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MANAGEMENT CHALLENGES RELATED TO THE CHANGES OF THE ANTI-MONEY LAUNDERING POLICIES IN 21ST CENTURY

A b s t r a c t: In this paper we will make a brief preface into AML regulations and its evolution in recent years. As first we will start with several definitions, later on we will show how those regulations have been changed and how they are currently being. In the second part of the article we will focus on the influence of changes on the banking system and other financial institutions. Afterwards we will show the examples of fines which those institutions had to pay due to not being compliant with all regulations and the most recent events in regard to violations of anti-money laundering policies.

K e y w o r d s: Anti-Money Laundering, banking regulations, Know Your Customer, financial terrorism, financial institutions.

J E L C o d e: F53, F55, E58.

INTRODUCTION

One of the most important challenges and threats in the financial sector especially in the management aspect in the XXI century is money laundering and terrorist financing. Global Banks and other financial institutions need to implement numerous regulations and control functions to meet requirements of regulators.

The main purpose of this article is to explain what money laundering and terrorist financing is, and how changes in regulation influenced and affect to the activities of financial institutions. The article will also show the special role of the banks in this system and indicate how important link in the fight against international financial crimes is the management in these institutions.

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In term of management, financial institutions today are facing a great challenge. The twenty-first century brought many benefits, but also challenges and threats for the financial sector. Currently, counteracting of money laundering and financial terrorism is a special expression of it. The banks play the most important role in the maintaining and protecting the whole financial system against the negative effects related to money laundering and financing terrorism which in the recent decades became a threat for the entire world.

This article is based on the method of observation on the experience gained while working on international projects for global banks in the field of Know Your Customer and Transaction Monitoring, however, because of bank secrecy is not possible to identify specific sources as well as some of the information had to be anonymised.

Although financial institutions are obliged by its regulators to protect the financial system, they are the most vulnerable and prone to risk. After all, there are ordinary people standing behind each financial institution, in the following part of this paper we will show a few examples. One of the examples will be the situation which occurred in 2018, when police officers and prosecutors entered the headquarter in Frankfurt and other offices of Deutsche Bank to conduct investigations in regards to violations of the money laundering legislations which has been done with the use of bank accounts held in Deutsche Bank. In this case, one of the consequences was the arrest of two heads of the compliance team.

For many years, topics related to anti-money laundering and terrorist financing have not come off from the main areas of interest of financial institutions, governments and international supervisory authorities. For people who are not directly related to those topics, it may seem that these problems are connected to third world countries, and in no way are problems of highly developed countries or European Union itself. However, when you look a few years back, at the examples of institutions which were involved in those violations in Estonia and Latvia, you can easily see that this point of view is far from the truth.

ANTI-MONEY LAUNDERING BACKGROUND

Where does the term money laundering actually come from?

There are many versions of the genesis of this term in the literature.¹ The most famous is referring to the 18th amendment to the US Constitution. It forced organized crime groups to find a way to legalize the proceeds from illegal activities, especially related to the production, transport and sale of alcohol. The purpose of this practice was and still is to conceal the true origin of the funds and make dirty money appear legal. [Hryniewicka, 2014]

¹ *Bazylejskie podstawowe zasady*, Core Principles for effective banking supervision, 2012.

One of the most recognizable criminal groups of that type in the 20th century was led by Al Capone. They were realizing that the best way to hide the sources of income would be to run ordinary business, which requires a lot of money, at the same time, they used ordinary laundry points that were very popular at the time. Criminals simply reported to the tax authorities much higher amounts than those directly obtained by the laundry machines. As a result, dirty money from illegal sources was washed out.

This is just the only one of many examples, but it is worth mentioning at least another criminal who has improved and developed this practice, namely Meyer Lansky (actually Meier Suchowlański), who used Swiss bank accounts for the use of the loan bank concept, which consisted in this that the banks cooperating with him granted bogus loans, which were quickly repaid with funds from unknown sources. To this day, the techniques that Meyer Lansky used to inject dirty money into the financial system have not been disclosed or well explained.

DEVELOPMENT OF ANTI-MONEY LAUNDERING REGULATIONS

The United States was the first who noticed the emerging problem and decided to create the first anti-money laundering regulations. At the turn of the 1960s, the first legislative initiatives appeared, aimed at creating regulations at the federal level of which the purpose was to fight the new threat [Rau, 2000].

