

Politically Exposed Persons (PEPs) in relation to AML/CFT

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Introduction

Financial Institutions (FIs) and Designated Non-Financial Businesses and Professions (DNFBPs) deal with various categories of customers whose risk levels differ due to several factors; of which are the customer's nationality, nature of activity, nature of investments with the financial institution (long, short or medium term), type of provided services such as private banking, ownership structure (for legal persons), total movements on account, etc.

In view of the diversity of risk levels connected to customers, financial institutions and DNFBPs should adopt an internal policy for risk assessment and management. They should classify customers into categories according to their risk profiles (mostly: high, medium and low) and update such policy and classification on a regular basis. For this reason, these institutions should collect and study sufficient information on their customers in order to classify them. Based on this classification, due diligence measures are determined, where enhanced Customer Due Diligence (CDD) measures should be adopted with the customers who belong to the high-risk category. These measures should include customers' acceptance policy, dealing with them, procedures of verifying their identity, required subsequent updating, and ongoing monitoring of transactions.

Among the categories of customers that FIs and DNFBPs should apply enhanced CDD with is Politically Exposed Persons (PEPs), according to Recommendation 6 of the Financial Action Task Force (FATF) 40 Recommendations.

The Middle East and North Africa Financial Action Task Force (MENAFATF)¹ has been concerned also with this topic and decided to form an ad-hoc committee in April 2007 to study this topic and draft a guidelines to help member countries. This paper should be considered as a tool, member countries may consult in full or in part, depending on the circumstances and the status of each country, when reviewing and developing their procedures, legislations, regulations and their Anti-Money Laundering and Combating Financing of Terrorism (AML/CFT) regimes; and to strengthen their compliance with the related FATF recommendation.

This paper includes a review of the definition of PEPs and the international requirements on the way to deal with them. It shows the risks connected thereto in relation to AML/CFT; in addition, it includes some guidelines to member countries on dealing with PEPs in relation to AML/CFT in order to enhance compliance with the related recommendations.

¹ The MENAFATF was founded as a regional body with a voluntary and co-operative nature for AML/CFT by a ministerial meeting held in the Kingdom of Bahrain on 30 November 2004. MENAFATF membership includes 17 Arab countries, and 12 entities and countries enjoy observer status.

First: Definition of Politically Exposed Persons (PEPs) and international requirements in dealing with them

The glossary annexed to the FATF 40 Recommendations defines the Politically Exposed Persons (PEPs) as “*individuals who are or have been entrusted with prominent public functions in 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. Business relationships with family members or close associates of PEPs involve reputational risks similar to those with PEPs themselves. The definition is not intended to cover middle ranking or more junior individuals in the foregoing categories*”.

The international requirements on dealing with PEPs in relation to AML/CFT are the requirements of Recommendation 6 of the 40 recommendations issued by the FATF, which provides for the following:

Financial institutions should, in relation to politically exposed persons, in addition to performing normal due diligence measures:

- a- Have appropriate risk management systems to determine whether the customer is a politically exposed person.
- b- Obtain senior management approval for establishing business relationships with such customers.
- c- Take reasonable measures to establish the source of wealth and source of funds.
- d- Conduct enhanced ongoing monitoring of the business relationship.

It is worth mentioning that according to recommendation 12 of the revised Forty Recommendations, the application of Recommendation 6 is not limited to financial institutions; all DNFBPs are also required to comply with this Recommendation.

Second: Risks associated with PEPs

PEPs are one of the high-risk categories of customers, particularly with regard to Money Laundering (ML). Business relationships with PEPs may represent high risks for FIs and DNFBPs as a result of assuming positions through which they might become vulnerable to, get involved in, or misuse their power and influence for, personal gain or the gain of family members or close associates. They might also or misuse or appropriate public funds. Such individuals might also use their families or close associates to conceal funds or assets resulting from the abuse of their official positions. In addition, they may also use their power and influence to access or control legal entities for similar purposes;

Hence the importance of the systems and procedures that enable FIs and DNFBPs to recognize their customers. The failure to apply CDD may expose

them to significant reputational, legal or operational risks. Persons with political and public positions are therefore considered to belong to a ML high-risk category of customers.

