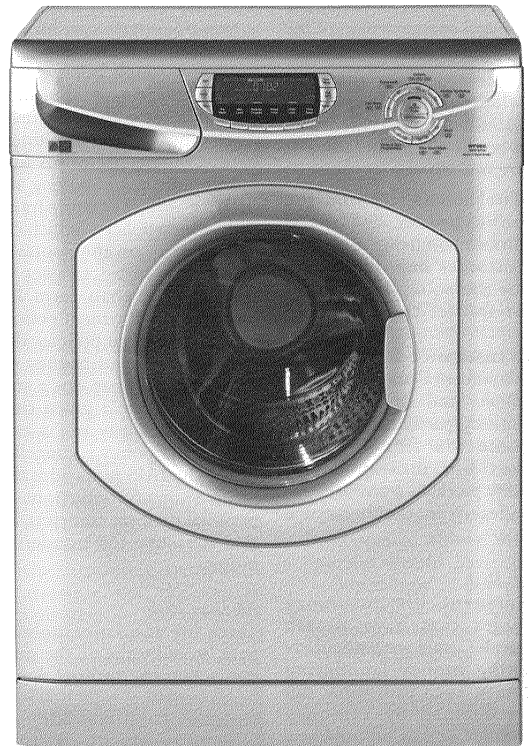


Are Insurers Considering Money Laundering Risks?

The insurance industry does not typically come to mind as one which is susceptible to unscrupulous finance practices. However, as Rohan Bedi - Head of Anti-Money Laundering Services, PWC Singapore and Jay Jhaveri - Director Asia, World-Check, explain, insurance is riddled with immune weaknesses. This feature outlines how the industry can best boost its defences



THE worldwide insurance industry generates premiums in the range of US\$2.4 to 2.6 trillion and is highly vulnerable to money laundering and terrorist financing. The vulnerability is more for life insurance and less for general insurance as a result of which anti-money laundering rules have generally focused on the former, albeit there is a move in countries like Luxembourg to extend anti-money laundering rules to the general insurance sector. Additionally reinsurance involving smaller companies may pose some risks albeit this market tends to be dominated by big players and captive reinsurance companies.

Money laundering in the context of insurance is often found to have a close link with insurance fraud. The cost of all these operational risks is of course higher premiums for ordinary customers. The number of people being murdered for life-assurance policies is also rather staggering.

Key Issue – Perspective
Insurance companies – both life and general – tend to have high levels of self-confidence in their ‘know your customer’ systems which tend to be anti-fraud driven. While laundering schemes can involve fraud, systems that are created keeping anti-fraud alone in mind will definitely have shortfalls from an anti-money laundering perspective.

An anti-fraud policy is concerned that premium payments clear, not with whether they are made with structured instruments or from suspicious sources. Purchase of a life insurance policy with a single, lump-sum payment and subsequent redemption at cash value may not directly inflict any economic harm on the insurance company, but can be used to launder the proceeds of crime. Terrorist financing also increasingly uses money laundering techniques for raising and moving monies.

The launderers objective is very simple – put in dirty money, walk

off with an insurance cheque that can then be banked as the proceeds of insurance.

Businesses

The insurance industry can generally be divided into three major sectors based on a company's line of business – life, property/casualty and health.

Life insurance provides protection against the death of an individual in the form of payment to a beneficiary. Life insurance may also offer ‘living benefits’ in the form of a cash surrender value or income payments. Recently, life insurers have developed products that offer a variety of investment components, such as interest indexed universal life (which has interest credits linked to external factors) and variable life (where the amount and duration of benefits are linked to investment experience) and that offer the insured the ability to overpay the premium for a fixed rate of return. Such products are marketed to investors as part of a diversified portfolio, often with tax benefits. Annuities, which are generally considered part of the life insurance sector, are purchased to provide a stipulated income stream over a period of time and are frequently used for retirement planning purposes.

Property insurance indemnifies an insured whose property is stolen, damaged, or destroyed by a covered peril. Casualty insurance provides coverage primarily for the liability of an individual or organisation that results from negligent acts and omissions that cause bodily injury and/or property damage to a third party.

Health insurance covers the costs of health care, and many insurance companies, particularly the larger ones, offer more than one kind of insurance product.

Distribution Channels

An insurance company may offer its products through a number of different distribution channels.

- Some insurance companies sell their products through direct response marketing in which the insurance company sells a policy directly to the insured.
- Other companies employ agents, who may either be captive or independent. Captive agents represent only one insurance company; independent agents may represent a variety of insurance carriers.
- Insurance may also be purchased through other third parties, all of whom

must be licensed insurance agents, but may describe themselves to customers as financial planners or investment advisors.

- A limited number of companies offer certain types of policies via the Internet.
- A customer also may employ a broker such as a salesperson who searches the marketplace for insurance (in the interest of the customer rather than the insurer) to obtain insurance.

