

Comply or complain?

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Let's be honest, there are not many people who enjoy giving out their personal information, let alone the piles of paperwork they have to complete every time they conclude a transaction. In a 2022 study released by global identity verification giant, Jumio^[1], 57% of consumers across the UK, USA, Mexico and Singapore say they are frequently asked to verify their identities. The burden of certifying your personal information when dealing with new institutions or explaining your financial history over and over may be frustrating in the least, but what's actually behind all the red tape?

It's safe to say that global compliance practices have changed dramatically in the last two decades. The internet has made information readily available, increasing opportunities for global trade, but equally increasing the ways in which criminals operate. There are many factors required in every transaction, and there is an increased pressure on international bodies to work together to combat global criminal activity and protect the sanctity of the world economy.

But are these measures completely justified, or is it a matter of punishing the masses for the dastardly deeds of the few?

How extensive is criminal activity?

For most, the level on which criminals operate is unthinkable. As the famous Socrates saying goes "You don't know what you don't know".

According to a publication by London-based global compliance giant Napier, is it estimated that the amount of money laundered globally in one year is 2% - 5% of global GDP or \$800bn - \$2tn in dollar terms. ^[2]

The publication highlighted the following facts:

1. The average global money laundering risk score – as reported by the annual Basel AML Index - saw an increase in 2021 from 5.22 to 5.3 (out of a maximum score of 10)
2. Global financial crime fines handed out in 2021 totalled \$9.95bn, down from 2020's record breaking figure of \$22.86bn, according to a report by AML Intelligence
3. Corruption, bribery, and fraud accounted for a whopping 69.6% of FinCrime fines handed out in 2021
4. FinCrime fines fell by 78% from 2020 to 2021, with just \$2.86bn given out compared to \$13.15bn in 2020 – \$7.2bn of which related to the Malaysian 1MDB scandal
5. 0% of money laundering offences in the US in 2020 involved loss amounts greater than \$1.5 million
6. The median amount of money laundered in the US in 2020 was \$301,606
7. Despite its association with the Silk Road and the dark net, only 1.1% of all cryptocurrency transactions are known to be illicit

8. In EUROPOL's 2020 highlights, they reported the recovery of \$22,553,523 in cash; 118 bitcoins, 4 properties, gold and silver coins worth a total of \$6.26 million, and \$2.39 million worth of asset seizures from criminal finances, money laundering and asset recovery operations
9. The NCA estimates that fraud alone causes losses to UK consumers, businesses and the public sector worth around \$258 billion every year, and that money laundering costs the UK more than \$136 billion a year. Combined, these figures are equivalent to 14.5 % of the UK's annual GDP
10. The amount of criminal funds that are either channelled through the UK or facilitated by UK structures, "can reasonably be said to run into the tens of billions of pounds, and probably the hundreds of billions" (The UK Treasury Select Committee)
11. Serious and organised crime costs the UK an estimated \$50.4 billion a year

From the above, it becomes clear that it is necessary for some measures to be put in place to protect the global population from criminal activity, but why are all the additional questions asked?

A few key concepts:

In order to understand compliance a bit better, there are a few globally accepted concepts^[3] to be aware of when it comes to international transactions:

Know your client ("KYC") - *To identify the client (and its beneficial owners) and the true beneficiaries of the transaction*

Anti-Money Laundering ("AML") - *Money Laundering is the process of concealing the illicit origin of proceeds of crime and integrating it into the formal economy.*

Counter Terrorist Financing ("CTF") – *Terrorist financing is defined as the financing of terrorist acts, and of terrorists and terrorist organisations. Counter terrorist financing is the measures put in place to prevent such actions taking place.*

Politically Exposed Persons ("PEPs") - *Foreign PEPs are individuals who are or have been entrusted with prominent public functions by a foreign country, for example Heads of State or of government, senior politicians, senior government, judicial or military officials, senior executives of state owned corporations, important political party officials.*

Domestic PEPs are individuals who are or have been entrusted domestically with prominent public functions, for example Heads of State or of government, senior politicians, senior government, judicial or military officials, senior executives of state owned corporations, important political party officials. Persons who are or have been entrusted with a prominent function by an international organisation refers to members of senior management, i.e. directors, deputy directors and members of the board or equivalent functions. The definition of PEPs is not intended to cover middle ranking or more junior individuals in the foregoing categories.

