



POLITICALLY EXPOSED PERSONS

A High Risk Group, Domestic or Foreign

In March 2008, New York governor Eliot Spitzer had to resign following investigations that owe their origin to Suspicious Activity Reports (SARs) filed by two banks in New York (North Fork Bank and HSBC) with the US treasury department and the Internal Revenue Service. Spitzer moved large sums of cash in bank accounts under his control, and the two banks reported the transactions as suspicious. Last month, the Enforcement Directorate (ED) in India, as part of its ongoing investigation against former chief minister of Jharkhand, Madhu Koda and his accomplices for charges of disproportionate wealth and money laundering, questioned a state-owned bank whether certain transactions alleged to have been done by some front-end entities on behalf of accused were reported as suspicious to Financial Intelligence Unit (FIU) India. The bank claims that it has done no wrong and has complied

with existing AML and KYC laws, rules, and guidelines.

In the first case, SARs filed by the banks have sparked off the investigations whereas in the second the investigators are finding out whether STRs should have been filed by the bank! However, it would be naïve to hastily conclude that AML/KYC framework in India is weak. The problem lies in 'deciding what is suspicious and what is not'. The guidelines for identifying suspicious transactions leave a lot to subjective interpretation. Suspicious transaction reporting is relatively new to Indian financial services industry and the right balance between too many false positives (which can waste resources) and a few false negatives (such as the Koda case) will be achieved as the industry gains experience.

The two cases have one similarity- both involve domestic politically

influential persons. Almost all AML jurisdictions treat politically influential persons of foreign countries (called politically exposed persons or PEPs) as a high risk group requiring enhanced due diligence by financial institutions dealing with them, but are silent on domestic ones. With increasing government ownership of financial services companies post-crisis, the issue of dealing with domestic politically influential persons has become complex on account of conflict of interest.

Who is a PEP?

There is no universally accepted definition of PEP. PEPs are essentially individuals who have been entrusted with prominent public functions. This potentially puts them in a position from where they can abuse their official functions and powers for their vested interests by peddling, embezzlement, receipt of bribes,

and other criminal activities. Most jurisdictions use the same or a slightly modified version of the definition provided by the Financial Action Task Force (FATF) in its guidelines. US Patriot Act and the European Directive use similar definitions that can be summed up as follows:

1. A current or former senior official in the executive, legislative, administrative, military or judicial branch of a foreign government whether elected or not.
2. A senior official of a major foreign political party.
3. A senior executive of a foreign government-owned commercial enterprise, being a corporation, business or other entity formed by or for the benefit of any such individual.

on money laundering while the US inter-agency guidance uses the term 'senior foreign political figure'. The BIS paper on customer due diligence for banks refers to PEPs as 'potentates'.

The term should be essentially understood to include individuals whose current or former position can attract public recognition beyond the borders of the concerned country and whose financial transactions can evoke public interest. As regards to any past position, a rule of thumb of one year gap after giving up any political function should be taken into consideration. Examples like heads of state, government and cabinet ministers, influential functionaries in nationalised industries and government administration, senior judges,

appear in laws, regulations and guidelines in various AML jurisdictions, it is widely recognised by financial institutions, governments and regulators worldwide that PEPs are a high risk group from a money laundering perspective and require enhanced due diligence.

Reputation and compliance risk

The lack of enhanced due diligence in their dealings with PEPs exposes financial institutions not only to compliance risk in the form of regulatory fines and penalties for non-compliance, but also to serious reputation risk. Some jurisdictions prescribe that a financial institution has to expressly state whether it has dealings with PEPs or not. A single error or act of negligence in dealing with a PEP is sufficient to make the reputation risk materialise.

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The reason is not far to find - stories about PEPs are lapped up by the media. Therefore, it is more of a reputation risk than compliance risk if the institution fails to sufficiently demonstrate due diligence in its dealings with PEPs. 'PEP identification is not about regulatory compliance. If you believe that this is about mere regulatory compliance and law abiding you will fail. Make no mistake about it. This is a game about risk management. It's about controlling risk,' says Jay Jhaveri, head, Asia, World-Check. The example of Riggs Bank who suffered severe reputation loss due to its dealings with the Chilean leader Augusto Pinochet should be a warning sign for other banks to not disregard the PEP risk management practices, he warns.

