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AML Briefing

Basic AML and Trade-Based ML Concepts

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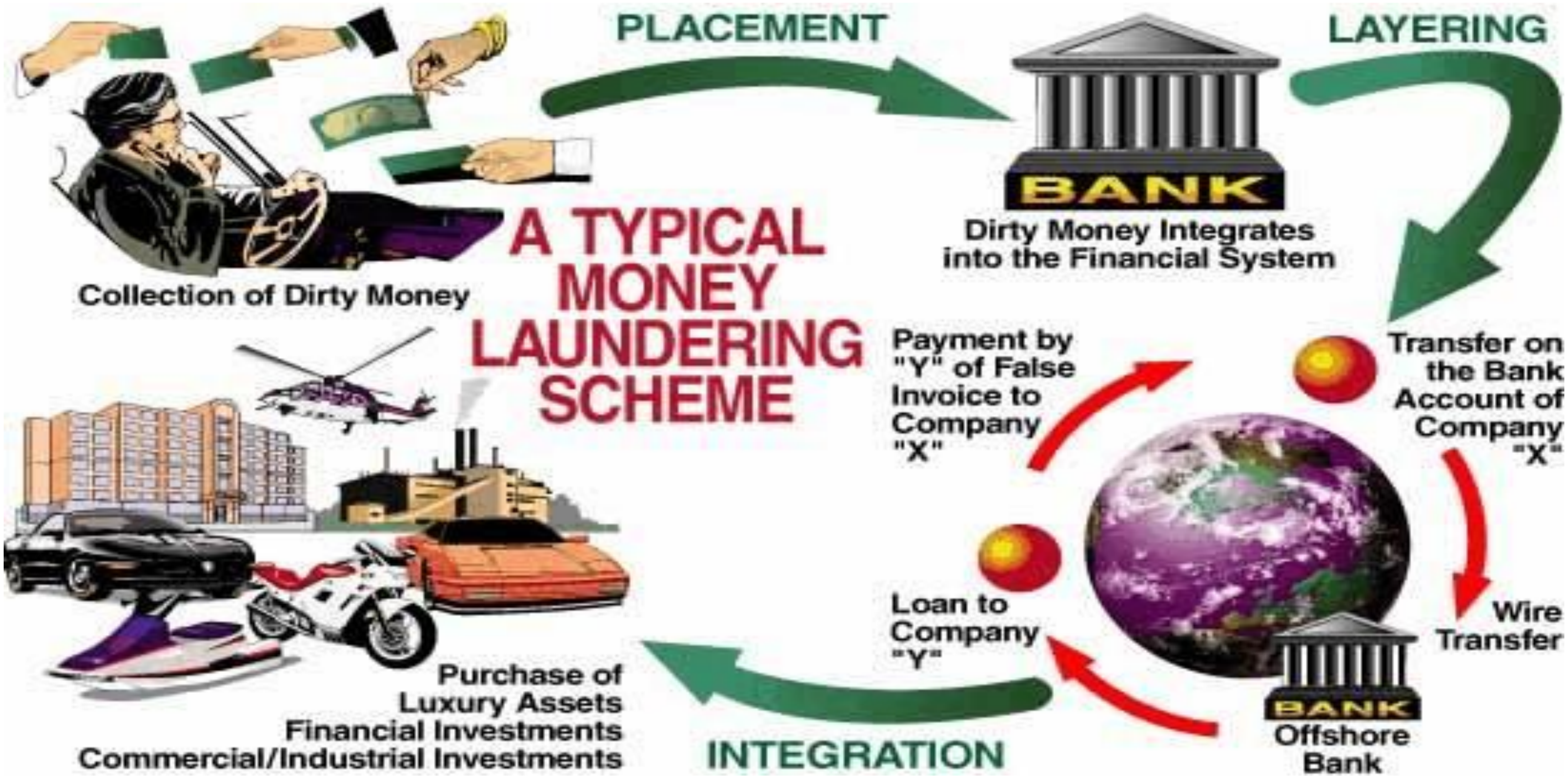
Stages of Money Laundering

