Fraud , Know- Your –Customer (KYC) and Money Laundering

A PRESENTATION

AT

THE 4TH ANNUAL INSITUTE OF CERTIFIED PUBLIC ACCOUNTANTS OF KENYA (ICPAK)

FINANCIAL CONFERNCE

HILTON HOTEL, NAIROBI

BY CNTRAL BANK OF KENYA

Outline

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Background

- Financial crimes relating to fraud and money laundering are increasing at an unprecedented rate. Both domestically and internationally
- Globally, efforts are underway to strengthen legislation international best practice worldwide to combat money laundering and financial crime.
  - FATF – Issuance of Revised Standards on Money Laundering in 2012
  - Basel Core Principles – Revised Core Principles
- The huge amounts of money involved in these illegal activities ensure that criminals continue to exploit ways of increasing their activities .

Accountants vulnerability to Fraud and Money Laundering

- Criminals often turn to the expertise of professionals 'gatekeepers' to aid them to minimize suspicion surrounding their criminal activities.
  - Accountants
  - Lawyers,
  - Notaries
- Accountants provide a wide range of services closely related to economic activities, that are vulnerable to fraud and money laundering.
  - Creation of corporate vehicles
  - Buying or selling of property,
  - Performing financial transactions
- Accountants are highly regulated by professional ethics and are less likely to be linked to performing illegal economic activities
- Professional secrecy privilege granted to 'gatekeepers' such as accounts means that launderers activities may not be revealed.

Accountants vulnerability to Fraud and Money Laundering

Some of the functions performed by accountants that are the most useful to the potential launderer include

- **Financial and tax advice ;**
- **Creation of corporate vehicles or other complex legal arrangements**
  - Use of complex legal structures that may serve to confuse or disguise the links between the proceeds of a crime and the perpetrator.
- **Buying or selling of property;**
  - Property transfers may serve to disguise transfers of illegal funds (layering stage)
  - May represent the final investment of these proceeds after their having passed through the laundering process (integration stage).

Accountants vulnerability to Fraud and Money Laundering

- **Performing financial transactions** – Sometimes accountants may carry out various financial operations on behalf of the client
  - Cash deposits;
  - Withdrawals on accounts;
  - Retail foreign exchange operations
  - Issuing and cashing cheques,
  - Purchase and sale of stock, sending and receiving international funds transfers, etc.).

- **Opening accounts on behalf of customer therefore gaining introductions and therefore access to financial institutions.**

What is Money Laundering ?

The Financial Action Task Force on Money Laundering (FATF), which is recognized as the international standard setter for anti-money laundering(AML) efforts, defines the term money laundering as;

"the processing of criminal proceeds to disguise their illegal origin in order to legitimize the ill-gotten gains of crime"

Generally, what constitutes a money laundering offence?

- To knowingly (or should have known) assist a criminal to obtain, retain or invest funds derived from criminal activity.
- To warn / tip-off suspects of an investigation.
- To fail to report suspicious transactions.

What is Money Laundering?

- Initial concern over money laundering began with its early connection to illegal trafficking of narcotic drugs.
- A **predicate offence** is the underlying criminal activity that generates proceeds that, when laundered leads to the offence of money laundering.
- Today, ill-gotten gains are produced by a vast range of criminal activity referred to as **predicate offences.**