The first act of which the purpose was precisely to counteract money laundering, was the amendment to the Federal Deposit Insurance Act (FDIA) released on October 26, 1970 by the US Congress. As a result of this amendment, two new parts appeared: Financial Recordkeeping and Reports of Currency and Foreign Transactions. These laws are known as the Bank Secrecy Act.² The purpose of these regulations was to formally oblige US financial institutions to assist US authorities in the prevention and detection of money laundering practices and tax evasion. Among other things, it introduced the obligation to create, maintain and maintain a register of client transactions for a minimum period of five years and to report all money transactions above \$10,000 as well as international money transactions and financial instruments of the same value sent from or to the United States. From the acts that required financial institutions to create new departments operating to this day, there was an obligation to identify the parties to the transaction, determine the legal capacity of these parties or define the subject of the transaction, which significantly influenced the management of financial institutions, especially in terms of back office services. It should also be mentioned

² Federal Financial Institutions Examination Council Bank Secrecy Act/Anti Money Laundering Info Base, https://www.ffiec.gov/bsa_aml_infobase/pages_mauul/olm_002.htm, [access on: 18.04.2020]

that the provisions of the Bank Secrecy Act include for the first time criminal sanctions for violating the above-mentioned behaviour [Mdingir, 2001].

Nowadays, the international community, seeing the need to combat money laundering or terrorist financing, tries to create newer and newer regulations to adequately respond to the needs of the modern world and the threats that appear in this aspect.

One of the most famous pieces of legislation that criminalized terrorist financing was passed after the terrorist attacks of September 11, 2001, was the USA Patriot Act (Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism).³ The ease with which terrorists managed to organize attacks, and with the help of financial institutions, showed the urgent need to decode and disable the mechanisms that made it possible to finance terrorism. This made it necessary to strengthen anti-money laundering regulations. The USA Patriot Act has imposed, directly and indirectly, not only on American financial institutions but also those outside the United States, which, however, operate in the United States, additional obligations. All access points to the US financial system were to be tightly controlled from now on, and the regulations introduced meant that the US wanted to be able to control the flow of every single US dollar. For this reason, the regulations also affected foreign companies with their influence and scope of anti-money laundering and terrorist financing standards.

One of earlier example is the Money Laundering Control Act introduced in the United States in 1986. On the basis of the norms contained in this document, the United States tried to gain allies also on the international arena, especially among the countries of the Group of Seven (G7), in order to cooperate in the detection, confiscation of and freezing the profits of drug trafficking and reducing money laundering [Pływaczewski, 2002]. In 1988, during the summit of this group in Toronto, it was not possible to reach an agreement to establish, as proposed by the United States, a special international body with special powers to fight against money laundering, detection and confiscation of illegal financial sources. One of the few successes of this summit was the recognition of drug trafficking as a serious threat and the decision to step up the efforts of the international community to combat these threats. A year later, the Financial Action Task Force - FATF was established in Versailles, which included sixteen countries. The result of the work of this group was the presentation in 1990 of a report on money laundering and 40 recommendations, the application of which was to affect the outcome of the fight against this practice [Hulse et al., 2008].

40 FATF recommendations have become a milestone in the development of regulations on combating money laundering and financing of terrorism. Also,

³ Department of Justice, The USA Patriot Act: Preserving Life and Liberty, <https://www.justice.gov/archive/II/highlights.htm>, [access on: 16.04.2020 r.]

after the attacks of September 11, 2001, FATF adopted an additional nine special recommendations for the fight against terrorist financing. Today, the FATF is one of the most important international bodies that develops and promotes a policy of counteracting of money laundering and the financing of terrorism.

