AML Audit and Correspondent Bank Transaction Monitoring for Diamonds

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Transactional monitoring systems are limited in their effectiveness to identify illegal transaction activity. A weak link in the financial system exposes all banks and financial institutions to this illegal activity. Most recent are charges by Belgian authorities to HSBC for their lack of compliance for the better part of 10 years\(^1\) (1999 to 2011) to have allowed individuals and businesses to dodge taxes, hide cash and transport untraceable money that would include diamonds.

1) **Types of Correspondent Bank Monitoring Systems that May Alert Illegal Transaction (i.e. Diamonds) Activity**

Transaction monitoring systems for the banking industry continue to evolve. Standard vendor models can be customized to screen large populations of activity that include cash, checks and wires. Alerts can be generated when thresholds are broken for analyst review, and simple models create alerts based on set thresholds or a word match from a “watch list.” Advanced models include abnormal transactional activity for the period of which fuzzy character recognition techniques, sequential numbering, and in-depth wire reviews of multiple intermediaries (i.e., bank customer’s customer) provide quality alerts. The ability of transaction monitoring model customization allows an institution to produce quality alerting for review. Institutions also have moved toward fully automated alerting and controls that remove manual overrides of the alert generation or review process.

Correspondent monitoring systems continue to strengthen across the financial industry. However, financial innovation creates more challenges as new products are introduced globally. Electronic banking and new financial products will continue to contribute to transactional volume growth and each present unique challenges for institutions to monitor transaction activity. The ability to monitor effectively will take time to develop, leaving a short-term opportunity for illegal transactional activity not currently monitored by the financial institution.

2) **Enforcement Actions of the Global Diamond Trade**

Past enforcement actions of the global diamond trade has been limited. Organized crime has the ability to utilize precious gems as a substitute for currency. Diamonds in particular are attractive, since historically, they maintain their value and are easy to move across countries virtually without detection. Diamonds are personal property, and do not have to be declared as part of a cross-border currency transaction. They do not have to be subject to confiscation by law enforcement and no currency exchange is required. Diamonds as an alternate currency has more appeal than precious metals (i.e., gold and silver) since they have more price volatility and do not maintain a steady value.

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On April 3, 2014, federal prosecutors announced that while HSBC Holdings has made improvements to its anti-money laundering (AML) system, “much work” remains for the U.K.-based bank as part of its $1.9 billion deferred prosecution agreement with the U.S. Department of Justice. On February 9, 2014, Belgium, center of the world diamond trade, charged HSBC’s Swiss Private Bank with fraud with many dealers under investigation around the world.

3) Correspondent Banks’ Challenges to Monitor Diamonds in the Current Regulatory Environment

a. Account Secrecy

Over the past few years, the financial industry has seen many offshore accounts within tax havens to be uncovered and closed mainly due to the Organization for Economic Co-operation and Development (OECD) tax haven list and the Foreign Account Tax Compliance Act (FATCA).

I. FATCA is the U.S.’ federal law that requires U.S. persons, including individuals living outside the U.S., to report their financial accounts held outside the U.S., and requires foreign financial institutions to report to the Internal Revenue Service (IRS) information about their U.S. clients. FATCA was enacted by Congress to make it more difficult for U.S. taxpayers to conceal assets held in offshore accounts and shell corporations to help recapture federal tax revenues. FATCA is a portion of the 2010 Hiring Incentives to Restore Employment (HIRE).

II. OECD produces a list of countries that are known tax havens. Past identified tax havens have included Antiqua and Barbuda, Belize, Bahamas, British Virgin Islands (BVI), Cayman Islands, Cyprus, Guernsey, Gibraltar, Isle of Man, Jersey, Liechtenstein, Malta, Mauritius, Monaco, Panama, Samoa, San Marino, Seychelles, and Turks and Caicos. Current identified tax havens are Nauru and Niue. The OECD also developed new standards to force tax havens to disclose the names and fortunes of tax dodgers.

Unfortunately, wealthy individuals and businesses still have investment vehicles at their disposal that are not yet transparent and do not have effective oversight. These vehicles include:

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5 “The Wolfsberg Trade Finance Principles, 2011, Pages 3 - 4
I. Hedge funds – This industry continues to grow with the current size of $2.6 trillion across 11,000 funds globally, and enjoy global tax advantages.