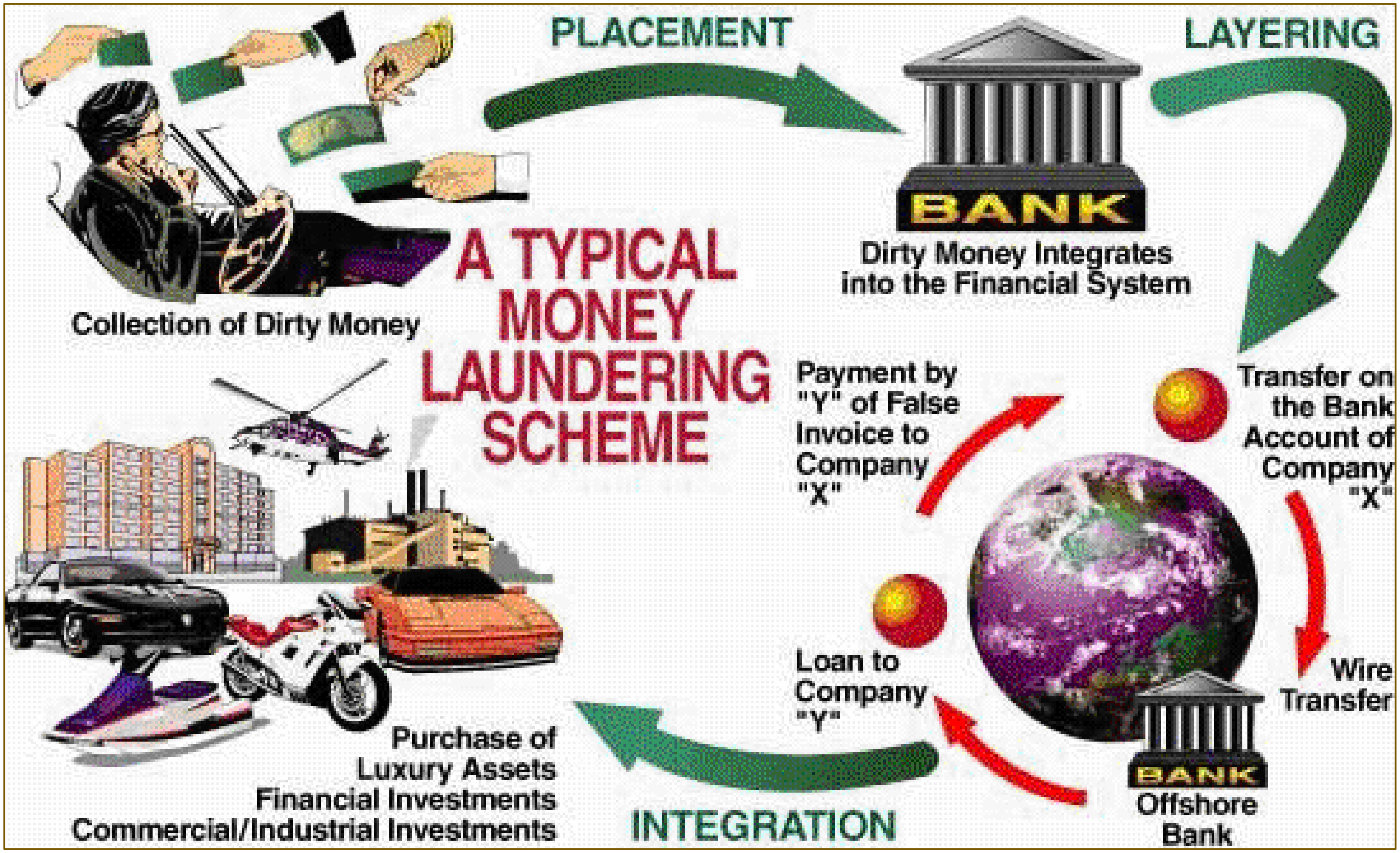
- Robbery
- Human Trafficking
- Drug Trafficking
- Arms Trafficking
- Corruption and Bribery
- **Fraud**
- Kidnapping
- Racketeering

- Smuggling
- Extortion
- Forgery
- Piracy
- Insider trading and market manipulation
- Counterfeiting currency
- Environmental crime

The Money Laundering Cycle

1. **Placement -** Funds are separated from their illegal source and placed into a financial institution - moving the funds from direct association with the crime
   - Depositing cash into a bank account,
   - Cash purchase of a security
   - Converting funds into financial instruments, such as money orders or checks
2. **Layering -** The ill-gotten gains enter the financial system - the separation of criminal activity from their origin by creating complex layers of financial transactions designed to disguise the audit trail.
3. **Integration –** The integration of funds into the legitimate economy - using an apparent legitimate transaction to disguise illicit proceeds
   - Purchase of assets, such as real estate, securities or other financial assets, or luxury goods

The Money Laundering Cycle



Case Study

- **Placement**. In 1994, two alleged narcotics traffickers used an accounting firm to launder criminal proceeds generated from drug sales. The "clients" of the firm would on a regular basis hand their accountant cash in brown envelopes a shoe boxes for which no receipt was issued. The funds were then stored in the accountant's office until he decided how they could be introduced into the financial system and laundered. At any one time, there was between USD38,000 and USD63,000stored in the accountant's office
- **Layering** The law enforcement agency investigating the matter found that the accountant established company and trust accounts on behalf of his clients and opened personal bank accounts in the names of relatives. He then made structured deposits to those accounts with the funds received from the alleged traffickers. He the brought the trucks back into the country and sold at a profit,
- The Accountant also used some of the funds to purchase properties.

What is Fraud?

- Fraud is a broad concept that refers generally to any intentional act committed to secure an unfair or unlawful gains.
- Financial fraud typically falls into four broad categories:
- **Misappropriation of assets —** This category involves external and internal schemes, such as embezzlement, payroll fraud and theft.
- **Expenditures and liabilities for improper purposes —** This category refers to commercial and public bribery, as well as other improper payment schemes.
- **Fraudulently obtained revenue and assets, and costs and expenses avoided —** This category refers to schemes where an entity commits a fraud against its employees or third parties, or when an entity improperly avoids an expense, such as tax fraud.

What is Fraud?