Overall Risks

Money laundering risk should not be predicated solely on the existence of an ability to obtain a refund on a purchased financial product. Rather, the focus should be on the ability of a money launderer to use a particular financial product to store and move illicit funds through the financial system.

- Inconsistent regulation of the industry may be exploited especially in the integration stage.
- STR filing is also low compared to size of the industry. The size of the industry, easy availability/diversity of products and structure of business, all create vulnerabilities.
- The business may be cross-

Firstly, the perspective...

Good anti-fraud culture does not equate to good anti-money laundering culture – this is critical to appreciate

border involving intermediaries not necessarily affiliated with or under the control or supervision of the company.

- Placement risks also exist wherever cash is accepted including by intermediaries who do not follow rules or are untrained.
- The beneficiary and the policyholder are often different, raising issues of customer due diligence – for the policy-holder only or also for the beneficiary?

Life Insurance Risks

The number of customers, value of assets and sheer volume of activity, particularly around income tax filing season, makes life insurance and annuity products a favourite for launderers in the insurance sector.

High Risk

Permanent life insurance policies that have a cash surrender value are particularly inviting money laundering vehicles. Such cash value can be redeemed by a money launderer or can be used as a source of further investment of his tainted funds, for example, by taking out loans against such cash value. These policies operate in the same manner as unit trusts or mutual funds i.e.,

most popular types of lump-sum investment in recent years. They are generally promoted as low-risk investments because returns are passed on to policyholders through bonuses and this aspect is very appealing even for those with illegal funds.

Because of their investment nature, single premium unit linked policies and buying and selling of second-hand endowment policies (which can be assigned) are the contracts which are more subject to abuse, rather than term life insurance. Endowment policies are life insurance policies that pay out a sum of money on death and also pay out a sum of money after a given time and may also pay out a cash value if the policy is cancelled early. The IAIS notes adds that lump sum contributions to personal pension contracts, are also attractive for laundering money.

Medium Risk

Term life insurance policies have 'stored value' in the sense that when the insured dies, a death benefit is paid, however, an insured can generally not 'cash in' or take a loan against a term insurance policy in order to receive back so-called laundered funds. Moreover, contrary to the hypothetical abuse of a term policy, owing to health-check and 'insurable

stealing people's identities, washing drug money by taking out insurance policies in their names and cashing in the proceeds after murdering them – the scam happened over the course of a decade.

Low Risk

On group life insurance, group annuities, corporate-owned life insurance (COLI), and bank-owned life insurance (BOLI), the industry does not believe that these categories are susceptible in any material way to terrorist financing or money laundering schemes. With these products, the business relationship is essentially between the insurance carrier and the employer or association itself. In addition, only regular employees (in the case of a private company, for example) or members (in the case of an association) are generally eligible to be covered by these types of products.

Credit life insurance policies are issued to a lender or an individual borrower and are structured to pay off a loan in the event of the borrower's death. Credit life insurance is an unlikely prospect for money laundering for many reasons: including the fact that most policies name the lender as the beneficiary, not the borrower.

Customer Due Diligence (CDD)

The revised FATF 40 revised 2003 recommendations gives examples of the types of circumstances where it would be permissible for verification to be completed after the establishment of the business relationship, in order not to interrupt the normal conduct of business. Simplified CDD or reduced measures could be acceptable for life insurance policies where the annual premium is no more than US\$/EURO 1000 or a single premium of no more than US\$/EURO 2500, insurance policies for pension schemes if there is no surrender clause and the policy cannot be used as collateral.

The IMF in its FSAP anti-money laundering methodology for the insurance sector states, "All the verification subjects of joint applicants for insurance business should normally be verified. Where there are a large number of verification subjects (eg: in the case of group life and pensions) it may be sufficient to carry out full verification requirements on a limited group only, such as the principal shareholders, the main directors of a company, etc."

Three Anti-Money Laundering Risk Models

On a risk based basis, insurance companies must start using the three anti-money laundering



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risk models outlined below:

- **Geography and Country Risk.** For example, is the premium payment coming from FATF black-listed countries or other high-risk countries i.e. drug producing or conduit countries, state sponsors of terrorism, Eastern European countries with high crime rates, Caribbean countries at high-risk for laundering, etc.
- **Business and Entity Risk.** Is the background business a high-risk one for money laundering: eg: export-import, cash-intensive business, jeweller etc.? Is any beneficial owner on a regulatory black-list (eg: terrorists) or high-risk list (eg: politically exposed persons)?
- **Product and Transaction risk.** Does the person purchase policies that are high-risk for money laundering and are the associated transactions (including premium payments and the benefits) generating red flags for laundering?

