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An Examination of Policy Implications on PEPs

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Summary

This paper, endeavours a look briefly at the policy implications of PEPs, focusing on the following:

- the reasons behind the Financial Action Task Force on Money Laundering (FATF) regulatory initiative for PEPs
- the effects of not including domestic, but only foreign public office holders in existing PEP definitions
- the criteria and the legitimacy of authority/ies deciding when to begin and terminate PEP status
- the perspective of extending PEP monitoring to individuals holding important positions in the private sector, that is, to financially exposed persons
- the effects of PEPs regulation on global governance

Keywords : Crimes, money laundering, accountability, governance, finance.

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AN EXAMINATION OF POLICY IMPLICATIONS ON PEPs

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The purpose of this paper is to look at politically exposed persons (PEPs) as a tool of international governance from a political science perspective. The European Union Third Money Laundering Directive defines PEPs as 'natural persons who are or have been entrusted with prominent public functions and immediate family members, or persons known to be close associates of such persons.¹ However, other organisations, such as the Wolfsberg Group, have different definitions of PEPs, extending them to ruling royal families.² The lack of a global codified definition for PEPs is one of the reasons that creating global regulation towards tackling corruption amongst these individuals is so difficult.

The reasons behind the FATF regulatory initiative for PEPs

The new financial age has brought with it a renewed interest in and scrutiny of corruption and abuses associated with PEPs, who have been involved in cases ranging from the execution of a public servant, Zheng Xiayou, in China for taking bribes, to the imprisonment of Rod Blagojevich, the governor of Illinois, on grand corruption charges. It is difficult to estimate the amount of public assets stolen or extorted by PEPs, but estimates by World Bank suggest that more than \$1 trillion is paid in bribes each year,³ while the proceeds of corruption stolen from developing countries alone ranges from \$20 billion to \$40 billion per year.⁴ The methods of moving and concealing these stolen assets have also become more advanced. Previously, corrupt PEPs deposited money under their own names in foreign jurisdictions or used relatives to open bank accounts. Current techniques continue to include abuse of bank facilities, but also the buying of real estate; the purchase and movement abroad of precious metals, jewels, art work, and the like; and the physical cross-border movement of currency and negotiable instruments. The use of close associates and corporate vehicles has been and remains a vexing problem. Ultimately this level of corruption not only has a negative effect on the relevant countries' economies, but also makes them less attractive to businesses and other more stable nations. It also has a detrimental effect on any banks who may be involved in the money-laundering scheme, who are often subject to large fines and a tarnished reputation. For example, in 2003, the UK's Financial Services Authority fined Northern Bank £1.25 million for money laundering. This damaged the bank's

¹ Choo, K. *Politically Exposed Persons: Risks and Mitigation* (2008), p. 2.

² *ibid*

³ The World Bank, "The Costs of Corruption," (April 8, 2004) quoting Daniel Kaufmann, Director for Governance, World Bank Institute. Link available at <http://go.worldbank.org/LJA29GHA80>.

⁴ UNODC and The World Bank, "Stolen Asset Recovery (StAR) Initiative: Challenges, Opportunities, and Action Plan" (World Bank, Washington, DC, 2007), p. 9.

reputation, and it was eventually taken over by Danske Bank.

Eventually, the international community launched efforts to mitigate the potential risks posed by PEPs. In 2003, the Financial Action Task Force on Money Laundering (FATF) introduced a number of preventive measures to identify these higher risk individuals and to improve the monitoring of their transactions. These measures are set forth in Recommendation 6 of the FATF 40+9 Recommendations, with the related requirements of customer due diligence in Recommendation 5. Also in 2003, the United Nations Convention against Corruption (UNCAC) called for enhanced scrutiny of accounts held by PEPs in Article 52(1) and (2) as a means to prevent and detect the transfer of the proceeds of crime. In 2006, FATF stated that the lack of the rule of law and of measures to prevent and combat corruption may significantly impair the implementation of effective anti-money-laundering /combating the financing of terrorism (AML/CFT) framework. In addition, studies have been undertaken by FATF and the FATF-Style Regional Bodies (FSRBs) on PEPs in the context of corruption and money laundering.⁵

The effects of not including domestic, but only foreign public office holders in existing PEP definitions

Identifying individuals or customers, such as PEPs, who pose an increased risk of laundering corrupt funds is an important part of a bank's AML controls. Essential to the identification process is having a definition of PEPs. Unfortunately, as mentioned above, there is no internationally agreed definition of PEPs. As a result, understanding who these customers are and how far the definition of PEPs should stretch is a difficult and politically sensitive topic.

Currently, UNCAC does not distinguish between foreign and domestic PEPs, which has the effect of requiring that States Parties mandate the application by financial institutions of Enhanced Due Diligence (EDD) to both foreign and domestic PEPs. However, despite political obligations under the UNCAC, most legislators have made a political decision not to classify domestic office holders as PEPs.

