



CLOSING BANKS TO THE CORRUPT: THE ROLE OF DUE DILIGENCE AND PEPs

People in positions of power — often called Politically-Exposed Persons (PEPs) — may abuse their entrusted role for their own personal gain, feeding grand corruption.

Banks provide one of the stopping places for these ill-gotten monies. Until now, financial institutions and their regulatory authorities have failed to prevent them from being a safe place for the corrupt. Now is the time to close this loophole.

Grand corruption most typically involves prominent public office holders who abuse their position of power by stealing state monies or accepting bribes. These acts have a devastating impact on a country's well-being. They fuel capital flight and harm the investment climate. They distort the delivery of social services and sap money from public coffers for key basic services.

One essential step to stopping grand corruption is ensuring that the corrupt do not have a safe haven to hide their ill-gotten funds. The corrupt often turn to banks and other financial institutions to legitimise their monies, bringing them into the formal financial system. Yet while financial institutions form a critical part of the problem, they are also a critical part of the solution.

Financial institutions can prevent these flows from ever entering the system. They can do this by effectively identifying perspective investors and clients as "Politically Exposed Persons" (PEPs): individuals who have held or are in public office. By flagging potential PEPs, banks are then able to do additional checks on the source of funds and to ensure that they are free of corruption.

While banks and other financial intermediaries currently have a duty to take such a step, they often fail to fulfil it. This lack of compliance must end.

Banks and other key actors (from lawyers to accountants) must do their part and comply with their due diligence duties on PEPs. At the same time, regulatory authorities must act to close the enforcement gap and to stop banks from servicing the corrupt.

THE ISSUE

WHO IS A PEP

“Politically Exposed Persons”, or PEPs, are individuals who are, or have been, entrusted with high-level positions in public service. Definitions often include heads of state and senior politicians as well as high-ranking officials from government, the military and state-owned companies. The PEP classification may extend from the person to his or her family members and close associates.

While PEPs may or may not be corrupt, they represent a high risk which financial institutions have the burden to assess. There are regulatory measures that exist internationally, regionally and nationally that require financial institutions and selected businesses to undertake such an assessment as part of efforts to combat money laundering and illicit flows.¹

A key part of the assessment process involves verifying the information and identity of perspective PEP clients, even when the person may be the beneficial owner of a corporate entity or legal arrangement, or when the client may operate via intermediaries (such as family members or business associates). Once a bank has identified a PEP, financial institutions must treat them as high-risk customers. They must conduct enhanced due diligence (both before and after entering a business relationship), scrutinise their funds, closely monitor their transactions and report suspected irregularities via “Suspicious Activity Reports.” Enhanced due diligence includes obtaining information on a customer’s source of funds or wealth, the intended nature of the business relationship and senior management approval to take on or continue with a customer.²

IDENTIFYING THE LOOPHOLES

In spite of these measures, many banks continue to provide the corrupt with a place to put their money. This loophole has been created as result of the overall lax enforcement of anti-money laundering regulations and how banks currently undertake due diligence on PEPs. As of 2010, out of 124 assessed jurisdictions only two per cent were fully compliant with FATF recommendations on PEPs.³ Among OECD countries, data from 2005-2011 reveals a non-compliance rate of 56 per cent, with no country in full compliance.⁴

The problem of enforcement is particularly challenging in developed countries.⁵ According to a 2011 report by the UK’s financial regulator, more than a third of the banks inspected lacked effective measures to identify customers as PEPs and over half of them did not apply meaningful enhanced due diligence in high risk situations.⁶ This is partly due to the fact that existing rules fail to encourage banks to adequately monitor relationships with PEPs despite the high risks (reputational, economic and legal).