II. Structured investment vehicles (SIVs) – SIVs may be set up to eliminate the identification of a politically exposed person (PEP) in the ownership tree of the entities structure, while at the same time tax payments are optimized (i.e., minimized) within the current domicile’s tax structure.

III. Trade finance – Trade Finance principles have been put in place to define standards for the control of AML risks associated with trade finance activities, but risks still remain, especially if both parties are controlled by the same persons. This includes over-invoicing, under-invoicing, multiple-invoicing, short shipping, over shipping, deliberate obfuscation of the type of goods and phantom shipping.

b. Know Your Customer (KYC)
KYC guidelines include a Customer Identification Program (CIP), customer due diligence (CDD) and enhanced due diligence (EDD), to identify AML risk. Institutions should conduct a risk-based approach that includes country risk, customer risk and services risk. EDD may be required for services that include international correspondent banking services, international private banking services and services that involve banknotes and precious metals trading and delivery.

A strong onboarding process and periodic assessments reduces illegal activity at each institution, but the presence of “gatekeepers” such as accountants, lawyers, and wealth management professionals creates the ability to circumvent tax laws legally (i.e., tax loopholes) or by various illegal means. The ability of these gatekeepers to understand client onboarding and transaction monitoring procedures and standards, allows them the knowledge to provide tax optimization services that may include tax evasion and illegal transactions for wealthy clientele.

c. Current Correspondent Banking Monitoring Scenarios
Leading AML transaction monitoring software vendors provide similar types of monitoring functionality with the ability to customize parameter settings for optimal transaction coverage. Scenarios include, high-risk geography, patterns of funds, outliers and rapid movement of funds. Watch list functionality compliments these customized strategies to detect suspicious transactional activity for further investigation.

Transaction monitoring scenarios provide broad coverage to effectively monitor for suspicious transaction activity. Unfortunately, monitoring scenarios will have limited

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6 http://www.cnbc.com/id/101955552, 31 August 2014
7 “FATF’s Best Practices paper on Trade Based Money Laundering”, June 2008
8 “The Wolfsberg Trade Finance Principles, 2011, Pages 3 - 4
9 “Wolfsberg Risk-Based Approach Guidance”, 2006, page 2
results on the wealthiest parties who have financial resources to hire gatekeepers (i.e., lawyers, accountants, wealth advisers) to help navigate legal restrictions and tax codes to optimize wealth by legal or illegal means.

The ability global and investment banks have to trade over-the-counter (OTC) currency and commodities allows clients the opportunity to utilize this OTC infrastructure for a diamond platform to move money globally.

For example, gold has a standard contract trading on the NY COMEX division of the Chicago Mercantile Exchange (CME) futures exchange. The standard size of the gold contract on the futures exchange is 100 ounces. If the current price is $400 per ounce, then the contract value is worth $40,000. Currently, the price of gold is $1,200 per ounce due to gold price volatility. Clients have the option to originally purchase gold in the cash market. An OTC dealer will make a bid/ask quote to the client. Once the client buys/sells the cash gold, they have the ability to move this cash trade to the futures exchange. This can be executed by a swap trade, which would be a cash to forward swap or an exchange for physical (EFP) transaction. This is not important for this paper, but this type of OTC metals pricing (i.e., gold, silver) can also be applied to diamonds within the same OTC structure.

In the OTC market, global gold dealers are trading partners (i.e., counterparties). To create this similar structure, diamond dealers become trading counterparties across the world and can agree to a standardized contract size (i.e., $40,000). This dollar amount is also important since it is a smaller U.S. dollar contract amount and stays away from a large transaction size for monitoring. Contracts among dealers can be settle by the diamond delivery equivalent of $40,000.

Unlike a standardized metal’s contract (i.e., gold equal to 100 ounces), the diamond OTC contract can be set at $40,000. Diamonds have a history of holding a more stable value than other metals in the past, especially due to the past monopoly of DeBeers. This monopoly provided an excellent control to minimize price fluctuations and risk. The long standing and effective control over the supply of diamonds in the market place (supply curve) allowed the ability to avoid price volatility that would occur in a normal supply and demand (i.e., gold) marketplace.

