

FINANCIAL CRIME: HOW FINANCIAL INSTITUTIONS CAN MITIGATE MONEY LAUNDERING RISK ASSOCIATED WITH POLITICALLY EXPOSED PERSONS AND IMPROVE THEIR COMPLIANCE PROGRAM

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Abstract

The customer acceptance policy of financial institutions stipulates that the Bank shall enter in business relationship and offer banking products and services to customers based on risk appetite correlated to the reputational risk. According to Financial Action Task Force (FATF), a politically exposed person (PEP) is “an individual who is or has been entrusted with a prominent public function: Heads of State or of government, senior politicians, senior government, judicial or military officials, senior executives of state owned corporations, important political party officials, etc.” The business relationship involving politically exposed persons (PEPs) is classified according to Know Your Customer and Anti Money Laundering Principles with high risk, because PEPs have the position to influence some decisions at state level, being involved in corruption, bribery schemes; they have access to significant state funds which can be laundered through companies owned by PEPs, their relatives or close associates by abusing of PEPs high position. The purpose of this scientific research is to highlight the money laundering risk indicators connected to PEPs and to propose mitigation measures to be applied by financial institutions, while strengthening their controls, as a part of an effective compliance program. .

Key words: Anti-Money Laundering, Politically Exposed Person (PEP), Sanctions, Compliance Program.

The economic activities performed in many developing countries favors initiation and after that the development of an impressive number of illegal activities, named as financial crimes.

Each modern society contains also a shadow economy, based on own rules where illegal activities take place and dirty money are obtained.

In many cases the authorities perform investigation activities when it is too late; the wrong things are visible and cannot be contested, when there are unbalances in society.

Each new governance, has the major objective to demonstrate how corrupt was the previous governance and based on this the dimension of financial crimes is increasing as a result of the intensification of the organized crime.

In this sense, the organized crime is using the corruption of politicians, judicial and financial bodies, customs authorities, etc.

For financial institutions is very important to apply the principles of Know Your Customer (KYC), in relation to PEP, which are classified from Anti Money Laundering (AML) point of view with high risk because of: *bribery, money laundering, terrorist financing* activities they may

be involved in and for which must be applied by the financial institution enhance due diligence measures, which include but are not limited:

- prior approval of the initiation/continuation of the business relationship with a PEP client by the senior executive (executives or employees that have sufficient knowledge of the institution’s exposure to money laundering and financing of terrorism and have a senior position to make decisions regarding that exposure and who are not necessarily members of the Board of Directors)

- collecting additional information about the source of funds and the source of wealth related to the business relationship or transactions and their verification (e.g. supporting documents);

- paying close attention to the client-related personal information from third parties (e.g. the press, requests for information from authorities, etc.);

- the high value transactions of clients assigned to the PEP category have to be approved in advance by the senior executive;

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➤ enhanced, continuous monitoring of the business relationship and transactions performed through accounts.

The purpose of this scientific paper is to highlight the importance of applying the KYC principles regarding the PEP clients, to highlight PEP specific regulatory trends, define risks connected to PEPs and to describe how to apply best practices to mitigate risks associated with PEPs while strengthening the existing controls.

MATERIAL AND METHOD

This scientific investigation was realised after the analysis of the following legal regulations:

- Law on Preventing and Combating Money Laundering and Terrorist Financing no. 308 of 22.12.2017
- 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;
- 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;
- Order no. 17 of 08.06.2018 regarding the approval of the Guidelines on the Identification and Monitoring of Politically Exposed Persons
- Regulation No. 200 of 09 August, 2018 on requirements for prevention and combating money laundering and terrorist financing in the activity of banks;
- Wolfsberg Guidance on Politically Exposed Persons (PEPs) (released 2003, revised 2008, updated 2017)
- FATF Guidance on Politically Exposed Persons (2013)

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

RESULTS AND DISCUSSIONS

Politically Exposed Persons are subject of various investigations by international organizations, being defined as:

- Individuals who have or have had positions of public trust such as government officials, senior executives of government corporations, politicians, important political party officials, etc. and their families and close associates. (Wolfsberg Group, 2017).
- Natural persons who are or have been entrusted with prominent public functions and

immediate family members, or persons known to be close associates, of such persons (EU Money Laundering Directive (4th 2015),

➤ An individual who is or has been entrusted with a prominent public function: Heads of State or of government, senior politicians, senior government, judicial or military officials, senior executives of state owned corporations, important political party officials, etc. (FATF, 2013; FATF, 2019),

➤ Natural persons that exercise or exercised during the last year prominent public functions at national and/or international level as well as members of the governing authorities of political parties (Law 308/2017 on Preventing and Combating Money Laundering and Terrorist Financing).