Also, not only the United States is working on developing regulations. Another source of law is the resolution of the United Nations, it is worth to mention:

- The United Nations Security Council Resolutions of 2001 or 2004. Resolution 1373 of 2001 (S / RES / 1373/2001) called on Member States to cooperate in order to prevent terrorist acts and combating these acts by fully implementing the relevant international conventions on terrorism, including an asset freezing without any delays.
- Resolution 1526 of 2004 (S / RES / 1526/2004) imposed an obligation on the state establishing internal reporting requirements and procedures for cross-border money movements based on applicable limits

Another example of the provisions being introduced are directives issued by the European Union, which must be implemented in a timely manner into the internal legal order by the all EU members. The purpose of the AML directives is to standardize the actions of states in the aspect of counteracting money laundering. The most extensive was the 4th EU directive AML No. 849/2015, which entered into force on June 25, 2015. It imposed many new requirements on the EU Members which had to amend their legal systems by June 26, 2017. It also took into account the FATF recommendations from 2012, which led to the harmonization of European Union regulations with international regulations in the field of AML. The fourth directive introduced, inter alia, the extension of the definition of Politically Exposed Persons, clarification of the Ultimate Beneficial Owner and its position in the ownership structure, and many other requirements for getting to know the risk scale of clients.⁴ One of the latest amendments was the issue by the European Parliament and the EU Council of Directive 843/2018 known as Fifth AML Directive of July 9, 2018 on the prevention of the use of the financial system for money laundering or terrorist financing. Its main goal is to create conditions for an efficient exchange of information in order to increase the effectiveness of counteracting money laundering and terrorist financing within the EU.

BASIC DEFINITIONS AND MANAGEMENT IN THE FINANCIAL SECTOR

Money laundering is the process of concealing the origins of money obtained from the illegal sources (for example trafficking of the narcotics, bribes, frauds, extortions, theft) and passing the money through a complex sequence of transactions or transfers.

⁴ Dyrektywa Parlamentu Europejskiego i Rady UE 849/2015 z dnia 20 maja 2015 r.

Usually we distinguish the three stages of that process: placement, layering and integration. Short description of those terms with some examples you can find below.

Placement - during this stage illicit money (from illegal sources) is placed into financial institutions (opening a several bank accounts with small amounts of cash, deposits, etc.)

Layering - is the process of making many banking transactions, investing in funds, making loans, with the purpose of hiding the origin and destination of the money (concealing the originators and the beneficiaries).

Integration - it is the last stage of the money laundering process. On this stage money usually is invested in high value assets (jewellery, cars, boats, arts).

Terrorist financing is the process where money from legal or illegal sources is transferred to the organisations with terrorist purposes.

However, what is the difference between Money Laundering and Terrorist Financing?

As first sources of the money in case of terrorist financing not necessarily has to be illegal, very often money for terrorist financing comes from legal sources, through several foundations or funds created for political and ideological purposes. Secondly the beneficiaries of money laundering are the same persons (or related to them) as the originator, what we cannot say in terrorist financing cases.

Even if those two processes are slightly different many times, they are connected with each other. In both of these cases people and organisations engaged in it, want to conceal the real beneficiaries and sometimes the origin of the money.

In those processes usually they use several tactics like:

- Making the transfers to\in offshore jurisdictions⁵ or registered there their companies,
- Using straw men,
- “Investing” money via several foundations or funds,
- Creating and using shell⁶ and shelf⁷ companies

In 2017 the worldwide revenues generated from 11 major crimes were estimated to range between US \$ 1.6 trillion and \$2.2 trillion per year. For instance, Drug trafficking - \$426-652 billion, Illegal logging \$52-157 billion, human trafficking \$150 billion, migrant smuggling \$150 billion, counterfeiting \$923 - 1.13 trillion.⁸

⁵ Offshore jurisdiction - low or no-tax country with corporate laws, which maximize financial privacy and at the same time they minimize corporate regulators, e.g. Cyprus, United Arab Emirates, Curacao, Malta, Cayman Islands

⁶ Shell companies give the impression that a number of different, reliable entities are involved in a transaction or relationship. In fact, these entities have been created for this very purpose and they have no substantial purpose (they are in fact empty shells)

⁷ Shelf company - is an entity which has been created and left without any activity

⁸ http://www.gfintegrity.org/wp-content/uploads/2017/03/Transnational_Crime-final.pdf, [access on: 17.07.2020 r.]

It is the banks, as obliged entities, that bear the greatest burden of transaction monitoring, which may raise suspicions as to the legality of funds derived from illegal activities. The available sources show that from all financial institutions, it is the banks that provide the most information in regards to implementation of financial operations bearing the hallmarks of money laundering. [Masciandaro et al., 2007] Estimated the banks provide from 60% to even 100% of all suspicious transaction reports. [Roudaut, 2011] All the aforementioned regulations impose further obligations on banks, which means that they incur significant financial outlays adapting to the new requirements, and this does not translate into profits of financial institutions, but at most reducing operational risk or reputational risk.

