



Basel III and the Challenges to Bank IT

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The Lexicon of PEP Risks in Global AML Framework



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The Financial Action Task Force (FATF) pile up the pressure on financial institutions to crack down on crime by issuing a revised set of anti-money laundering (AML) recommendations in February 2012, but despite this effort there is still huge gaps in AML international standards. Financial institutions operating globally will still face the challenge of getting their due diligence right because of the lack of harmonisation in the global AML framework.

The revised FATF recommendations include among others an obligation for financial institutions to identify domestic customers who are politically exposed and to treat them in the same manner as the foreign customers who are classified as politically exposed persons (PEP). This revision is

Politically Exposed Person: a public official, who by dint of their position could potentially have opportunities to appropriate public funds or take bribes; or their family members of close associates. The anti-money laundering regulations require that bank accounts belonging to PEPs or companies controlled by them should be subjected to extra scrutiny.

supposed to assist in the identification and repatriation of assets associated with corruption before they reach global financial capitals. But this effort would achieve very little as long as there is no similarity in the interpretation of PEP.

Many countries have modelled their AML legislation on United Nations Convention against Corruption (UNCAC) or on EU Directives. Both standards take different approach on PEP. The variation in AML law creates opportunities for corrupt individuals and companies to launder the proceeds of their crime by moving money from one jurisdiction to another or

by cutting deals to ensure that corrupt money stays offshore. In many reported corruption cases where PEP is involved, we found that intermediaries (most often a family connection with PEP) would launder their ill-gotten gains. So how deep and how far should the screening of domestic PEP go, the challenge for financial institutions in these circumstances is to spot the transactions which are hiding the proceeds of crime by understanding PEP's source of funds and wealth in the enhanced due diligence (EDD) process.

In the UK, the Financial Services Authority (FSA) reported

last year that three-quarters of the banks reviewed failed to take adequate measures to establish the legitimacy of the source of wealth and the source of funds, and "around a third of banks, including the private banking arms of some major banking groups, appeared willing to accept very high levels of money laundering risk if the immediate reputational and regulatory risk was acceptable."

Effective scrutiny of transactions with proceeds of crime is a major challenge, given the high level of sophistication in money laundering techniques. For financial institutions with branches overseas, the level of corruption in some countries could frustrate their anti-money laundering and anti-bribery measures they have in place.

PEPs present a multi-dimensional risk to financial institutions

The enhanced scrutiny process that financial institutions need to develop is complicated by the fact that in many jurisdictions PEP screening is not performed adequately. In addition, non-PEP customers can become PEPs, sometimes without a financial institution's knowledge through marriages (legal or cultural marriages) with a PEP family member, or promotions within government to a "senior" position. There is currently no definitive list of PEPs which leaves financial institutions to rely heavily on commercial companies that research and provide lists of PEPs and their associates, along with information about business dealings, court cases, corruption allegations and appearances in the press. To bridge the gap in due diligence, domestic financial services regulators should be required by FATF to assess the effectiveness of commercial databases of PEPs on which financial institutions rely to carry out their customer due diligence or governments should be called to compile lists of domestic PEPs and provide a definitive basis against which to apply EDD measures. There are also important gaps in connection with ensuring sufficient transparency over beneficial ownership of assets and the time limit of PEP after leaving office.

Both the FATF recommendations and the UNCAC now advocate the identification of domestic PEP, but unlike the UNCAC, FATF can use its black list of "high-risk" and "non-cooperative" jurisdictions to put countries under pressure to comply with 'domestic PEP' identification.

Most European Countries and the U.S. have no requirement for financial institutions to scrutinise accounts held by

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domestic political figures. Domestic PEPs have not been a priority in many countries and the theory that

politicians will pass legislation that may incriminate them remain to be seen.

The lack of a coherent approach in international standards can be seen in the table below.

INTERNATIONAL STANDARDS	APPROACH TO POLITICALLY EXPOSED PERSONS
FATF	<ul style="list-style-type: none"> List the individuals who are PEP. For example, Heads of State or of government, senior politicians, senior government, judicial or military officials, senior executives of state owned corporations, important political party officials. Business relationships with family members or close associates of PEPs involve reputational risks similar to those with PEPs themselves. Silent on companies that are related to PEP's close associates. Focuses on those "entrusted with prominent public functions in a foreign country" regardless of their country of residence. No distinction between domestic and foreign PEP (prior to February 2012 domestic PEP was not covered).
3rd EU Directives	<ul style="list-style-type: none"> PEPs are defined as "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". It does not distinguish between domestic and foreign PEPs, but requires that firms identify and apply EDD to PEPs who reside outside the jurisdiction. As a result, the Directive does not require EDD for PEPs who reside inside the jurisdiction even if they were entrusted with a prominent public function overseas. Has time limit imposed on PEP. The degree of relationship focuses on immediate family members, which may not be sufficient in cultures and jurisdictions in which the extended family maintains very close ties. PEP covers joint beneficial ownership of legal entities or legal arrangements.
UNCAC	<ul style="list-style-type: none"> Does not distinguish between foreign and domestic PEPs, which mandate the application of EDD to both foreign and domestic PEPs. Includes as close associates both persons and companies that are related to the individual entrusted with the prominent public function No time limit for PEP (once a PEP, always a PEP)
Wolfsberg	<ul style="list-style-type: none"> Referring to individuals holding or having held positions of public trust, such as government officials, senior executives of government corporations, politicians, important political party officials, etc., as well as their families and close associates. PEPs potentially represent higher risk because they either are in a position to exert undue influence on decisions regarding the conduct of business by private sector parties, or have access to state accounts and funds.

Conclusion

Due diligence by financial institutions will vary in depth, but as the Arab Spring brings regime change across Northern Africa and the Middle East, financial institutions should review the robustness of their ABC and AML/CFT system with PEP and to treat those that pose "higher risks" of corruption in the same manner as their foreign counterparts and seek senior management approval for the accounts

transactions; determining the source of the account-holder's funds and monitor their accounts closely. If initial background checks fail a more specific and detailed inquiry will be needed. This process may also require forensic auditor to review financial and other records to substantiate source of wealth and source of fund. Financially Exposed Persons (FEP) holding important position in the

private sector should go through a similar monitoring process to PEP, as they are no less vulnerable to corruption.

Disclaimer - This article is intended to provide commentary and general information. It should not be relied upon as legal advice or any sort of formal advice.

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