Examples at Unusual Activity

- Transactions where the nature, size or frequency appears unusual, for example, customer requests for early termination or cancellation (within one year from date of inception) of a single premium policy,

especially where cash had been tendered.

- Unusual transactions, a person residing in another city with little connection to the city in which you have your branch, requests a life insurance policy.
- Transactions that are incompatible with the customer's normal activity or are beyond the customer's apparent financial means, the customer requests a single premium contract with a large sum assured.
- Transactions in which funds are received by way of a third party cheque, especially

Operation Capstone

In 2002-2003, 'Operation Capstone' (a multinational investigation) exposed a US\$80 million Colombian drug money laundering ring that was purchasing investment grade life insurance policies with cash surrender values, with Cartel associates as beneficiaries. The drug proceeds were sent in the form of cheques and wire transfers to insurance companies by third parties around the globe. Owing to high liquidation penalties for policies that were in existence for a few years only, the beneficiaries incurred a cost of almost 40%.

According to the investigating authorities, the cartels primarily targeted small independent insurance brokers with little training in international anti-money laundering procedures.

"Know your customer" and "Know your broker" regimes were not enforced.

a launderer can over-fund the policy and move funds into and out of the policy for the cost of early withdrawal penalties. Annuity contracts pose a significant money laundering risk because they allow a money launderer to exchange his illicit funds for an immediate or deferred income stream. With-profits insurance bonds invest in a mix of shares, fixed-interest securities and property; they have become one of the

interest' requirements, a money launderer cannot easily use an elderly or ill person as a front to obtain a term policy and launder money. Therefore, the industry feels that term life insurance products should be excluded from anti-money laundering regulations or alternatively, that regulations exclude policies sold for small premiums. However, a scam in the US reported in June 2004, suggests that criminals are now

The Three Bases

Insurance Companies need to take a systematic approach to risk that covers all three bases rather than just one or the other:

1. Geography and Country Risk
2. Business and Entity Risk
3. Product and Transaction risk

where there is no apparent connection between the third party and the customer.

- Abnormal settlement instructions, including payment to apparently unconnected parties or to countries in which the insured is not known to operate.
- A sudden request for a significant purchase of a lump sum contract from an existing customer whose current contracts are small and of regular payment only.
- A life insurer receives large or unusual premium payment in cash from customer. In particular, a life insurer should be vigilant in verifying information and the nature of transaction of any customer if any single payment is in cash exceeding US\$10,000.
- Transactions in which funds are received from or paid to a customer's account in a financial haven country, or in foreign currency, especially when such transactions are not consistent with the customer's transaction history.
- The receipt of premiums from offshore and/or lightly or unregulated financial intermediaries.
- Overpayment of premium with a request to refund the excess to a third party or to a different country.
- Assignment of a policy to unidentified third parties and for which no plausible reasons could be ascertained.
- A number of policies taken out by the same insured for low premiums, each purchased for cash and then cancelled with return of premium to a third party.
- A policyholder may exercise cooling off rights on life insurance products where the sum invested must be repaid and abnormal exercise of these rights is apparent.
- Employees or agents who have consistently high activity levels of single premium business far in excess of any average company expectation.
- The use of an address that is not the customer's permanent address (eg: utilisation of the agent's office or home address for the dispatch of customer documentation).
- Frequent changes of beneficiaries, using the policy as a bearer asset, or as collateral in part of a wider money laundering scheme together with the early surrender of investment type policies, especially where to do so defies economic logic.

The unusual is not the same as the suspicious. Even customers with a stable and predictable transactions profile will have periodic unusual transactions. And many customers will, for perfectly good reasons, have a persistently erratic pattern of transactions. Identifying what is unusual, therefore, is only the starting point – firms must assess whether what is unusual gives rise to suspicion.

Non-life Insurance Risks

Laundering risk elements discussed above are lower in insurance products offered by property and casualty insurers, and much less by title or health insurers, although, to the extent that these sectors develop products with similar investment features, or features of stored value and transferability, regulations would need to cover them.

Theoretically, a money launderer could purchase property or casualty insurance for a business with tainted funds and transfer the business to a confederate who could cancel the policy and obtain a refund of the cleansed funds. However, this does not mean that such products possess the elements of stored value and transferability that pose a significant money laundering risk. Underwriting practices generally would prevent the conveyance of a property and casualty insurance policy upon the purchase of a business. Moreover, as property and casualty insurers determine premiums by the value of the insured property and the perceived risk, the products they issue are not effective vehicles for laundering predetermined sums.

Instances of non-life money laundering happen through bogus claims, for example, a money launderer purchases a legitimate business and then by arson or other means he causes a bogus claim to recover part of their investment. Other examples include money being laundered by purchasing an asset in cash such as a car and making a false claim for its loss; using a general insurance agent to issue a policy for a non-existent building and refund the premium after it is cancelled; a five-year fire insurance policy is purchased with upfront payment of premiums with discount and cancelled after say a one-year period.