OTC dealers can charge a commission on the wire transaction movement among the diamond dealers. Commissions can be charged on the percentage of the contract size. To buy the $40,000 OTC diamond contract, the dealer would charge a 2 percent fee for this service ($40,000 * 2 percent = $800 fee. $40,000 - $800 (fee)= $39,200). To sell diamonds, the customer would pay, 40,800 ($40,000 * 2 percent= $800 fee).

The OTC structure, among global diamond dealers, banks and clients, have many benefits:

- Wire transfers across countries will avoid cash monitoring.
A standard contract size (i.e., approximate increments of $40,000) makes it easy for diamond dealers to settle out with clients (i.e., physical delivery of diamonds).

OTC dealers will make a commission on the wire transfers for the clients.

The OTC commissions, which can vary slightly can be of different amounts (i.e., 1 percent, 1.8 percent, 2 percent) to avoid monitoring of consecutive currency amounts.

A wire can be structured to only move across three high-risk geographies (HRG), thus avoiding a monitoring scenario of four plus HRGs. If banks have scenarios have review for HRG with four or more, two wires can be set up for a minimal fee to avoid monitoring. The gatekeeper provides an invaluable service by providing scenario specifics at the global banks.

Creating a broad network among diamond dealers and global banks creates a steady flow of money among clients. This will avoid a high percentage of wire transactions among specific entities (i.e. entity-based monitoring scenarios).

Wires will avoid check scenario alerting, such as consecutive checks and sequential checks.

Wires among diamond dealers will be much smaller than wire size typical among correspondent banking clients. This will allow this transaction activity to continue unnoticed by monitoring activities.

Gatekeepers that have knowledge of transaction monitoring scenarios at the global banks and the OTC structure for wire transactions of diamond contracts (i.e., diamond), allow clients to effectively move currency globally with low commissions and with little tax implications.

4) **AML internal audit roles include:**

I. **AML Technology Implementation**

Audit reviews the design process to select scenarios and threshold settings for implementation and verify the operating effectiveness of alert generation.

II. **Data Integrity Verification**

Audit reviews and tests implemented IT process controls. End-to-end data reconciliation processes to ensure that data source transactions reconcile to monitoring systems and ultimately analyst screens. Develop an effective reconciliation utility with proper configuration, sourcing and standardization, monitoring and event identification, and exception reporting and response.¹¹

III. **Tuning Activities**

Internal audit will review the process of model development, testing, verification and implementation, to ensure that activities are in accordance with institution policy and procedures.

¹¹ PWC, "From Source to Surveillance: the hidden risk in AML monitoring system optimization", September 2010
IV. Model Validation
Model validation includes independent testing of the scenarios in place. Internal audit’s review of this model validation process confirms that the independent testing was comprehensive and complete.

V. Confirm System and Business Reliability
Audit reviews business continuity plans (BCPs) to confirm that they are inclusive, up-to-date and updated regularly. Audit also reviews the disaster recovery (DR) plan to verify evidence for a risk-based recovery and the allocation of resources from short-term and long-term disruptions.

5) OCC Model Risk Management

In general, OCC Model Guidance covers four primary areas:  

I) Pre-model validation is the assessment of model types to be constructed for a specific application. Factors that would affect the ability to correctly model the event of interest. This will include complete and accurate data, and the expertise and experience of the modeling team.

II) Model build validation demonstrates how the model actually fits the data and the proficiency to provide correct estimates. Validation of each model should be conducted with common industry-wide tests of model fit and complimented with additional internally developed model fit tests.

III) Ongoing model validation ensures that model parameter settings continue to generate quality alerts. New financial products and electronic banking growth will require additional monitoring. Also, global growth of the institution may require tuning to maintain the accuracy of the models.

IV) Model governance framework must be set up and documented to outline the intent of the model, the scope of the model and limitations of the model, the responsible party building, testing and validating the model. In addition, institutions need to manage regulatory challenges, tuning methodology and know-how, liaising with multiple parties, achieving global consistency, managing the alert investigation team and measure success/effectiveness.