The FATF 2003-2004 report on ML Typologies included that because of the political status of such persons within their countries of origin or diplomatically when they represent their countries abroad, there is often a certain amount of discretion afforded by financial institutions to the financial activities carried out by these persons or on their behalf. If a PEP becomes involved in a criminal activity, this traditional discretion often becomes an obstacle to detecting or investigating such crimes. Diplomatic immunity may also constitute a further obstacle in certain cases relating to these persons, given that this immunity may enable them to easily bring their funds out of their country of origin. In addition, PEPs often resort to other parties (such as associates, friends, family members or intermediaries) to execute financial operations on their behalf. This adds to the level of risk related to them in connection with ML/TF.

Variables affecting the determination of the risk level connected to PEPs

By analyzing the risks connected to PEPs, we find that several factors contribute to increasing or decreasing the risk level connected to these persons, namely:

- Politically exposed person's nationality

Risks related to dealing with PEPs from countries where corruption is widespread are higher than the risks of dealing with the persons of other nationalities.

- Person's position, authority and powers

The higher ranking the person's position, power or authority is, the higher the risks of this person being involved in money laundering crimes are. Whilst all holders of public positions are prone to corruption or abuse of position to a certain degree, those holding senior, prominent or important positions usually represent an increased risk, as they might have substantial authority over policies and operations or to use or allocate government-owned resources.

- Business relationships volume and complexity

Concerning the business relationships concluded or established by a PEP with financial institutions of all types or with DNFBPs, the size of these business relationships and their complexity represent an indicator on the higher level of risks connected to this person.

- Types of products or services offered

The types of products or services offered to a PEP affects the level of risks connected to this person, as certain categories of services comprise a high level

of risk due their nature, such as the private banking. The PEP's use of these services or products constitutes an additional element that increases the risk.

- Foreign parties dealt with

PEPs often rely on offshore companies and banks, shell companies, firms located in particular areas, banks in countries that apply bank secrecy laws or countries that do not sufficiently apply AML/CFT standards. All these external parties and other factors indicate high risks connected to PEPs in relation to AML/CFT.

- Challenges associated with the application of Enhanced CDD Measures

The difficulty to apply enhanced CDD measures on PEPs undoubtedly increases the level of risks related to them. Reviewing the PEPs definition, it includes that business relationships with family members or close associates of PEPs involve reputational risks similar to those of PEPs themselves. Thus, the financial institutions and DNFBPs face serious difficulties in identifying family members or close associates of PEPs correctly. In addition, the difficulty increases when certain alterations occur as per the current (existing) customer's status, for example when he/she becomes a PEP after promotion, elections, or marriage. Therefore, the failure to apply enhanced CDD measures may result from the financial institutions' and DNFBPs' failure to know PEP's family members, relatives, partners or changes that occur to his/her occupational or social status. It might also result from the customer failing to submit important/valuable information or giving insufficient/misleading/wrong information or details.

Risk Management and Mitigation

The application of enhanced CDD measures when dealing with PEPs does not mean ceasing the establishment or entry into business relationships with these persons, as they are not criminals, terrorists, money launderers or drug traffickers. No legislation in any FATF or FSRBs countries prevents dealings with them. However, it is necessary for financial institutions and DNFBPs to realize the risks connected to them and deal therewith in an appropriate manner.

The risks related to PEPs may be mitigated through the following:

- 1) To get more information about these persons and their family members and associates, and adopt enhanced CDD measures to identify them and monitor their transactions in a scrutinized appropriate manner. The enhanced CDD measures applied to identify them may include the following:
 - Identify the customer and the beneficial owner.
 - Know the customer's country of residence.
 - Review resources (such as available lists of names) to determine whether the customer is a PEP.
 - Obtain information directly from the customer concerning the possibility of him becoming a PEP.

- Know the objective of opening the account and the volume and nature of the activity expected for the account.
 - Obtain information on the occupation and the other income sources.
 - Know the source of wealth and funds.
 - Obtain information about the direct family members or associates who have the power to conduct transactions on the account.
- 2) The senior management full commitment to apply the “Know Your Customer” program, by setting the appropriate procedures and verifying their efficiency.
- 3) To clearly determine the responsibility; internal audit and compliance departments should be responsible for the assessment of compliance with policies and procedures relating to the identification and verification of customers and beneficial owners. Certain controls could be applied for the identification and management of relationships with PEPs. These controls may differ according to the type of service. For example, retail banking relationships controls may differ from those considered appropriate for a private banking/wealth management environment. In general, those controls may include:
- Reasonable procedures to identify PEPs and accept dealing with them under the same procedures applied on new customers. The senior management should be responsible for approving any business relationship with those persons.
 - For existing customers, enhanced CDD measures should be applied on anyone who has become a PEP.
 - Enhanced monitoring measures on the business relationships and the accounts of PEPs. Such measures should be subject to periodic review to verify the application of the CDD measures, risk assessment, and to apply proper controls.
 - To maintain ongoing training programs for the employees, including training sessions on sufficient application of KYC procedures and on the manner how they should deal with PEPs and all relevant procedures. The time and content of the training program should be modified according to the trainee’s occupational level. The training should also include new and old employees in all departments, focusing on the methods of verifying the customer's identity by the staffs who directly deal with the customers.