- Money-laundering: process that disguises illegal profits without compromising the criminals who wish to benefit from the proceeds
- Two reasons why criminals - whether drug traffickers, corporate embezzlers or corrupt public officials - have to launder money:
  - the money trail is evidence of their crime; and
  - the money itself is vulnerable to seizure and has to be protected
- Money-laundering is a dynamic three-stage process that requires:
  - placement, moving the funds from direct association with the crime;
  - layering, disguising the trail to foil pursuit; and,
  - integration, making the money available to the criminal, once again, with its occupational and geographic origins hidden from view.

Source: The United Nations, Office of Drugs and Crime <https://www.unodc.org/unodc/en/money-laundering/laundrycycle.html>

The Money Laundering Cycle



Source: The United Nations, Office of Drugs and Crime <https://www.unodc.org/unodc/en/money-laundering/laundrycycle.html>

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General Effects of Money Laundering

- Increased crime and corruption. Characteristics of legal framework in ML havens:
  - Limited number of predicate offenses
  - Limited coverage of institutions and persons
  - Weak penalties and law enforcement
- Undermines legitimate private sector
- Weakens FIs. Types of ML risks on Fis:
  - Reputational
  - Operational
  - Legal
  - Concentration

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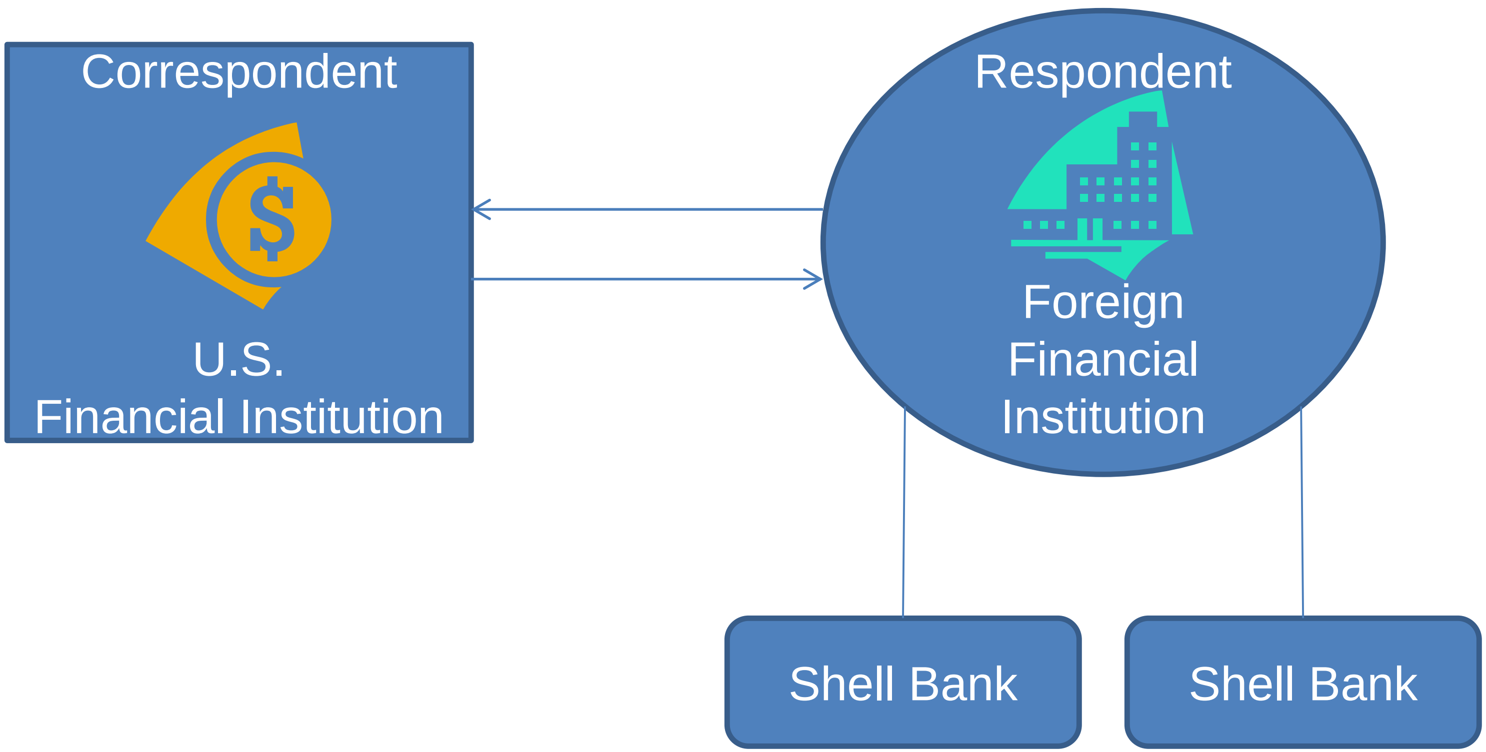
Methods of Money Laundering
- Banks & Other Depository Institutions