6) AML internal audit roles that can enhance correspondent banking transaction monitoring of diamonds in a number of ways:

I. AML Technology Implementation
Management information (MI) reporting implementation provides institutions with the customization needed for enhanced monitoring required for increased

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12 April 4, 201q – OCC Supervisory Guidance on Model / Risk Management
effectiveness. Standard automated model scenarios are best practice within the financial industry and the institutions’ customized parameter settings to the business model. It is no surprise that extremely wealthy clients who choose to hide money will be advised how to avoid alerting of suspicious transactions due to standard transaction monitoring models. MI reporting is a customized tool to complement the automated strategies. Reports are not public information outside of the financial investigations unit (FIU) group. This gives the institution an advantage for transaction monitoring detection.

Transaction monitoring best practices of cash and checks are widely known, and can be adjusted to stay below best practice scenarios. Wire activity, especially international wires, remains the most challenging payment method to monitor across global borders and can be effectively monitored with advanced MI reporting.

Effective reporting includes:

a. Party pair reports
b. Party reports
c. Many to one reports

Alerts resulting from automated and manual transactional monitoring along with MI reporting are primarily dependent on quality data. Global controls must be in place to minimize and prevent wire stripping.\textsuperscript{15} Comprehensive data reconciliations from payment source systems to analyst monitoring screen (back to front) are equally important. Comprehensive reconciliation is not simply data counts at each control point, but includes additional reconciliations such as currency totals and the completeness of dates in the date fields.

II. Tuning Activities

Diamond dealers have the ability to create standardized diamond contracts to wire money globally. Party pair reports give the user the ability to detect incremental currency amounts transmitted by diamond dealers. For example, each diamond dealer can be reviewed for dollar amounts of $40,000. This would be a currency alternative. Increments would be in 40,000 (1x), 80,000(2x), and 120,000(3x). If the dealer moves currency in, they can avoid large dollar amounts for transaction monitoring and alerting.

Commissions of set dollar amounts can also be subtracted/added directly from wire transfers. A 2 percent fee ($800) can be applied to the $40,000 standard diamond contract for a net wire fee of $39,200 or $40,800. Different commission

\textsuperscript{15} Jason Wingo & Julien Chanier, “Wire Stripping: managing compliance risk ability to monitor and prevent wire stripping, September 2013.
rates per client will avoid round dollar amounts and reduce the patterns of the wires such as structuring. Note that each standard wire to foreign jurisdiction can be settled by the delivery of actual diamonds.

Reports can be modified to review diamond dealer transactions that avoid normal automated scenarios. A pattern of approximate multiple $40,000 transactions will present the appearance of the alternate global currency (diamonds), with the ability to distribute money globally with physical (diamond) settlement while avoiding automated monitoring detection.

III. Model Validation

Customized MI reports complement automated transactional monitoring, new CIP and KYC activities. A validated global platform allows the FIU to conduct in-depth customized MI reporting that targets diamond dealers’ transactional activity. MI reporting can complement automated scenarios required in the industry and allow a higher level of analysis to detect illegal diamond transaction activity. In addition, advanced MI reporting stays within the FIU of the respective institution, unlike standard automated industry strategies.

KYC and automated transaction monitoring are limited in their effectiveness in the diamond trade. Many transactional monitoring platforms at institutions are not dynamic to quickly address global events. One may assume that the wealthiest individuals who choose to hide assets and/or conduct illegal transactional activity have ample resources to effectively evade standard automated monitoring scenarios.

The use of MI based reports give the FIU team members the ability to provide advanced reviews of illegal diamond transaction activity. These reports allow the ability to analyze transaction trends, names of people, names of businesses, and names of countries.

The ability of quality MI report reviews presents the FIU with important information to conduct an in-depth investigation, create a manual alert and escalate the alert for a potential suspicious activity report (SAR) filing, along with potential account restrictions or closure. This dynamic review of transactions will complement the normal automated alert review. As a result, new automated scenarios can be created and alerts generated, based on consistent patterns identified that lead to better transaction monitoring.

7) Conclusion

The combination of gatekeepers with knowledge of transaction monitoring scenarios at the global banks, wire transactions for OTC diamond contracts and global diamond dealers, continue to allow people to effectively move currency globally with low commissions and little tax implications. Automated transaction monitoring controls are important to detect improper activity, but institutions must enhance monitoring with customized report reviews to counter the efforts of global tax avoidance.