Hence when we talk of non-life insurance money laundering the connection with fraud becomes intimate and insurance companies typically have systems geared for this, albeit the anti-money laundering perspective still has to be imbedded.

Agents, Brokers and the Anti-Money Laundering Programme

Many insurance products are sold through agents of insurance companies. Because of their direct contact with customers, insurance agents are in a unique position to observe the kind of activity that may be indicative of money laundering. This may be especially true when insurance agents sell investment products that do not need to be thoroughly scrutinised by the insurance company for underwriting purposes because they lack a health or death contingency.

Thus, an insurance company should obtain all the relevant information necessary from its agents and brokers for the purposes of filing reports of suspicious transactions. The primary responsibility for establishing and maintaining an effective anti-money laundering programme is on the insurance company. Requirements for anti-money laundering rules for brokers and agents:

- Money launderers look for the weakest link when it comes to getting their illegal profits into the legitimate financial sector. Individual agents and brokers who are unfamiliar with money laundering tactics are likely targets. Red flags such as

Focus on...

Agents and brokers need to be trained and contractual obligations created for customer due diligence and escalation of suspicious activity information

large cash premium payments, requests for pre-signed forms type facility, lack of explanation for wealth or unusual methods for paying insurance premiums, may be overlooked.

- Even with a sales-driven objective, the insurance brokers have a great deal of control and freedom regarding policies. Brokers often maintain pre-signed payment instructions for policy withdrawals to enable clients to affect such withdrawals with a telephone call. Brokers sometimes pay insurance premiums from their own accounts; presumably they are subsequently reimbursed by the client in cash.
- Insurance companies often have little knowledge of the complex pyramid of sub-brokers.

- Given that a significant percentage of insurance products are sold through intermediaries who are often the only ones having personal contact with the clients, it has been argued that they need full fledged anti-money laundering programmes including STR filing with emphasis on the importance of collecting and know your customer (KYC) information. Full accountability will come only with independent requirements.

Even in countries where the requirement of anti-money laundering programmes is not applied to agents and brokers, the insurance companies' anti-money laundering programme is required to incorporate policies, procedures, and internal controls based upon the insurance company's assessment of the money laundering and terrorist financing risks associated with its products, customers,

Key aspect...

Know your broker is a key aspect of an anti-money laundering programme

distribution channels, and geographic locations i.e. agents and brokers need to be integrated into the anti-money laundering programme. Hence 'know your broker' is a key aspect of an anti-money laundering programme.

In the US, the FinCEN (the FIU) states that some elements of the anti-money laundering compliance programme will best be performed by personnel of agents and brokers, in which case it is permissible for an insurance company to delegate contractually the implementation and operation of those aspects of its anti-money laundering programme to such an entity while remaining fully responsible for the effectiveness of the programme, as well as ensuring that government examiners are able to obtain information and records relating to the anti-money laundering programme and to inspect the agent or the third party for the purposes of the programme.

The IAIS stated in a June 2003 paper that the anti-money laundering programme should also enable insurance companies to foster close working relationships between underwriters and claims investigators; to determine the true identity of prospective

policyholders and where the applicant for an insurance policy is acting on behalf of another person, to take steps to verify the beneficiary's identity.

Overall Framework

Hence, the anti-money laundering compliance programme consists, at a minimum, of the following:

- The development of internal policies, procedures, and controls to detect and report money laundering activities and other linked regulatory violations. On a risk-based basis, this would include an effective KYC programme that would identify prospective clients, business purpose of relationship and accounts, the sources of their assets and funds, and intended use of funds.
- The designation of a compliance officer. Such a person would have to be independent of any profit centre and should report to senior management and the board of directors.
- The implementation of an employee-training programme also covering agents and brokers, which should cover the relevant legal and regulatory requirements, the policies and procedures for initiating and monitoring client relationships, the maintenance of appropriate records and the identification of suspicious transactions or activities.
- An independent audit function to review and test the implementation of the anti-money laundering programme.

Conclusion

In conclusion, the risk of money laundering in the life insurance sector can easily be underestimated or even overlooked altogether. The FATF Working Group on Typologies 2004-05 is researching the vulnerabilities of the insurance sector to money laundering, based on concerns that STR filing is low compared to size of the industry. In Asia, some life insurance companies follow a system of 'defensive reporting' i.e. they report all cash premium receipts of S\$20,000 and above automatically as STR filing, without any queries. This practice transfers the customer due diligence responsibilities onto the national FIU without the firm performing its statutory role. Furthermore, non-life insurance money laundering is an area to be watched as it has hitherto been unregulated for anti-money laundering and this will definitely attract launderers. ●