1. Electronic transfers of funds (wire transfers) – Fast conduit for moving money
2. Correspondent banking – Provision of banking services by one bank (correspondent bank) to another bank (respondent bank). ML vulnerabilities:
   - Unknown 3rd party customers
   - Large volumes of transactions from customers' customers w/out knowledge of usual transactions
   - Difficulty knowing respondent bank's supervisory regime
   - Difficulty knowing respondent bank's AML controls
   - "Nesting," which adds another layer (respondent bank has sub-respondents)
   - <u>Key thematic issues</u>: Indirect relationships and PTAs

Methods of Money Laundering
- Banks & Other Depository Institutions

- Illustration: Nesting



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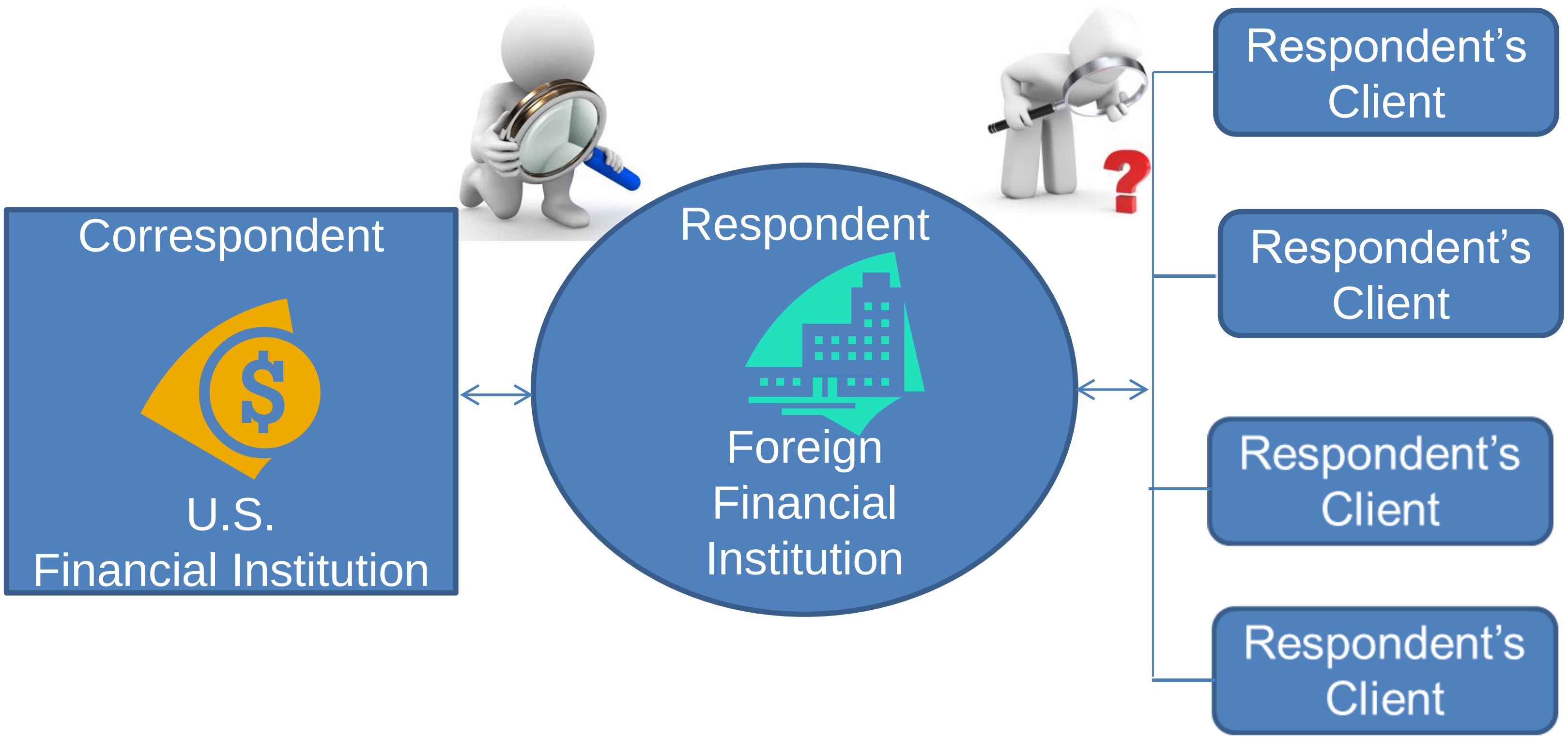
Methods of Money Laundering
- Banks & Other Depository Institutions