So what are the effects of not including domestic office holders in the definition of PEPs? Firstly, the legal and reputational risks remain the same, whether the PEP is domestic or foreign. PEPs controls are designed to draw attention to, and mitigate, the increased money laundering risk posed by this category of customers. While corruption is more prevalent in some countries than others, domestic politicians are subject to the same pressures and perverse incentives as their foreign counterparts and should be treated accordingly. In some cases, corrupt money may enter the financial system first through a bank in the victim country, and then through correspondent relationships into the major banks in larger financial centres.⁶

Second, although some have argued that covering both domestic and foreign PEPs would be too burdensome on banks, evidence gathered in the course of the visits suggests otherwise. Many of the banks most at risk of having corrupt PEPs as clients do not distinguish between foreign and domestic PEPs. In fact, most banks stressed that a distinction made little business sense and that it was easier to set up systems to include both domestic and foreign PEPs. Often it is

⁵ Greenberg, T. Gray, L. et al *Stolen Asset Recovery: Politically Exposed Persons* (2009)

⁶ Greenberg, T. Gray, L. et al *Stolen Asset Recovery: Politically Exposed Persons* (2009), p.27.

easier and less resource-intensive to identify domestic PEPs. In addition, the banks were concerned about the reputational risk of banking a corrupt PEP more generally, a risk that exists equally among domestic and foreign PEPs.⁷

Finally, such efforts would increase the credibility of the governments' commitment to fighting corruption and money-laundering, particularly the States Parties to UNCAC that have committed to treating domestic and foreign PEPs equally.⁸

The criteria and the legitimacy of authority/ies deciding when to begin and terminate PEP status

Neither the FATF 40+9 Recommendations nor UNCAC impose or recommend any time limits on the period of time that a customer remains a PEP after the prominent public official has left their position ("once a PEP, always a PEP"). While this may be appropriate in some circumstances (for example, with some heads of state), a prominent public official's career is often short-lived. Applying EDD measures to all former office holders—and their families and close associates—for an infinite time would be disproportionate.⁹

This circumstance has led some jurisdictions to introduce time limits after which banks are no longer obliged to treat former PEPs automatically as high risk customers. One jurisdiction only considers for current office holders, their families, and close associates (that is, once the PEP leaves office, EDD can cease). However, the length of time after which a customer has left a prominent public function is not indicative of the relative money laundering risk associated with their business relationships.

Time limits are necessarily artificial and pose problems: they can impart a false sense of security that a customer no longer poses an increased risk of money laundering. Evidence suggests that corrupt PEPs do not cease to move illicit funds after leaving office and some may continue to receive payments. Indeed, public officials, their families, and close associates may wait until after leaving to move the funds. This problem is intensified the shorter the time period the PEP continues to be treated as a PEP.

Banks should, therefore, be encouraged to consider the ongoing PEP status of their customers on a case-by-case basis using a risk-based approach, and regulatory authorities should provide guidance on what this entails. Many banks continue monitoring PEPs for years – even decades – after they have left office.¹⁰ Where risk is low, banks can consider declassifying the relationship, but only after careful consideration of risks and involving senior management approval.

The prospect of extending PEP monitoring to individuals holding important positions in the private sector, that is, financially exposed persons

It has been suggested that PEP monitoring be extended to persons holding important positions in the private sector. As Sohn writes, "a Chief Financial Officer of a sizeable corporation presents a similar financial risk" to a PEP in a

⁷ Ibid.

⁸ Ibid.

⁹ Ibid., p.31.

¹⁰ Greenberg, T. Gray, L. et al *Stolen Asset Recovery: Politically Exposed Persons* (2009), p.31.

prominent public position.¹¹ These individuals may also have access to insider information that could lead to insider trading and other illegal activities.

The effects of PEPs regulation on global governance

There is an ongoing call for greater control to criminalize corruption and the associated economic crimes at both international levels (e.g. UN Convention against Corruption – the first legally binding international instrument against corruption, which has been ratified by over 100 member jurisdictions) and regional levels (e.g. OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions – the OECD Convention).

These frameworks require member jurisdictions to implement relevant legal instruments and supranational administrative measures to cover a wide range of acts of corruption, if these are not already criminalized under existing legislation. At least 37 jurisdictions have criminalized foreign bribery and disallowed tax deductions for bribe payments, as well as taking further steps required by the Convention and other OECD anti-bribery instruments.¹²

Signing the UN convention is easy, but implementing effective legislation requires the political will and the support of the people to make a difference. That political will may not be forthcoming. Transparency International's (TI) Global Corruption Barometer (GCB) produced each year indicates that political parties and the parliament/legislative bodies are perceived to be the most corrupt. These two groups have remained at the top of the sectors/institutions perceived to be most affected by corruption since the GCB was first published in 2004. In 2006 TI asked respondents in 67 countries to assess their government's fight against corruption.¹³ Their results indicate that very few respondents believe their government is doing enough (Transparency International, 2006). Of those 67 countries, 57 have signed the UN Convention Against Corruption.

Conclusion

The push for greater regulation against corrupt PEPs is one that is universal, as seen by the signing of the UN Convention Against Corruption by 152 states, but the lack of real political will to implement and enforce legislation remains a problem. Johnson writes that "the problem of corruption amongst those who are supposed to be combating it will need to be dealt with at a local/domestic level before countries are able to deal with enhanced Client Due Diligence (CDD) for foreign PEPs. No amount of global regulation will be effective if the corruption starts with a country's own public officers."¹⁴

However, from a political science perspective, the increasing calls for global governance on finance, especially after the recent financial crisis, and the more authoritative role of the UN, suggest that more global oversight and enforcement on PEPs will become a reality in the future.

¹¹ Sohn 2003, quoted from Choo, K. *Politically Exposed Persons: Risks and Mitigation* (2008), p. 13

¹² Choo, K. *Politically Exposed Persons: Risks and Mitigation* (2008), p.10.

¹³ Johnson, J. *Little Enthusiasm for Enhanced CDD of the Politically Connected* (2006), p.4.

¹⁴ Op.cit, p. 10.

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