4. An immediate family member of such an individual.
5. Any individual who is publicly known to be a close, personal or professional associate.

Wolfsberg principles

The definition that is used by the global regulators is very generic and leaves a lot of room for interpretation. For example, the Swiss Federal Banking Commission uses the term 'person occupying an important public function' in its guidelines

members of ruling royal families etc can be considered PEPs.

The term family should include spouse, children, parents and siblings. Blood relatives and relatives by marriage can be classified under the term family. The term close associates would include business colleagues and personal advisors or consultants. (Source: <http://www.wolfsberg-principles.com/faq-persons.html>)

Thus, though there are some differences in PEP definitions that

Identification of PEPs

Identifying a PEP can be a daunting task especially in cases where the customer does not provide the necessary important information or misrepresents the facts. Although financial institutions globally are making efforts towards identifying such individuals, it is a widely known fact that they lack the necessary powers, means as well as information at their disposal to do so. They have restricted access to information and need to rely heavily on whatever is provided by the individual. Information obtained from business documents and media also may not be enough.

However there are certain principles that can be followed by banks in addition to the standard Know Your customer (KYC) procedures to identify a PEP. The first and foremost question a bank should ask is whether its client or other people involved in the business relationship perform a political function. This should be the first trigger in case of clients from corruption-prone countries. Letting the bank's client advisor deal exclusively with individuals from a particular country or region can improve the bank's overall understanding of the political and social environment of that particular part of the world. The topic of PEPs and identifying them should form an integral part of the regular KYC training programmes that are conducted by financial institutions. 'The front-end of financial institutions definitely has to be aware as to what needs to be classified as a PEP. I mean if you are approaching a politician, if you are approaching a celebrity, if you are approaching a public figure the



Neeta Rege

onus lies on the front runner to come back and confirm that this person is a PEP where there is enough reasons to raise an alarm that this person can be a PEP,' opines Neeta Rege, head compliance, India, Standard Chartered Bank. Besides this banks can also use databases, also known as watch lists that list the names of PEPs.

Misconceptions related to Identification of PEPs

In an earlier article, David Leppan, founder of World-Check, a pioneer in PEP databases, observes: 'A common misconception involved in the identification of PEPs revolves around screening of all political or government office holders. The FATF is very clear when it defines PEPs as being 'senior' people. It does not include middle ranking or junior individuals. However, the real risky PEPs are the middlemen and the advisors who are more often than not the ones involved in account opening. Identifying the most risky front men takes years of patience and effort, trying to

work one's way through the global relationship networks.'

Another misconception, according to Leppan is the idea that PEPs are usually individuals. But the fact is that PEPs usually use legal entities like companies outside of their home country for their dealings. FATF, in a consultation paper in 2002 acknowledged the fact that the proceeds of corruption are typically transferred by PEPs to a number of foreign jurisdictions and concealed through private companies, trusts or foundations. There is high probability that a financial institution may already be having a business relationship with a PEP via a legal entity. Readers can easily relate this observation to Madhu Koda case, where legal entities involved in bullion trade were used.

PEP monitoring and screening

Ever since the terrorist attacks of 9/11, privacy has taken a backseat and national security has come to the forefront. Everything changed after that date and PEPs soon become an integral part of legislative amendments and regulatory expectations. Financial institutions are now required to go over their client relationships in order to identify PEPs.

Once a PEP is identified what action is to be taken thereafter is a different kind of issue. If an institution identifies a PEP in its database it doesn't mean that they cease their relationship with the PEP. Banking with PEPs means performing enhanced due diligence on them and monitoring their transactions more closely to locate the sources of their funds and their wealth. Their transactions should be scrutinised carefully to see if their dealings

involve any amounts larger than normally expected of them. Just like practices in handling SARs, institutions need to have an established policy from a process standpoint on how deep they would go into unearthing the PEP relationship. This requires the banks to have a clear understanding of the types of transactions that would be considered normal for their PEP clientele with regards to their country. Once the normal transactions have been identified, the authorities should then carefully scrutinise those transactions that fall outside this norm. 'So every three months you look at a PEP account, check whether the transactions which