- Illustration: Indirect Relationship



Methods of Money Laundering
- Banks & Other Depository Institutions

3. Payable-through accounts (PTAs) – Respondent bank's customers can conduct their own transactions through the correspondent account without need of clearing. ML risks:
   - PTAs w/ foreign institutions licensed in offshore financial centers
   - Correspondent bank can regard respondent bank as sole customer and does not do CDD on latter's customers
   - Sub-account holders may have currency deposit and withdrawal privileges
   - Respondent bank may have a subsidiary and can offer services as a branch without supervision
4. Concentration accounts – Internal accounts established to facilitate processing and settlement of multiple or individual customer transactions within the bank, usually on the same day (may have complicity of internal staff)

Methods of Money Laundering
- Banks & Other Depository Institutions

5. Private Banking – Personalized & confidential products and services. Semi-autonomous operation.
6. Structuring – Designing a transaction to evade triggering a reporting or recordkeeping requirement. Ex. Depositing cash and purchasing monetary instruments in amount under the threshold
   - Cuckoo Smurfing – form of ML linked to alternative remittance systems, where criminal funds are transferred through accounts of unwitting persons expecting genuine funds from overseas
7. Credit unions/building societies – Relatively small size makes it harder for ML, but contain high levels of cash transactions, which increase ML/FT risks

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Methods of Money Laundering
Trade-Based ML

- Process of disguising proceeds of crime and moving value through the use of trade transactions to legitimize illicit origins or finance their activities
- TBML typologies:
  1. Over-invoicing / Under-invoicing (mis-invoicing)
  2. Over-shipping / Short-shipping
  3. Ghost-shipping
  4. Shell companies
  5. Multiple invoicing
  6. Black market trades

Methods of Money Laundering
Trade-Based ML

Trade mis-invoicing (TM):

- Type of illicit financial flow where either the importer and/or exporter manipulate the value (price, quantity or quality) of trading goods in their Customs declaration
- Motives: disguising capital flight, exploiting trade incentives, evading tariff/tax, avoiding trade regulations
- Can involve illegal transfers or legal profits
- Examples:
  - Over-invoiced imports to disguise capital flight as a form of trade payment
  - Under-invoiced exports to conceal trade profit abroad (e.g. tax havens)
  - Over-invoiced exports or under invoiced imports to incorporate illicit proceeds into domestic legal financial system

