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An Overview of AML for the Beginner

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27 May 2008

What is it

Money laundering as a crime has existed from around 5000 BC in the form of informal money transmission businesses in ancient China. It received some attention in the 1970's with the Bank Secrecy Act being passed in the USA. However, it only came into the limelight with the passage of the USA PATRIOT Act in October 2001 in response to the tragic events of September 11 2001.

Money laundering is the process of making dirty money (the proceeds of drugs and serious crimes) appear legitimate so that it can be invested and the fruits of crime enjoyed by criminals. It is the world's third largest business behind foreign exchange and oil. The IMF estimates the amount of money involved in money laundering is 2%–5% of global GDP, which equates to US$590 billion to US$1.5 trillion annually. It is estimated that some 10% of the money circulating in the world's financial markets has it's origins in crime.

Money laundering schemes range from the simple (buying winning lottery tickets) to the complex involving cross-border organised laundering by criminal gangs. Organised large-scale money laundering is usually a three staged process of *Placement* or depositing cash (USD 100 and now even EUR 500 notes are a favourite) into multiple accounts, *Layering* or passing it around the financial system through different accounts, financial institutions and countries so as to confuse the money trail, and *Integration* or investing it in assets and businesses – at this stage the money appears legitimate and is difficult to identify as the proceeds of crime.

Money launderers have always actively used shell companies (or paper companies) and trusts, including specifically those created in offshore jurisdictions (which tend to have a lighter regulation regime) for organised money laundering. *In such schemes, there are companies that exist only to confuse the paper trail.* Launderers use a number of other factors to compound the impact of these vehicles. For example, exploiting known banking secrecy, corporate secrecy or trust law provisions (neither the banks nor the registry of companies may reveal details

easily; there may be a creditor unfriendly trust law/ other loopholes) to create layered ownership structures; using bearer share companies, nominee services (nominee shareholders, directors, and authorised signatories) in such structures to reduce transparency; and using offshore banking accounts which again may have differential standards of regulation and supervision. *Some offshore jurisdictions have given lip-service to global regulators retaining much of their vulnerabilities.*

IMPACT

Any nation that is conscious of the need for law and order is sensitive to the need for prevention of money laundering or anti-money laundering (AML) as it's called. This is increasingly important because of the growing problem of terrorism and the fact that terrorists are switching to more conventional money laundering mechanisms to launder the proceeds of crime including drug trafficking. *Money laundering also impacts the way resources are allocated, social equity, strength of democracy, and international investments (e.g. if a country is blacklisted).*

CFT

Combating the Financing of Terrorism (CFT) is an increasingly important aspect for AML practitioners. Terrorists use all kinds of sources of monies – Illegal sources include drug trafficking, fraud, extortion although traditionally they focussed on genuine sources such as charity collections for funding their operations (this is still a vulnerability in many countries). The other development on this front is the emergence of small networks of terrorists who are not part of any larger organised group but are self trained over the internet and are also self financed including using the proceeds of petty crime (including Intellectual Property Rights (IPR) Theft). Monitoring customers of a financial institution against a database of petty crimes committed is an expensive task and terrorists may not use bank accounts. This is a dangerous development as it takes the focus out of the financial system where AML capabilities traditionally exist. Terrorists also resort to identity theft as do money launderers (in the initial stages of money laundering). *This has created a whole new focus on tools to manage identity theft risk – technology/ databases have helped although this is more in the West.*

In general, non-documentary verification processes are growing in importance for AML/CFT and for example, Politically Exposed Persons (PEP) databases produced by select commercial vendors are now a recommended option for due diligence in many regulations/ guidelines.

FATF & PREDICATE CRIMES

The Financial Action Task Force (FATF) is the global watchdog on AML/CFT issues. Their latest principles for member countries to implement are a revised set of 40 principles for AML in June 2003 and 8 Special Recommendations on CFT issued in October 2001 followed by a 9th recommendation on cash couriers in October 2004. With regard to CFT, the FATF is especially concerned about the misuse of non-profit organisations, wire transfers through banks, hawala transfers (alternative remittances) and cash couriers (for smuggling of cash cross-border).

Besides the financial sector, the FATF now focuses on a range of other businesses for AML including lawyers, accountants, trust and company service providers. Lawyer-client accounts and accountant-client accounts are protected by professional privilege but this does not cover situations where they have knowledge of criminal activities/intent. The FATF also requires a higher standard of transparency (identification of beneficial owners) during setting up of a company/ trust structure.

The FATF recommended list of 20 minimum predicate crimes for money laundering includes terrorist financing, counterfeiting and piracy of products (IPR Theft), corruption, fraud, insider trading and market manipulation. Tax evasion is not specified and continues to be a contentious issue. Some countries like the UK 'technically' have an "all crimes" reporting regime. Many others treat tax evasion as a criminal offence (US) but not under the AML regulations. *However, foreign tax evasion monies find their way into many financial hubs and this continues as a contentious issue.*

STR filing requirements occur with initial contact with a prospect client and at account opening (for business declined for AML reasons), and during the life of an account. STR filing is usually time-bound under law with a predefined chain for internal reporting. The reporting standard underscores that the *staff need not have definite knowledge of money laundering activities – suspicion is the threshold for reporting*. This includes knowledge of circumstances which would put an honest and *reasonable person* on inquiry, but failing to make reasonable inquiries, which such a person would have made. There are two big sins in AML – *"wilful blindness"* or closing ones eyes to the obvious and not filing an STR where required, and *"tipping off"* or informing the client that an investigation is underway/ an STR has been filed. These offences can lead to fines or even jail sentences.