requirements, they need to have an effective system with controls in place to ensure that heightened risk entities are properly identified and reported to the relevant authorities. This requires rigorous business processes and an ability to accurately screen against a wide variety of watch lists and sanctions lists published and provided by different regulatory bodies. It is also important that such screening is done at regular intervals. The data of the customer or the company should be properly audited to remove invalid data and inaccuracies. If the data resides in different locations then it should be integrated at one point. An effective client screening system

powerful fuzzy matching algorithms for identifying a PEP even where data is misspelled, incomplete or sometimes missing. It should be tolerant to linguistic and multinational differences in spellings, dates of birth and associated data.

An effective screening system should also eliminate any repetitive work and not produce the same matches every time the clients are screened. It should also eliminate false positives. The entire screening process should be auditable allowing for reporting of compliance procedures.

Criticality of data quality

Like any other business process, effective screening for PEPs relies on data that is fit for the purpose. Failure to address data quality usually results in a multitude of problems with both 'false positives' and 'false negatives'. False positives create an additional administrative burden requiring sifting through possible matches looking for supporting information and evidence. This adds to the monetary cost. But false negatives can cause loss of reputation. Failure to identify a sanctioned entity can be very fatal for a bank.

While there may be a few organisations that are unaware of the quality of their data and lack in completeness, accuracy and appropriateness, the ones that are aware find the task of rectifying poor data quality insurmountable. Extensive profiling and auditing of data can improve the data quality in financial institutions. It can identify those areas that require standardisation, de-duplication, cleansing, validation or

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have happened in the account are aligned with what has been disclosed and there should be a system of raising it to a level and approval. It shouldn't be lying at the account level,' states Rege. A financial institution should also identify the PEP's business and industry along with his personal financial situation. Gathering sufficient knowledge of the PEP's affiliations, employment and associations can go a long way in developing a PEP profile.

Requirements for effective screening

In order for organisations to screen for PEPs, to achieve compliance with national and international regulatory

should be able to connect multiple data sources and integrate different data formats, content and structure from disparate systems.

The system should also enable easy and clear segmentation of different customer sets, businesses, regions and geographies. The match rules should allow for customisation depending on the differing risk factors. It would be wise to have a screening system in place that not only screens new incoming customers but also existing clients to see if they, in any sort of way, have an association or deal with a PEP. The system should perform 'exact' as well as 'inexact' name searches using

improvement to make the screening process truly effective. The two major challenges encountered with data quality are:

1. Over-filled or multi-purposed name data for individuals and entities; and
2. Location or other meaningful information entered into free-format text fields.

Location data is extremely valuable in case of screening for PEPs. The effectiveness of a screening process will be dramatically affected by the accuracy of this particular data field.

Variables affecting the risk level of PEPs

There are several factors that contribute towards the determination of the risk level associated with a PEP. **Nationality** would be one such factor. PEPs from countries where corruption is widespread pose a higher level of risk to a financial institution. Similarly the person’s position and authority also impacts the risk levels. The higher the person’s **position and authority**, the higher are the risk levels associated with him and vice versa. People in higher positions and authority have substantial control over policies and operations and access to government-owned resources. This makes them prone to higher levels of corruption. **Volume and complexity of business relationships** is also a factor that affects risk levels of PEPs. The more complex the business relationships of a PEP and the higher the volume of his business, the riskier he becomes for a bank. The risk levels associated with a PEP also get determined by the

types of products or services offered to him. There are certain **types of products or services** like private banking that comprise a higher level of risk due to their very nature. When such services are offered to and used by PEPs, it increases their risk levels. PEPs also often rely on foreign parties like offshore companies and banks from countries that do not sufficiently apply AML/CFT standards to conceal their dealings. If a PEP is found to be dealing with such parties, he would automatically become a high risk client for a financial institution.

Management and mitigation of PEP risk

As earlier mentioned, identification of PEPs does not necessarily mean ceasing of business relationships with them. There is no legislation existing in any FATF country that requires a financial institution to stop dealing with PEPs. However, it is

adopt heightened scrutiny when dealing with them.