The identification of PEPs is complicated by the lack of consistent terminology for who is a PEP or who should be included among “family members” and “close associates.” Potentially high-risk categories such as prominent political party officials, diplomats and sub-national politicians are not universally included. Moreover, most international standards require enhanced due diligence mechanisms to be automatically applied only to foreign PEPs. The Financial Action Task Force (FATF), the main global anti-money laundering body, has expanded enhanced due diligence (EDD) recommendations to include domestic PEPs yet they are only treated as ‘high-risk’ after an internal bank-led assessment; if they are deemed low or normal risk, no EDD is done when they are taken on as customers.⁷

To determine whether a client is a PEP, some financial institutions screen their clients against commercial databases of PEPs, while larger banks may possess

CASE STUDY – THE DOUGLAS ABUBAKAR CASE

Between 2000 and 2008 Jennifer Douglas, a U.S. citizen and wife of former Nigerian Vice President Atiku Abubakar, successfully transferred over US\$ 40 million of allegedly illicitly acquired funds into more than 30 US bank accounts, using offshore corporations. These monies were largely the result of reported bribery payments made to her husband to win public contracts.

Although she listed her occupation as unemployed or a student, the US banks maintaining her accounts allowed multiple, large offshore wire transfers into her accounts without further investigation. According to the US Senate Subcommittee that investigated the case, Jennifer Douglas’ personal expenses reached up to US\$ 90,000 per month.

The five banks holding her accounts claim that they did not know that Jennifer Douglas was a PEP and never subjected her accounts to monitoring, in spite of the amounts involved coming in via wire transfers from Switzerland and Nigeria.⁶ When one bank finally found out that she was a PEP after being a client for seven years, they closed her account, only to have her lawyer successfully persuade other banks to provide a new account. Until now, she has never been prosecuted in the US or Nigeria.⁸

their own in-house lists. While these databases may allow for the fast processing of large volumes of information, they are often neither entirely accurate nor comprehensive. Moreover, databases are often powerless against corrupt PEPs hiding who use intermediaries to open their accounts.

MONITORING PEPs

Once a PEP has been identified, banks are obliged to monitor these clients as part of enhanced due diligence requirements. In order to fulfil these regulatory obligations, financial institutions and other regulated businesses (e.g. lawyers, Company Service Providers, real estate agents, casinos, etc.) must obtain additional information about any PEP client throughout the relationship as well as the nature and purpose of the business.

In order to determine a PEP's source of wealth and funds, documented information can be requested from the customer and also obtained from public registers (e.g. registers for land and property, asset disclosure, and companies). Asset declarations, which many countries require high-level public servants to fill, can provide useful data for banks to compare against the information provided by the customer or with account activity. However, the quality of income and asset disclosures can be quite poor, undermining the process.

For monitoring to be effective, it should follow a risk-based approach around well-defined red flags for PEPs and must be continuous. Monitoring should not stop after a business relationship with the client has started or when a person leaves public service (see side bar). Ongoing monitoring of PEP and former PEP clients, through the tracking of transactions, may reveal unusual patterns or behaviour not consistent with the customer's profile, which should promptly be reported to Financial Intelligence Units (FIUs). The monitoring process should be well documented and the institution performing it held accountable for deficiencies through commensurate sanctions, even when money laundering is not detected. Monitoring should also be considered of non-PEPs who represent high-risks of being corrupt (see side bar), while regular checks should be run in order to identify whether an existing non-PEP customer has become a PEP.

RECOMMENDATIONS

INTERNATIONAL BODIES MUST:

- Align and broaden definitions of PEPs and eliminate distinction between foreign and domestic PEPs.
 - Expand internationally-agreed definitions of PEPs to include public functions considered high risk.
 - Use lists of officials required to file asset declarations to identify who is considered a PEP for each country.

GOVERNMENTS MUST:

- Strengthen and enforce their PEP and AML regulations.
 - Ensure all countries have FATF-compatible regulations that are enforced and monitored. Countries lacking such PEP regulations must urgently adopt them.
 - Countries with relevant PEP legislation must enforce it and promote clearer and more stringent PEP regulations nationally and internationally.
- Ensure the capacity and resources of regulators are commensurate to the financial activity to be monitored.

A PEP NO MORE?

To effectively close the loophole that allows corrupt monies to access banks, there needs to be continuous monitoring of PEP clients, even after they leave public office.

Some regulations — including at the EU-level — have set a specific time limit after which a former PEP stops being considered as high-risk.