Methods of Money Laundering

Trade-Based ML

Motivation	Type of TM	Type of TM	Motivation
	Exporter	Importer	
To bring in illicit money	Over-invoiced exports	Over-invoiced imports	To disguise capital flight as a form of trade payment
To conceal trade profit in Offshore Financial Centers	Under-invoiced exports	Under-invoiced imports	To bring in illicit money (most commonly looked at by Customs)

Goods

Payment

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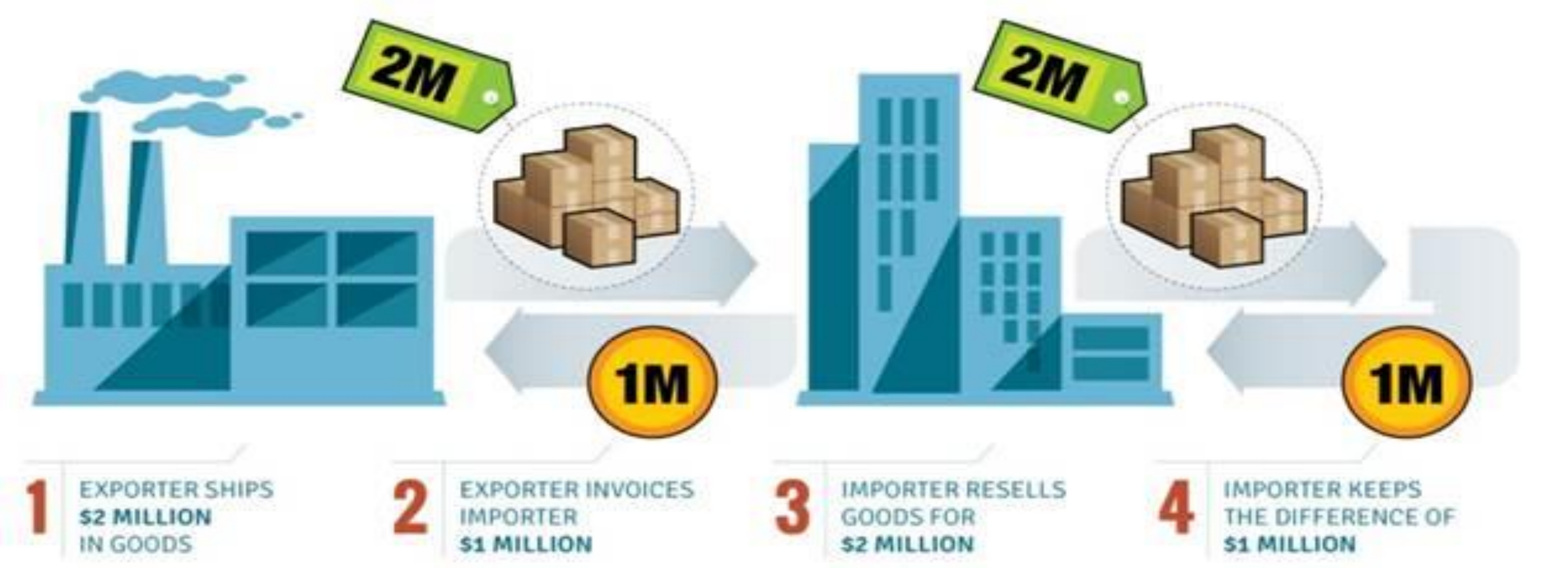
Methods of Money Laundering
Trade-Based ML

Illustration: Trade Mis-invoicing (Under Invoicing)



Source: Association of Certified Anti-Money Laundering Specialists (citing Combating Terrorism Technical Support Office) <http://www.acams.org/aml-resources/trade-based-money-laundering/>