The estimated amount of money spent on just anti money laundering compliance by financial institutions indicates the importance but also emphasises how money launders can afford to commit more money to beating this compliance. The estimated total spend by all financial institutions on just anti money laundering complies varies between jurisdiction. In 2017 the cost of AML Compliance in German was estimated around \$47 billion, in France \$19 billion, in Italy \$12 billion, in Netherlands \$2 billion.⁹

This makes banks try to intensify their resources and optimize procedures. For this reason, the world's largest banks invest where possible in paperless, artificial intelligence, which they then use, for example, in transaction monitoring, which is required of them by law. These processes were significantly accelerated due to the pandemic. Banks that previously used outsourcing services, looking for savings, try on their own, using only their personal resources, to meet the requirements set for them. Over the past year, it could be noticed that banks tried to hire more AML specialists, thanks to which they were able to find savings from their own funds and resources.

One of the contributing changes has already been made by EU Directive No. 2005/60/WE in 2005 when the transformation from the rule-based approach to the risk-based approach took place, through which financial institutions independently verify the client and the related risk. As a result, the banks, as obliged institutions, had to bear higher and higher costs of combating the threats of money laundering and financing of terrorism. Additionally, banks have been obliged to create and develop their own criteria for the analysis of the risk of money laundering, hence the whole responsibility of risk assessment has been transferred entirely to banks. As an example we would like to show you the research done for the Financial Services Authority¹⁰, which proved that with the change in regulations, financial institutions incurred significantly higher costs, assuming also that the outlays are transferred directly to customers, and the

⁹ The True cost of anti money laundering compliance, September 2017, LexisNexis Risk Solutions

¹⁰ PwC LLP, Anti money laundering current customer review cost benefit analysis. PwC for Financial Services Authority, London 2003

banks themselves incurred nearly three times higher costs compared to other financial institutions.[Geiger, Wuensch, 2006]

In result banks use the various tools to meet all requirements included in the newest acts. The procedures related to Know Your Customer (KYC), Due Diligence (DD), Activity Monitoring (AM) and also Transaction Monitoring (TM) have the greatest impact on management systems. The new requirements imposed on banks meant that they also had to adapt their management systems and procedures to the current situation.

The largest global banks also use outsourcing of specialized companies (e.g. big four: E&Y, KPMG, PwC and Deloitte), which also provide services in the field of counteracting money laundering and terrorist financing. Companies providing such services are developing with enormous speed due to the need to reduce risk, banks are willing to allocate large financial outlays for such companies to eliminate the possibility of receiving much higher penalties for complying with the rules set by regulators and auditors. Due to the pandemic, the number of projects had to be limited in recent months, as banks are also looking for savings in this field, moving towards the implementation of modern technologies and solutions while maintaining the standards imposed by national, European and international regulations.

SELECTED FINES IMPOSED ON BANKS IN THE LAST FIVE YEARS

As already mentioned, all regulated financial institutions are required to have their own policies and to apply procedures, in particular due diligence, regulations to promote high ethical and professional standards in the banking sector, to prevent banks from being used intentionally, knowingly or even inadvertently for illegal activities.¹¹ In recent years, it is clearly visible that despite the introduction of new regulations, especially at the international level in the field of anti-money laundering, financial institutions are more and more scrupulously controlled in connection with breaches of banking secrecy and anti-money laundering regulations. International regulators imposed huge fines on the world's largest banks, such as French BNP for violations in regards to the International Emergency Economic Powers Act for participation in prohibited transactions in 2002-2012, where one of the parties of the transactions were Iran, Sudan or Cuba – BNP paid nearly \$9 billion in fines.¹² Also English bank HSBC agreed to pay almost \$2 billion to US government to allow their banking systems to be used to launder money from the sale of drugs originating in, for example, Mexico, and to violate sanctions laws by doing business with clients in Ultra High Risk

¹¹ *Bazylejskie podstawowe zasady*, Core Principles for effective banking supervision, 2012.