However, these time limits should be considered only the minimum floor.

Cultural and political factors often determine the degree of influence a former PEP may still exercise even after he or she leaves office. For this reason, a risk assessment rather than statutorily prescribed time limits can best determine when a person's PEP status should be ended.

PEPs AND BEYOND

While all PEPs can be considered potentially high-risk customers, they are not the only category that require careful scrutiny.

Individuals operating exclusively in the private sector can represent a high money-laundering risk. Red flags to identify private and public sector customers should include:

1. type of client
 - non-resident customers,
 - high net worth individuals,
 - people with known dubious reputations,
 - corporate clients with unnecessarily complex or opaque beneficial ownership structures;
2. type of business
 - clients operating in high-risk sectors,
3. geographic area
 - clients linked with high-risk countries,
4. product, service, and transactions
 - transactions which are unusual,
 - lack an obvious economic or lawful purpose,
 - complex or large;
 - might lend themselves to anonymity.⁹

- Work with Financial Intelligence Units to develop red flags to identify PEPs and provide guidance and feedback to reporting institutions on submitted SARs.
- Adopt sanctions severe enough to act as deterrents.
 - Apply penalties when controls, procedures and processes by financial institutions are deemed inadequate, even if money laundering is not found.
 - Ensure increased personal responsibility for senior officials at banks who fail to uphold PEP regulations.

FINANCIAL INSTITUTIONS MUST:

- Adopt appropriate risk management procedures to find out if a potential customer (or beneficial owner) is a PEP.
 - Establish control mechanisms that draw on a range of sources: commercial and in-house databases, exchange of information within the company group, asset declaration filings, and internet and media, among others.
 - Set up a PEP committee, including in-house anti-money laundering experts, to ensure transparency of a bank's decision to accept a PEP client.
- Task senior management to vet and monitor PEPs.
 - Require their approval to establish a business relationship with a PEP (or continuing it with a customer who becomes a PEP).
 - Ensure someone from senior management oversees PEP regulations and periodically reviews PEP clients.
- Conduct Enhanced Due Diligence measures prior to and after establishing a business relationship with a PEP.
 - Include steps to verify the sources of wealth and funds.
 - Require high-risk PEP clients to prove that the source of their funds is legitimate in order to qualify as a client.
 - Review regularly all PEP customers based on a risk assessment and against a customer's profile.
 - Use regular checks to find out whether an existing customer (or beneficial owner) has become a PEP.

Notes

¹ See: UN Convention against Corruption (Art. 52), the Financial Action Task Force (rec. 12) and the Fourth EU Anti-Money Laundering Directive.

² See www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF_Recommendations.pdf (pgs 65 – 66).

³ StAR. "Politically Exposed Persons. Preventive Measures for the Banking Sector", 2012, p.8.

⁴ OECD, "Illicit Financial Flows from Developing Countries: Measuring OECD Responses," 2014, 33. UNCAC includes in the definition of "close associates" both natural persons and companies, while the FATF and the EU only mention the former. In the definition of "family members," the EU focuses on immediate families, while the FATF and the UNCAC leave the exact definition open to interpretation.

contained in FATF (Interpretive Note 10, par. 15).

⁵ StAR. 2012, p.13.

⁶ FSA, "Banks' management of high money-laundering risk situations", 2011.

⁷ See: FATF recommendation 12 and 22, June 2013: www.fatf-gafi.org/media/fatf/documents/recommendations/guidance-peg-rec12-22.pdf.

⁸ For case, see: www.huffingtonpost.com/bruce-fein/nigeria-crucifying-democr_b_803110.html.

⁹ A list of minimum standards for assessing high risk factors is contained in FATF (Interpretive Note 10, par. 15).

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Transparency International
International Secretariat
Alt-Moabit 96
10559 Berlin
Germany

Phone: +49 - 30 - 34 38 200
Fax: +49 - 30 - 34 70 39 12

ti@transparency.org
www.transparency.org

blog.transparency.org
facebook.com/transparencyinternational
twitter.com/anticorruption