Methods of Money Laundering

Trade-Based ML

Illustration: Example of Black Market Peso Exchange

Problem

- International trade in goods and services can be used as either a cover for money laundering or as the laundering mechanism itself. What is most important for the launderer when engaging in this method? The ability:

a. To over- or under-invoice the goods
b. To sell the exported goods for as much as possible
c. To use goods that do not need to be declared
d. To use high-value assets such as luxury cars or boats

* Lifted from ACAMS Study Guide for the CAMS Certification Examination (5th Ed)

Ensuring an Adequate AML Program – Selected Standards

- Basel Committee on Banking Supervision:
  - Observed deficiencies in several national KYC policies. Issued “Core Principles for Effective Banking Supervision” to ensure adequate policies, practices and procedures are in place (incl. KYC). Also issued 2001 Paper “Customer Due Diligence for Banks”
  - 4 key elements of KYC (Know Your Customer)
    1. Customer identification
    2. Risk management
    3. Customer acceptance
    4. Monitoring
  - 7 customer identification issues:
    1. Trust, nominee and fiduciary accounts
    2. Corporate vehicles (particularly with nominee shareholders or shares in bearer form)
    3. Pooled accounts and those opened by professional intermediaries
    4. PEPs
    5. Non-face-to-face customers
    6. Correspondent banking
    7. Introduced businesses

Ensuring an Adequate AML Program – Selected Standards

- Banks should not only establish identity of customers, but also monitor account activity. Appropriate time to conduct regular review of records, to ensure they remain relevant:
  1. Transaction of significance takes place
  2. Customer documentation standards change substantially
  3. Material change in how account is operated

Ensuring an Adequate AML Program – Selected Standards

- FATF Recommendations Compliance Standards for AML/CFT:
  - FIs should conduct Customer Due Diligence (CDD) in the following instances:
    1. Establishment of business relations
    2. Transactions and wire transfers above thresholds
    3. Suspicious transactions
    4. Doubts on adequacy of previous customer identification

Ensuring an Adequate AML Program – Selected Standards

– Risk-based approach should be applied in the following instances:
  1. Identifying customers
  2. Identifying beneficial owners
  3. Understanding business relationships
  4. Ongoing due diligence
  5. Maintaining records
– Enhanced CDD is required for the following:
  1. PEPs
  2. Correspondent Banking
  3. Money or value transfer services
  4. New technologies
  5. Wire transfers

Ensuring an Adequate AML Program – Basic Considerations

- Basic Elements of an FI's AML Program:
  1. Internal policies, procedures and controls
  2. Designated compliance officer w/ day-to-day oversight over the AML program
  3. Ongoing employee training program
  4. Independent audit function to test AML program

Ensuring an Adequate AML Program – Basic Considerations

- Basic Elements of a CDD Program:
  1. Full identification of customer, including source of funds and wealth
  2. Transaction and activity profiles
  3. Definition and acceptance of customer, products and services
  4. Grading of risks
  5. Account and transaction monitoring
  6. Investigation/examination of unusual customer or account activity
  7. Documentation of findings

Ensuring an Adequate AML Program – Basic Considerations

- Assessing Risk:
  - No organization can reasonably be expected to detect all wrongdoing by customer, but it <u>needs systems and procedures to detect, monitor and report</u> risky customers and transactions
  - All categories of risk need to be identified and mitigated by controls, such as:
    - Identification and verification of customers
    - CDD policies
    - Suspicious activity monitoring
    - Economic sanctions screening
  - Risk-based approach is preferred over prescriptive approach, because it is:
    - Flexible
    - Effective
    - Proportionate