Third: Guidelines about dealing with PEPs in relation to ML/TF.

- 1- Countries should ensure that the applicable laws, regulations, or other enforceable means include a specific definition for PEPs. This definition should be in agreement with the one stated in the glossary annexed to the FATF 40 Recommendations.
- 2- Countries may clarify and interpret some points in the definition to help FIs and DNFBPs with the practical application. Those points should mainly include:
 - Identifying categories regarded as family members: to comprise for example the direct family members including the spouses, children, parents, siblings, and may be also extended to include the in-laws.
 - Identifying close associates: to include close co-workers who are widely known and/or personal advisors, particularly financial consultants or persons representing the PEP in the financial operations.
 - Considering that the basic element in defining a PEP is that he is a natural person. If this person or one of his family members, or close associates is involved in the management or supervision of or presidency of a legal person, this legal person should be subject to the same enhanced CDD measures applied on the PEP without being classified as such.
 - Encouraging the FIs and DNFBPs to consider a range of factors when determining whether a particular holder of a public function has the seniority, prominence or importance to be categorized as a PEP. Those factors may include the official responsibilities of the post, the position title, the level of power and authority associated with the position, and whether the person has the financial authority allowing him access and control over government funds or assets.
 - Defining a timeframe to be applied on the persons who occupy a prominent public position in a foreign country, whereas the FIs and DNFBPs should not automatically remove a PEP from PEPs category as soon as he/she leaves the position. The country should rather consider some other factors such as the nature of the position, the powers and the authorities associated with the position (mainly the financial ones), the period during which the person remained in this position, his reputation and other elements. In general, removing a name from a PEP list should be subject to a suitable level of senior management reviewing and approval, it should also be documented.
- 3- Countries should consider expanding the definition to include local PEPs (or at least the categories whose risks are deemed high by the country).

- 4- Countries should not extend the PEP category's definition to include medium and junior levels but rather concentrate on senior PEPs.
- 5- The competent authorities in the country should advise FIs and DNFBPs on ways to obtain lists of PEPs (e.g. from certain specialized international companies, which provide such lists through periodically updated electronic commercial databases). Those FIs and DNFBPs should apply internal procedures on ways to deal with those lists and benefit from them in an efficient way to identify PEPs, such as:
 - Designing an internal database containing the names of the PEPs and updating it on periodic basis.
 - Screening the names of the customers against the database to identify the status of PEP.
- 6- Supervisory authorities for FIs and DNFBPs should carry out the following:
 - Set the bases for the supervisory practices that govern the KYC programs and apply their procedures.
 - Observe the compliance of FIs and DNFBPs with the requirements of dealing with PEPs and draw the appropriate systems to manage the risks related thereto.
 - Identify the financial institutions and DNFBPs that do not set these systems, oblige them to take quick steps to comply, and conduct intensive follow-up in this respect.
 - Pay more attention to the application of R.6 by FIs and DNFBPs via their on-site inspection visits.
- 7- Countries should sign, ratify and fully implement the 2003 United Nations Convention against Corruption.
- 8- Competent authorities should provide lists of examples of the major transactions that could be executed by PEPs to FIs and DNFBPs to identify unusual transactions or such operations that may involve money laundering or terrorist financing. These lists may comprise the following for instance:
 - The PEP requests the execution of an operation through another institution or company that does not usually deal with foreigners.
 - The PEP requests that the operation be kept secret, e.g. by requesting it be registered in the name of another person or company.
 - The PEP executes several operations through more than one geographic area to conceal the nature, source or ownership of the funds.
 - Significant or frequent transfers of funds.
 - The PEP repeatedly reduces the balance of his account to the minimum.

- 9- Provide specialized on-going training to FIs' and DNFBPs' employees on dealings with PEPs, and applying the related procedures. This training should be part of the regular AML training. It is also possible to adopt a risk-based approach in this regard, to focus on training the staffs at the financial institutions that deal significantly with this category of costumers, such as banks that offer private banking.

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