2. Senior management of financial institutions should be totally committed to following the KYC norms and should set up appropriate procedures and verify their efficiency.
3. There should be a clear determination of responsibility. The bank’s internal audit and compliance department should be responsible for the assessment of compliance with policies and procedures related to identification and monitoring and screening of PEPs.
4. Training programmes should be conducted on a regular basis for sufficient application of KYC norms by the employees and to keep them abreast with the procedures and manner of dealing with a PEP.

Ranking PEPs

In the face of the acknowledgement of the fact that investigating all potential matches

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essential for banks to realise the importance of risks associated with such PEPs and deal with them in an appropriate manner. The following measures can be taken by a bank to mitigate the risks associated with its PEP clientele:

1. Get additional information from them like their family members, associates, resources etc and

brought out by a screening system at an institution is not feasible, there is a consensus in favour of a risk-based approach where priority is given to matches against the highest risk PEP records. Such an approach requires a method for grouping or ranking of PEP records by risk. The conventional method uses the various category and attribute

fields that are available in the records such as political position, country etc. Values are assigned to these categories which are later on aggregated to derive profile scores.

This top-down approach operates from the same premise that the level of risk assigned to a class or rank of PEPs adequately characterizes each individual member of that class. This however cannot be true. For example local officials may be characterized as low risk by a bank. However this does not mean that all local officials from developed countries are low risk. An official associated with a prominent political figure should necessarily be characterized as high risk.

This most definitely points towards the need for an approach of ranking PEPs, based on their actual connections to relevant entities and not on their membership to a particular class.

Indian AML framework and PEPs

With growing globalisation India's exposure to cross-border business has increased exponentially. And so has the threat of Indian financial institutions being exposed to the threat of money laundering grown. This has led to a series of changes in the nation's financial and regulatory environment to support global AML efforts in India.

In 2002, The Prevention of Money Laundering Act was enacted and detailed rules were framed thereunder in 2005, which came to be known as PMLA rules 2005. India's Financial Intelligence Unit called FIUInd was formed under

the provisions of this act. The unit today acts as an apex body for coordinating the country's AML efforts.

However, a recent survey conducted by KPMG titled 'The AML Survey 2009' among Indian financial institutions with the objective of understanding the level of their preparedness for AML compliance revealed that the AML regime in India is still in its nascent stages. The risk-based approach has only been mandated in Europe in 2007. Indian financial institutions would require additional efforts in their implementation of AML regulatory procedures.

The survey showed that 79 percent of the respondents felt comfortable with the additional burden placed on them by AML compliance. The risk-based approach was supported by 21 percent of the respondents.

The survey results also revealed that only 55 percent of the respondents agreed to having specific procedures in place to identify PEPs. This was despite the fact that PEPs were considered to be a key factor of consideration in the risk-based approach. Among the institutions that agreed to having a PEP procedure in place 55 percent asserted to using a combination of lists commercially available as well as internally developed.

About 82 percent of the respondents agreed that they had a procedure in place for sanction list monitoring. Although 70 percent of the respondents stated that they had an effective system for monitoring of transactions, it was still identified as a major area that needed improvement. The

survey also showed that 56 percent of the respondents filed less than 5 STRs every quarter. This was due to the reliance of the financial institutions on staff vigilance. The results also showed that only a minority of the respondents appointed external trainers for training.

The Indian financial institutions have come a long way since the Prevention of Money Laundering Act came into force in 2005. 66 percent respondents to the KPMG survey claimed to have implemented AML policies based on local regulations, but had benchmarked them against global best practices. In fact only 10 percent of the respondents had developed and implemented policies at local and regional levels. However organisations did encounter some issues while interpreting and implementing some of the global best practices. There is still a lot of ground to be covered by Indian financial institutions with regards to an integrated approach towards AML compliance.

It is true that after 9/11 the global financial industry has become more aware to the risks posed by their dealings with PEPs. However, it is still a tough job to unveil the real risky PEPs. But it is better for financial institutions to toil hard than to lose face in some unexpected financial scandal involving a client who should have been classified as PEP.

Also, as of now, dealings with domestic PEPs are supposed to be monitored using the suspicious transaction reporting route. Whether there is a need to classify them as high risk group involving increased diligence is open to debate. ■