PEPs clients generate for financial institutions the following risks: *compliance risk*, *reputational risk*, *legal risk*.

In this sense, financial institutions use various methods to identify the Politically Exposed Persons:

- Through self-declaration – when a customer declares in the process of initiation/continuation of the business relationship with the financial institution that he/she is a PEP and the financial institution is performing all the necessary diligences
- Using screening tools – when the financial institution's employer from Front Office is introducing the name/surname of the customer in the IT system of the financial institution and the data of the customer is screened against local and international PEP lists. When coincidences of customers with PEP lists are registered the employer from Front Office performs the necessary diligences regarding the approval of this customer according to the AML Policy of the financial institution.

Among the most famous providers of PEP lists are LexisNexis Solutions, Refinitiv World Check One, Fircosoft, etc.

In some cases, there are situations when in the lists offered by some providers doesn't exist local PEPs related to some functions from state, this creating deficiencies in identification local PEPs. In this case, it is recommended for the financial institution to create the local PEPs list, based on the provisions of the local legislation in force of the specific country.

It is very important to perform screening of customers against PEP lists because this process gives possibility to the financial institutions to identify the PEPs and to mark them with high risk, applying enhanced due diligence measures.

In the same time, PEPs are very careful and trying to shield their identity using different ways (FATF, 2013):

- Use of corporate vehicles (legal entities and legal arrangements) to obscure the beneficial owner.
- Use of corporate vehicles without valid business reason.
- Use of intermediaries when this does not match with normal business practices or when this seems to be used to shield identity of PEP.
- Use of family members or close associates as legal owner.

Therefore, as a part of enhanced measures applicable in business relations with the politically exposed persons, their family members or PEP related persons, the financial institutions must apply a process of analysis and verification by using special factors, such as (Cox D., 2014; Sullivan K., 2015):

- the person owns or controls, in whole or in part, directly or indirectly, a financial institution and/or a professional participant on the non-banking market;
- the person owns or controls, in whole or in part, directly or indirectly, a financial institution and/or a professional participant on the non-banking market that is a partner or correspondent in a transaction with the Bank;
- personal property or lifestyle is not in accordance with the legitimate sources of income or the known property of the person, as well as the transactions performed;
- there are reasonable suspicions that the person has attempted to hide the nature of his/her income;
- the person is responsible or able to influence significant public procurement processes;
- the person is responsible for the issue of licenses, permits, approvals, limited governmental permissions in sectors considered to have high risk of corruption, such as construction, mineral extraction, health care, etc.;
- the person has preferential access to the privatization of former state assets;
- PEP at the international level, who is a citizen or resident, or has business interest in a country with a high risk of illicit trafficking in drugs and psychotropic substances, a country with a political system based on an autocratic and authoritarian regime or a country that has been identified as having strategic deficiencies including high levels of corruption; Other criteria depending

on the risk identified in relation to the client, business relationship, conducted transactions, etc.

According to FATF, the financial institutions must be very careful at specific behavior of PEP, which may raise *reasons of suspicion/red flags* (FATF, 2013):

- The PEP is very interested about the AML policy or PEP policy of the financial institution
- The PEP doesn't want or feels uncomfortable to provide the financial institution the information about the source of funds or source of wealth
- After checking the information provided by PEPs about the source of funds source of wealth was identified that the information is not corresponding to the information officially available about salaries, asset declarations
- The PEP cannot provide justification about doing business in one or another high risk country
- The rapid movement of funds repeatedly by PEPs to and from countries with which PEP doesn't seem to have any business relationship
- At a company registered in high-risk jurisdictions, from the documents submitted or from other sources, the bank understands that the beneficial owner is a politically exposed person or persons associated with a PEP;
- Performing banking operations without any economic sense with involvement of politically exposed persons or transactions that do not reveal from their content the need to carry out such operations;
- The natural or legal person makes payments for the benefit of the politically exposed person or his family members for different types of services, but such transactions are not relevant to the specific activity for these natural or legal persons.

For monitoring purposes of PEPs it is very important to continuously monitor the Transparency International's Corruption Perception Index (CPI), which aggregates data from a number of different sources that provide perceptions by business-people and country experts of the level of corruption in the public sector (Transparency International, 2020; Golban A., 2019).