¹² BBC News, *Deutsche Bank Headquarters raided over money laundering*, [29.11.2018]

Countries such as Libya, Iran, Sudan, Burma and Cuba.¹³ In September 2018, Reuters reported that a record fine of nearly \$ 900 million was imposed on the largest Dutch bank, ING.¹⁴ The investigation revealed that ING had failed for several years to counter financial crimes by structurally, improperly screening the actual owners of customer accounts and not reporting suspicious transactions handled by ING. Earlier, in 2012, ING was fined \$ 619 million for intermediation in transactions with UHRC countries, after the publication of information about the fine, the bank's shares fell by nearly 2.2% within a few days.¹⁵

Another example where the bank has been punished due to violations of anti-money laundering legislations was Standard Chartered Bank, which in 2019 agreed to pay more than \$1,1 billion to the UK and US governments. The investigation showed that in 2009-2014 the bank brokered illegal transactions, for which it was fined \$ 330 million in 2012 for being non-compliance with sanctions imposed by the United States on Iran.¹⁶

One of the most striking examples of where the boundary between preventing and upholding the law and facilitating and laundering money was the action of the police and prosecutor's office on November 29, 2018, where the services entered the headquarters of the largest German bank in Frankfurt due to an investigation into money laundering by high-ranking compliance department employees. A department that is on the front line in the fight against financial criminals and is the bank's most important defence. Two directors of this department have found the investigation to help their clients launder money from illegal activities, using the bank's system. Moments after the media coverage of the entire action of entering the headquarters of Deutsche Bank, its shares fell by over 3%.¹⁷ The investigation itself was conducted since the disclosure of the information contained in the so-called Panama Papers scandal in 2016 - the scandal concerning the leak of confidential information from the law firm Mossack Fonseca.

Although banks are constantly introducing new security, they try to meet all their obligations, looking at the range of years for which banks receive penalties, it can be seen that law enforcement agencies, although working slowly, do it very accurately and it is only a matter of time when the media see the next light money laundering scandals.

¹³ HSBC pays record \$1.9 bn fine to settle US money-laundering accusations, "The Guardian", [11.12.2012]

¹⁴ Sterling, T.; Meijer, B. Dutch Bank ING fined \$900 million for failing to spot money laundering, Reuters, [4.09.2018].

¹⁵ Sterling, T.; Meijer, B. Dutch Bank ING fined \$900 million for failing to spot money laundering, Reuters, [4.09.2018]

¹⁶ Flitter E., Standard Chartered Fined \$1.1 billion for Violating Sanctions and Anti Money Laundering Laws, New York Times, [09.04.2019]

¹⁷ BNP's \$8.97 billion U.S. Fine Sets Bar for European Banks, Bloomberg, [01.07.2014]

SUMMARY

Looking at the modern world, where the situation is very dynamic and forces making very difficult decisions, this is an example of global banks which, despite the pandemic and the forced change of approach to work, for example the transfer of employees and many of the departments to the home office, they are still doing very well. The management system for back office departments dealing with KYC (Know Your Customer) and DD (Due Diligence) shows the modern approach of the management to the challenges they face. Managers use, among others, lean management techniques or management systems based on Prince Foundation or Agile. However, the greater the wall of banks to protect business and comply with regulations, the higher the ladders criminals build to overcome all barriers. In the era of digitization and artificial intelligence, today it is not known how bank systems will develop. The analyst is still sometimes necessary, a good example is the blocking of the transfer and the alarm that the Transaction monitoring system applied. The title of the transfer was: “opłata za franki”¹⁸. The amount did not raise any suspicions, the person ordering the transfer was identified and the recipient as well. However, the system detected the word Iran in the word “franki” and therefore withheld the transfer.

Every day, banking systems are exposed to attacks by financial criminals, as previously mentioned. But not only IT systems, but also management systems and the human aspect, the financial system still requires new regulations and tools that will help in preventing money laundering and financing of terrorism. This does not change the fact that the current global situation related to the pandemic also influenced the activities of banks and management, for example in the aspect of counteracting money laundering discussed here. Recent decisions made clearly show that in the near future the management boards of banks will continue to focus on looking for savings, however, assuming further development of anti-money laundering and terrorist financing regulations, they will focus on internal KYC and Due Diligence teams to reduce costs and allocate funds for development technology and automation of systems using artificial intelligence.

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¹⁸ Opłata za franki – Polish sentence, which was the name of the money transfer. In English it means fee for curtains (author's note)

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