and allow for an institution to focus on those customers and transactions that potentially pose the greatest risk of money laundering" (*The Wolfsberg Group, 2006*).*

Despite the fact, that there are many definitions, explanations regarding risk based approach, there is no universally accepted methodology regarding what represents the risk based approach, in this sense, the financial institutions deciding their own methodology they want to use in identification and management of the risk.

All the financial institutions have their own Know Your Customer Policies, where are stipulated which customers are accepted by the financial institution to conduct business with and which customers are not accepted by the financial institution.

The financial institutions apply gradual customer acceptance procedures depending on the risk associated with different client categories, the

potentially higher risk of some clients; determine higher level of approval of those customers.

For many financial institutions, from customer acceptance policy is prohibited:

a) to enter into business relationships with intermediaries that cannot provide the Bank with the necessary information about the holders of accounts they manage;

b) to open and operate either anonymous accounts for which the identity of the holder is not known and evidenced in a proper way or accounts under fictitious names;

c) to open accounts for individuals or entities known by official notification or public sources to be convicted of corruption, misappropriation of public funds, money laundering, tax evasion or other economic crimes;

d) to enter into business relationships with individuals/legal entities whose beneficial owner is unknown or kept deliberately unknown; also the Bank shall not initiate the business relationship with potential clients who for the identification purposes provide the Bank with false or insufficient information or submit to the Bank the documents/contracts/etc. which they wish to bring through the Bank and against which there are grounds of suspicion of falsification and/or fraud; in such cases, the prior opinion of the Back Office, Legal and Compliance & AML Departments is required, etc.

The customers during the identification process in the process of establishing the business relationship or in the process of updating the Know Your Customer file are classified as: Low, Medium and High Risk according to different criteria.

In the category of High risk customers are included, but not limited:

- Non-governmental organizations (NGOs);
- Clients that do not appear personally to identify themselves when initiating business relationships with the Bank (accounts opened by proxy, excepted salary projects);
- Activities frequently involving cash in considerable proportions;
- Clients that have a negative reputation on the market;
- Real estate agents;
- Lawyers, notaries or other independent self-employed professionals and accountants;
- Corporate clients whose beneficial owners/majority shareholders are politically exposed persons;
- Clients - insurance and reinsurance companies whose activity is complex and unusual;
- PEPs; etc.

In the process of establishing the business relationship with the financial institution, the high risk customers are approved by the Anti Money Laundering Officers, but also some of them are approved at the level of the Top Management of the Financial Institution (FATF, 2013; FATF, 2019; The Wolfsberg Group, 2017), namely the Politically Exposed Persons (PEPs) due to the fact that PEPs are risk holders, because of:

- ✓ ***Bribery***
- ✓ ***Money Laundering***
- ✓ ***Terrorist financing***

According to the Transparency International's Corruption Perception Index, the corruption in the public sector is highest in emerging economies, because of high level of bribery (LexisNexis,2018). In this sense, from the figure 1 is revealed that the highest level of corruption in the public sector was registered the following countries: Somalia, South Sudan, Syria, Afghanistan, Yemen, Libya, North Korea, Guinea Bissau, Equatorial Guinea.

The lowest level of corruption in the public sector was registered in the following countries: New Zealand, Denmark, Finland, Norway, Switzerland, Singapore, Luxembourg, Netherlands.

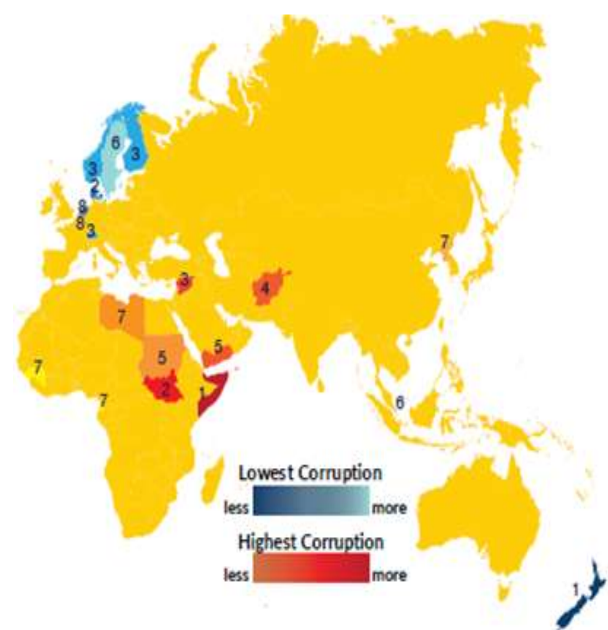

Figure 1. **The countries rated highest and lowest for public sector corruption**

Source: LexisNexis2018, https://p.widencdn.net/vhrpoa/US-EDDM-Pep-Talk

Thus, from the information above, we can conclude that PEPs are high risk customers, which need to be approved by the Top Management of the financial institution.

Identification of PEPs is performed by the employees from Front Office of financial institutions by collecting the information from customers through self-declaration, where they

indicate that they are PEP or not and also by checking the customers in the International Databases of PEPs (Thomson Reuters World Check lists, Lexis Nexis Lists, etc.) by Front Office and AMLO.

Before establishing the business relationship with the customer, it is very important to classify correctly the customer from AML point of view, giving the right risk category.

In the process of identification, the customers, the checking of customers in the PEPs lists and in the lists of sanctions and embargoes (UN, EU, OFAC, etc.) is very important, because this determine the financial institution to accept only customers which are not sanctioned or included in some crime lists.

The non-proper identification of customers can generate problems to the financial institutions, by receiving fines from the regulator or from other state/international authorities, because of accepting international unacceptable clients (for example accepting a terrorist as a client).

In the last 10 years, according to Fenergo website **$26 billion** in fines has been imposed for non-compliance with Anti-Money Laundering (AML), Know Your Customer (KYC) and sanctions regulations to financial institutions.

Among the financial institutions which received big fines for AML/KYC in the last years, we can mention:

- ✓ **Standard Chartered Bank ($1.1bn or £842m)** - for poor money-laundering controls and breaching sanctions against countries including Iran.
- ✓ **The Belgian unit of ING Group NV (350,000 euros or $394,485)** - for violating legislation against money laundering.
- ✓ **Mashreqbank PSC ($40 million) -** for poor AML Controls
- ✓ **UBS, in 2018, agreed to pay $15 million total** - for failing to report suspicious transactions in non-resident alien (NRA) customer accounts in its San Diego, California branch office.
- ✓ **Danske Bank (200 billion euros or $225 billion) -** for a money laundering allegations at its Estonian branch.
- ✓ **Nordea Bank** was fined with more than **$5 million.**

Thus, from the information mentioned above, we can reveal that the cost of non-compliance with AML regulations is very high, because of fines applied to financial institutions, but also because this is a reputational risk for the financial institutions, which very negatively influences their activity.

CONCLUSIONS

It is necessary that all the financial institutions to realize that the process "Know Your Customer" is essential in doing business.

When the financial institution knows its customers, it can manage the risks connected to these customers.

The process of "Know Your Customer" is a continuous process, being performed before the establishment of the business relationship with the customers and during the entire business relationship with the customers.

A non-proper identification process of customers can determine application of fines to the financial institution from the regulator or from other state/international authorities.

Therefore, in order to avoid the financial institution to be used by the criminals to launder their results of illicit activities (drugs, arms trafficking; tax crime; sexual abuse of minors; piracy, etc.) it is very important for each financial institution to apply the concept "Know Your Customer" in the process of establishment new business relationships with customers, as well as during the entire business relationship with customers, identifying the source of funds, the purpose and nature of transactions.

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