Analyzing the *figure 1*, we can reveal that the lowest level of CPI in 2019 was registered in: Denmark, New Zealand, Finland, Singapore, Sweden, Switzerland, Norway, Netherlands, Germany, Luxembourg and the highest level of CPI, was registered in: Somalia, South Sudan, Syria, Yemen, Venezuela, Sudan, Equatorial Guinea, Afghanistan, North Korea.

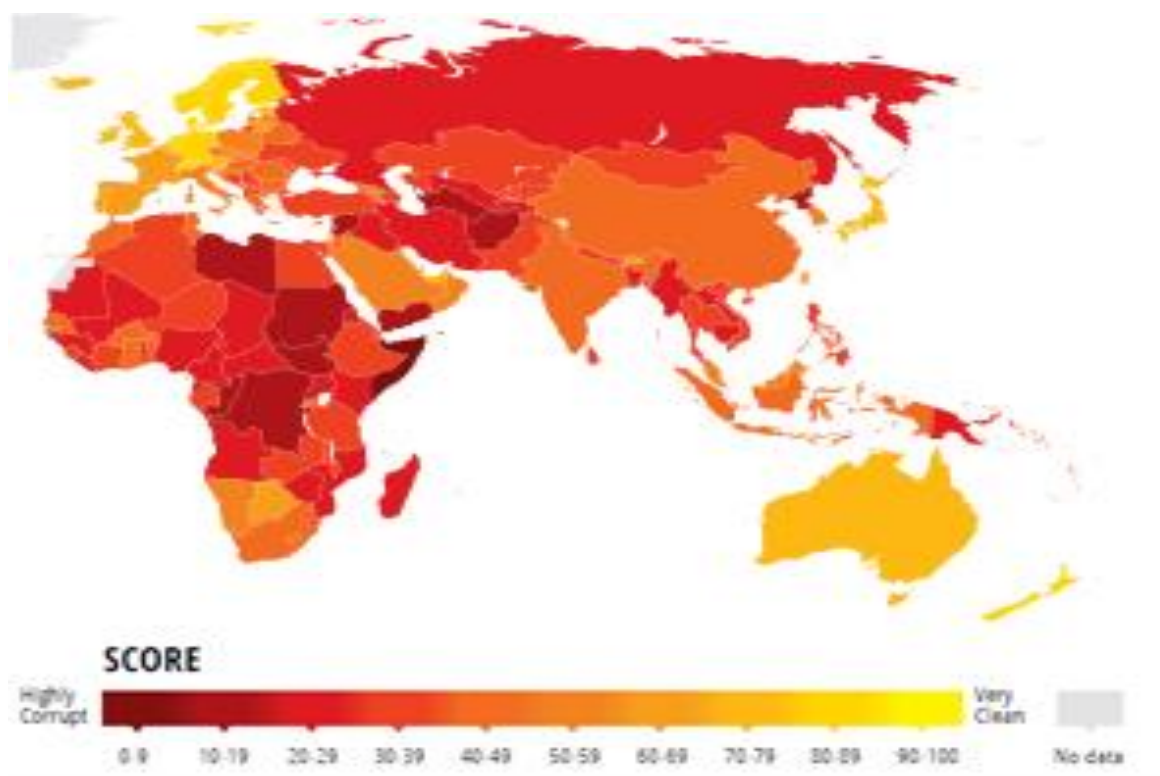


Figure 1 The Corruption Perception Index in 2019

Republic of Moldova was placed according to CPI in 2019 on the 120 place, between Sierra Leone (119) and Niger (120), Pakistan (120), Bolivia (123). Compared to Romania, the CPI for the Republic of Moldova is much higher than for Romania by 50 positions, which was placed on 70 place.

According to Corruption Perception Index Report (2019), the countries from Eastern Europe face:

- ✓ limited separation of powers,
- ✓ abuse of state resources for electoral purposes,
- ✓ opaque political party financing and conflict of interest.

In order to address effectively corruption, the political leaders from Eastern Europe have to prioritise public interests and set an example for transparency (Transparency International, 2020).

For financial institutions is very important to identify PEPs clients, to understand the purpose and nature of the business relationship and to apply enhanced due diligence measures (McCusker, R., 2006).

In case when financial institutions doesn't identify correctly the PEPs clients or do not apply enhanced due diligence measures regarding PEPs or do not report to local authorities the suspicious behavior of PEPs regarding money laundering and terrorist financing, the financial institutions risk fines/penalties from authorities.