. A survey conducted by one of the leading accounting firms revealed that frauds are normally uncovered through the following ways;

- In the course of independent audit 2%
- Internal audit –18%
- By whistleblowers – 30%
- By pure luck and circumstance – 50%
- Market conditions unravel the fraud (e.g. Madoff ponzi) 2%
- Failure to produce expected ROI on funds 1%

KYC-CDD Standard Setters

- Financial Action Task Force (FATF)
  - 40 Recommendations on Money Laundering and Terrorist Financing
  - Outlines customer due diligence measures for Financial Institutions and Designated Non-Financial Businesses and Persons (DNFBPs)
  - Guidance for Accountants (issued 2008)
- Sector-specific Groups:
  - Basel Committee on Banking Supervision
  - Coined the term ‘Know Your Customer’
  - International Association of Insurance Supervisors (IAIS)
  - International Organization of Securities Commissions (IOSCO)

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Preventive Measures

FATF recommends 3 preventive measures which Designated Non-Financial Businesses and Persons including should take in an effort to combat money laundering the activity :

1. **Deterrence; Customer Due Diligence (CDD)/ Know -Your - Customer (KYC)measur**es
2. Detection; Monitoring and reporting suspicious transaction reporting); and
3. Record-keeping - To facilitate investigations**.**

Customer Due Diligence (CDD)/KYC

What is required:

To identify the customer and verify the identity of the customer

Who is it imposed on:

- Financial institutions that conduct the 13 so listed activities as defined by the FATF:
- Designated Non– Financial Businesses and Professions (DNFBPs)
  - Casinos
  - Lawyers , legal practitioners
  - **Accountants**
  - Real Estate Agents
  - Dealers in precious stones and metals

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Customer Due Diligence (CDD)/KYC

When is CDD required ?

Accountants are required to take customer due diligence CDD measures :

- When establishing a business relationship;
- When carrying out occasional transactions;
- When there is a suspicion of money laundering;
- When there is doubt about the veracity of adequacy of previously obtained customer identification data;

Customer Due Diligence (CDD)/KYC

What is required?

An accountant's customer due diligence procedures procedures should :

- Identify and verify the customers identity.
- Understand the purpose and intended nature of the relationship.
- Identify and verify the identity of the beneficial owner.
  - For legal persons and arrangements this includes understanding ownership and control structure.
  - Conduct ongoing due diligence of the business relationship.

Reliance on Third Parties

Accountants are permitted to rely on third parties to perform elements of CDD measures . (Provided the that certain criteria are met).

- Identification data and other documentation relating to the CDD can be made available from the third party without delay.
- The accountant can satisfy him or herself that the third party is regulated and has measures in place for compliance with CDD and record-keeping requirements.
- When determining in which countries the third party that meets the conditions can be based, accountants should have review the available information regarding the country's level of risk to money laundering country.

Risk Based Approach

- Customers will be classified based on:
  - Type of Business / industry e.g. private banking, correspondent banking, politically exposed persons, Casinos
  - Country of origin e.g. NCCT, Jurisdiction with prevalent bank secrecy laws (whether customer operates or resides in a high risk country).
  - Type of Product /services e.g. wire transfer, Letters of credit, Cash handing, Credit cards
  - Nature of Transactions above the cash reporting threshold
- High risk – All DNFBPs, including accountants are required to perform enhanced due diligence for higher-risk customers, business relationships or transactions..
- Low risk – All DNFBPs, including the accountants, to take lower risk into account in deciding the extent of the CDD measures they will take may thus reduce or simplify. This is only when the level of risk has been assessed.

Politically Exposed Persons (PEPs)

- Politically Exposed Person s (PEPs) are individuals who have been entrusted with prominent public functions in a foreign country (Foreign PEP) or domestically (Domestic PEPs)
  - Heads of State or government
  - Senior Politicians,
  - Senior Government
  - Judiciary and Military
  - Senior executives of state owned corporations
- All DNFPBs including accountants are expected to conduct enhanced customer due diligence measures when dealing with PEPs.
- Enhanced customer due diligence requirements also apply to family members or close associates of PEPs.

Politically Exposed Persons (PEPs)

Enhanced Customer Due Diligence Measures in relation to PEPs include the following measures;

- Establishing appropriate risk management systems to determine whether the customer or beneficial owner is a PEP.
- Obtaining senior management approval for establishing or continuing an existing business relationship.
- Establishing the source of wealth and source of funds.
- Conducting enhanced monitoring of the business relationship.

New Technologies

DNBFPs including accountants should assess the money laundering risks that may arise due to

- Development of new products and business practices including delivery systems
- Consider the CDD measures when employing The use of developing technologies for both new and pre-existing products
  - Mobile Banking
  - E-commerce
  - Agent Banking

Issues to Consider

- Application of the Risk Based Approach to Customer Due Diligence measures risk based approach to AML/CFT measures
  - Kenya is yet to conduct a national risk assessment so as to be able to identify the AML/CFT risks.
  - Reporting instititutions often lack the expertise to conduct institutional/sectoral AML/CFT risk assessments
  - Newly established FRC to issue AML regulations that will expand on CDD measure
- Detailed Know-Your-Customer requirements have been cited as hampering access to financial services
  - Identification of the beneficial owner and taking reasonable measures to verify the beneficial owners
  - Sections of the Kenyan populace do not have some of the prescribed customer identification requirements. i.e. physical address, utility bill.

New Technologies