TWO KEY ISSUES

The "insider angle" to money laundering scams is a growing area of focus and proactive know your employee practices including pre-hire/ongoing employee screening, whistle blowing policies and channels, are all becoming essential in financial institutions especially in private banks and broker-dealers.

Grey or front businesses are a key challenge for AML professionals. The experience of enforcement over years has been that front businesses are used for both money laundering and terrorist financing. These are semi-legitimate businesses that have a legitimate registration and business activity but are also misused. This makes the task of detecting unusual activity more difficult particularly if the business is a reasonably large one. *Grey businesses are also typical in IPR Theft* where a licensed manufacturer overproduces a branded item (e.g. electronics) which is sold without accounting for it in the books of records. If such an enterprise is controlled by terrorists, the problem takes a very serious turn.

CIVIL RECOVERY

Civil recovery is a growing focus. Because of the poor track record in confiscating the proceeds of crime through criminal convictions for technical/other reasons, governments world-wide are now increasingly turning to civil recovery for AML purposes where criminal cases fail. This puts the burden of proof on the defendant to establish the legitimate origins of the property. It does not lead to a conviction or imprisonment i.e., the focus is on confiscation. *This can potentially be useful to bring to task IPR Theft perpetrators as industry bodies (e.g. a motion pictures association or the like) are often aware of many perpetrators but are unable to move against them for technical reasons.* Nonetheless, the experience of some newly setup asset recovery agencies in Europe has not been good with the amount of monies spent far exceeding the amount recovered – a key agency was merged into another agency in 2008.

TECHNOLOGY & AML FRAMEWORK

There is a growing focus on the use of technology for AML especially in the US and the UK and some countries in Europe. Banks have taken the lead in adoption although non-bank financial institutions are also taking the cue. The first round of implementations outside US/UK banks (e.g. in APR) has been for Know Your Customer (KYC) databases for sanctions/ high-risk clients screening although many banks are now looking seriously at adopting transaction trend monitoring technology. With proper technology backing, filings of Suspicious Transactions Reports (STRs) to the Financial Intelligence Units (FIUs) have also increased as has the quality of STRs. *Nonetheless, transaction trend monitoring technology does not work the same way across different businesses. Where cash transactions and third party receipts/ payments dominate, such technology is more effective.* If these two pieces are dropped out of the equation, the effectiveness of such technology gets reduced although it can still be used to monitor for securities offences such as insider trading and market manipulation.

Moreover, transaction trend monitoring technology has its limitations and detection scenarios cannot be setup for every pattern of suspicious activity – *data quality/ dependence is a huge issue*. Traditional AML approaches involving awareness and training (on regulatory requirements, internal policies and risk models) of front-line staff and their continuing vigilance is essential to a robust overall framework. AML is not an isolated activity – it is founded on effective KYC practices – The customer due diligence processes typically requires a standard level of verification and then is varied depending on the risk.

ROLE OF SENIOR MANAGEMENT

The role of senior management in an effective AML program is well documented in AML regulations/ guidance. From annual review and approval of the AML program to actual involvement in high-risk accounts (PEPs, correspondent banking accounts – onboarding, transactions, closure), to engaging with/ empowering (*supporting, funding, staffing*) the Money Laundering Reporting Officer (MLRO) - are all clearly spelt out in many regulations/ supervisory guidance*. Senior management are expected by regulators to be advocates of the AML philosophy* and to be proactive in meeting the needs of the MLRO.

However, senior management in many institutions still regard AML as an anti-business philosophy and believe that it adversely impacts customer service standards and business growth. *In some institutions MLROs are not empowered and STRs get suppressed for business reasons.* This has led regulators to ask financial institutions to focus on a risk-based approach (this makes AML more business friendly) and has also led to direct fines on some senior management executives as a wake-up call. *Nonetheless, AML focus is not a one-time thing and ongoing focus is difficult for an institution to maintain particularly with employee turnover and competition – it needs commitment and funding.*

A case in point is a leading US Private Bank that has gone through two written agreements with regulators. *Internal audit plays a key role in any AML framework – experience shows that they can be in need of training and awareness themselves especially in smaller institutions.*

CONCLUSION

Some academics and practitioners have argued that the whole AML philosophy is founded on weak assumptions and crime is better fought directly rather than through financial institutions. This line of thinking does not appear to have sufficient

power to cause a change in direction and enforcement is also periodically releasing data underscoring that STR filing is helping fight crime and terrorism. Nonetheless, information sharing – both within institutions domestic/cross-border (e.g. STR filing, mortgage fraud) and through formal channels, is an ongoing priority for enhancement of AML effectiveness – currently these are imperfect processes at best. *More information, that is currently with enforcement (e.g. suspect terrorists, lost and stolen passports), can also potentially be shared with financial institutions through secure channels.*

AML is a growing industry and is here to stay.

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[**DISCLAIMER:** The opinions in the article are the authors own and do not represent those of his employer.]

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