In 2020, financial institutions received fines for breaches in the AML/KYC area as follows:

✓ The Financial and Capital Market Commission fined *Signet Bank of Latvia* (906 610 EURO) - for violating anti-money laundering and anti-terrorism financing (AML) regulatory requirements.

✓ New York Regulator - The New York State Department of Financial Services fined *Deutsche Bank AG* (\$ 216.1 million) - for AML compliance failures, correspondent banking relationships with Danske Bank Estonia and FBME Bank.

✓ Chinese Central Bank fined *BNP Paribas Chinese Unit* (2.7 million yuan - \$378.200) – for failures in KYC processes and in reporting significant and suspicious transactions

✓ FCA, fined the *Commerzbank London branch* (£ 37.8 million) - for violations of AML controls.

✓ 5 banks from Kenia - *KCB Group KCB.NR*, *Equity EQTY.NR*, *Co-op Bank Kenya COOP.NR*, *StanChart Kenya SCBK.NR* and *Diamond Trust DTK.NR* faced AML fines (\$ 3.75 million) – for AML violations

Analyzing the figure 2 we can reveal that the dynamics of AML penalties have an increasing trend, registering in 2020 by approximately 2 times more penalties compared to 2018, being equal to \$ 8 billion. In the first semester of 2020, were registered 6 billion dollars penalties. The majority of the AML fines were related to the breaches

regarding the KYC procedures, reporting suspicious transactions, lack of AML controls,

Customer Due Diligence.

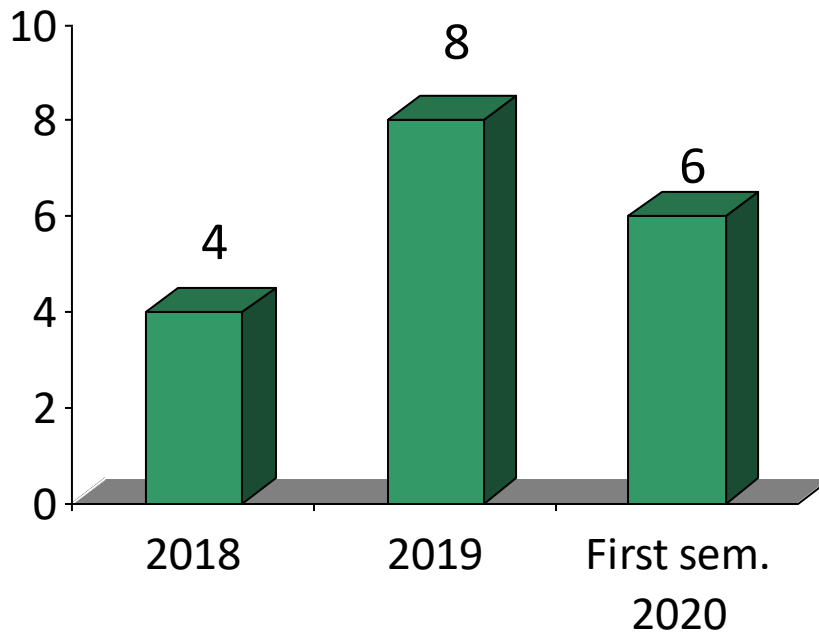


Figure 2 The dynamics of AML penalties during 2018-first semester of 2020, billion dollars

Therefore, from the investigations performed above, applying with good faith the principles of Know Your Customer, Enhanced Due Diligence Measures, Continuous monitoring and Reporting Suspicious transactions in case when there are reasons of suspicion/red flags regarding Politically Exposed Persons represent the necessary measures to be performed by Compliance/AML Officers which will protect the Bank against sanctions from authorities and will ensure a good reputation of the financial institution.

CONCLUSIONS

As a result of the performed investigations, we can highlight the following conclusions:

Financial institutions treat PEPs as high risk customers from AML point of view because of bribery, corruption, terrorist financing they may be involved in.

Identification of PEPs is performed using self-declaration of PEPs and automated screening tools;

PEPs care very much about their identity, in this sense using various methods to hide that they are the ultimate beneficial owner of assets, funds (corporate vehicles, family members, close associates).

For monitoring purposes, Transparency International's Corruption Perception Index gives

possibility to create an image about the level of corruption in the public sector all over the World.

The fines for noncompliance with AML rules increased by 2 times in 2019 compared to 2018, being equal to \$ 8 billion and to \$ 6 billion in first half of 2020, revealing the importance of respecting by financial institutions the AML/KYC rules, as follows: identification the source and destination of funds, identification the purpose and nature of the business relationship with the customer, documentation of transactions performed by the customers.

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