Ensuring an Adequate AML Program – Basic Considerations

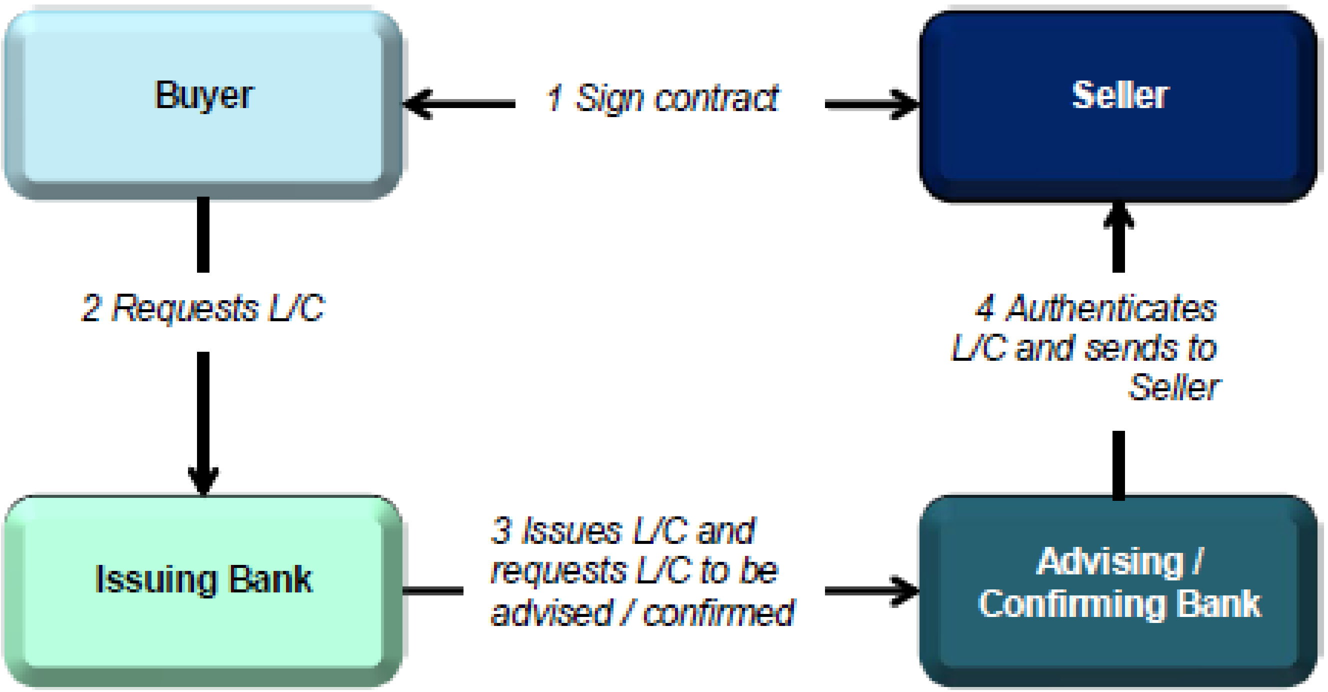
- Risk depends on:
  1. Geographical location – check terrorism and sanctions lists, FATF evaluations and overall reputation of country (ex. US State Department's "International Narcotics Control Strategy Report" and TI's "Corruption Perceptions Index"), and monitor major news media
  2. Customer type – check users of products/services, and look out for customer types that are considered high risk
  3. Products or services – certain products are considered high risk. Ask: Does the product/service:
     - Enable significant volumes of transactions to occur rapidly?
     - Allow customers to transact with minimum oversight?
     - Allow significant anonymity of users?
     - Have high transaction or investment value?
     - Allow payments to 3rd parties?
     - Have unusual complexity?
     - Require government verification of customer eligibility?

Ensuring an Adequate AML Program – Trade Control Considerations

- Broader AML/CFT requirements:
  - Develop policies/procedures to assess risks in trade-related customers and activities
  - Have procedures for transaction screenings and alerts, to flag common trade typologies
  - Consider as well:
    - Conducting “voyage checks” / “port checks” – verify:
      - Existence of the shipment
      - Shipment routes
    - Any association with high risk jurisdictions
    - Transactions involving high risk goods/services
    - Transactions involving dual-use goods
  - Consider information from customer and publicly available sources

Problem

- Flow Diagram of a typical L/C Issuance: Who is the "customer"?



* Lifted from Hong Kong Association of Banks, Guidance Paper on Combating Trade-based Money Laundering (1 February 2016)

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