Beneficial Owner ("BO") - *Beneficial owner refers to the natural person(s) who ultimately owns or controls a customer and/or the natural person on whose behalf a transaction is being conducted. It also includes those natural persons who exercise ultimate effective control over a legal person or arrangement. Only a natural person can be an ultimate beneficial owner, and more than one natural person can be the ultimate beneficial owner of a given legal person or arrangement.*

Source of Wealth/Funds ("SOW/SOF") - *The source of funds and the source of wealth are relevant to determining a client's risk profile. The source of funds is the activity that generates the funds for a client (e.g. salary, trading revenues, or payments out of a trust),*

while the source of wealth describes the activities that have generated the total net worth of a client (e.g. ownership of a business, inheritance, or investments). While these may be the same for some clients, they may be partially or entirely different for other clients

The process explained

The Financial Action Task Force ("FATF") is an international organisation established in 1989 working on combatting global money laundering and terrorist financing.

FATF set and monitor the standards that aim to prevent these illegal activities and the harm they cause to society. These standards are encapsulated in a workbook containing recommendations that are regularly updated. When monitoring implementation of these recommendations by member jurisdictions (of which there are over 200), the FATF considers if these recommendations have been complied with or if it needs to take remedial action.

Non-compliance with the recommendations may have severe implications for jurisdictions, as grey-listing by the FATF may impact decisions of credit rating agencies, and serves as a gauge for other jurisdictions about the risks of dealing with grey-listed jurisdictions.

These risks can be distinguished between:

- Geographic risk (the risk related to the jurisdictions that play a role in the customer relationship)
- Customer risk (the risk that the customer plays in the relationship, like their past and how they generated their wealth) and;
- Services risk (the risk that the financial services providers face based on their mandate from the customer).

The member jurisdictions implement the FATF recommendations by entrenching it into their legal system, which places an obligation on financial services providers and other advisors to obtain the necessary information about their clients. Whether or not these jurisdictions enact the legislation will also play a role in the FATF monitoring. Failure to comply may also cause jurisdictions to be placed on the FATF grey-list.

Case study

To illustrate the process of information gathering, meet John Doe:

John wishes to engage with a financial services provider who is registered in a FATF member jurisdiction. Before entering into a transaction with John, financial services providers need to know more about him in order to comply with the laws enacted by their government:

KYC Documentation

Including verification of his identity, such as a copy of his passport and proof of residence (depending on the legislation of the member jurisdiction).

Geographic risk

If John was resident in Finland (which is known to be active in monitoring AML and CTF compliance), it would reduce the geographic risk for the financial services provider in engaging with John. If John was resident in Syria however, the geographic risk will increase.

Source of wealth

John may be asked to provide his source of wealth and source of funds. If John was a member of a political party in charge of state

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funds and allocation of tenders, it would be a higher customer risk than if he was a medical doctor.

A common sense check also needs to be executed when it comes to what John stated his source of wealth is. If he was a 30 year-old warehouse worker earning £1,000 per month, it would not make sense if he stated in his source of wealth declaration that he amassed a portfolio of £5 million from career earnings.

Needs

The financial services provider also needs to identify John's needs. If John wants the financial services company to receive the proceeds of his gambling business, it will be a much higher services risk than when the mandate of the financial services provider is to manage the proceeds of life insurance John received from his deceased parent in a savings account.

The above are just examples of scenarios that financial services providers may face when interacting with clients. It may also be applicable when existing clients enter into agreements with third parties - the third party risk must also be determined before entering into agreements with them as to avoid being party to criminal activities.

Conclusion

International compliance is more to do with understanding the risk of transactions than information sharing. The larger risks are those where clients have no control over their own wealth, or where their funds are being managed by pension providers or discretionary asset managers.

The question it comes down to is: would you like to know who you are dealing with when putting your wealth on the line? The saying 'prevention is better than cure' rings true when it comes to compliance and when the thinking behind compliance is understood, people will be less likely to complain when being asked to provide their details.

References:

- [1] <https://www.jumio.com/digital-identity-2022-research/>
- [2] <https://www.napier.ai/post/financial-crime-statistics-2022>
- [3] The definitions of these concepts are provided by the Financial Action Task Force (FATF)

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