

How to Audit Controls to Manage Financial Crime Compliance (FCC) Risks Associated with Politically Exposed Persons



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1.0 Executive Summary

While risks associated with politically exposed persons (PEPs) are important to mitigate across all financial institutions, this paper will focus on auditing the financial crime compliance (FCC) risks associated with foreign PEPs in large U.S. financial institutions. Whether your financial institution has already defined a process and implemented controls for PEP customers or your financial institution is one that is looking to strengthen their anti-money laundering (AML) program by establishing processes for identifying and managing the risk of PEPs, it is vital to your AML program to ensure the appropriate controls are in place to deter, detect and report suspicious activity inherently associated with these customers. Internal audit plays an important role as the third line of defense in testing and evaluating the Bank Secrecy Act/anti-money laundering (BSA/AML) controls currently in place as well as identify gaps in controls not in place. This paper aims to provide solutions to internal auditors who audit controls to manage the financial crime and counter terrorism risks associated with PEPs.

1.1 Background

In the last five years, increased regulatory scrutiny has been evident by decisions made by financial institutions to de-risk their portfolio of customer types or products offered. In one such trend, is the de-risking of PEP relationships whereby big banks are terminating relationships with PEPs and by extension also closing business relationships where PEPs are the beneficial owner, controller or even an authorized signer of the relationship. In some instances this has also included terminating Embassy, Mission and Consulate (EMC) accounts. Many banks cite the reasons for terminating accounts for PEPs are due to the increased resources and compliance costs associated with maintaining these relationships. As such, these costs can outweigh the return on earnings and may arguably may banking PEPs unprofitable to the bank. Since the risks of potential fines by federal regulators—not to mention the reputational risks—opens the door to considerable exposure, which financial institutions (particularly large financial institutions) are looking to avoid or limit exposure, they de-risk their portfolio by exiting these relationships. The thought is, if a bank does not onboard or maintain accounts for PEPs, the regulatory, reputational and financial risks from this customer type goes down considerably.

Depending on your organization, you may refer to these types of customer by various names or acronyms. Generally the term ‘PEP’ is synonymous with the terms, foreign government official, senior foreign political figure, senior official and senior executive. Traditionally, this is someone who has substantive control, authority or influence over government policy, operations or resources.

Because of this, PEPs are considered a high-risk customer type. While this is not an exhaustive list, the most common risk factors associated with PEP customers include the following:

- Corruption
- Theft
- Embezzlement
- Money Laundering
- Bribery
- Terrorist Financing
- Adverse media causing reputation risks
- Misappropriation
- Extortion

2.0 What is a foreign PEP?

The 2014 Federal Financial Institution Examination Council (FFIEC) BSA/AML Examination Manual defines a PEP¹ to include any one of the following:

- A current or former:
 - Senior official in the executive, legislative, administrative, military, or judicial branches of a foreign government (whether elected or not)
 - Senior official of a major foreign political party
 - Senior executive of a foreign-government-owned commercial enterprise
- A corporation, business, or other entity that has been formed by, or for the benefit of, any such individual.
- An immediate family member (including spouses, parents, siblings, children, and a spouse's parents and siblings) of any such individual.
- A person who is widely and publicly known (or is actually known by the relevant bank) to be a close associate of such individual.

Although the FFIEC definition is widely used, financial institutions should tailor the definition to the financial institution's risk profile.

It is important to not just go by an individual's title when trying to determine if the diplomat meets your institutions definition of a PEP. Diplomatic positions and titles of those positions vary from country to country. The responsibilities and authority of one diplomatic may not be the same of a similarly titled diplomat in another country. When it is not readily apparent that the customer is a senior member of their government, it is a good practice to obtain information from the customer about what their job entails and what their responsibilities are in order to make an informed decision as to whether the diplomat meets your financial institutions definition of a PEP. Bank employees become uncomfortable calling PEPs to ask questions related to the nature of their role or ask questions about observed activity in their accounts. Failure to reach out to the PEP for clarity may result in the financial institution not having a complete picture of who their customer is.

¹ (FFIEC) Bank Secrecy Act/Anti-Money Laundering (BSA/AML) Examination Manual
https://www.ffiec.gov/bsa_aml_infobase/pages_manual/manual_online.htm

3.0 Case Examples

Financial institutions in the U.S. and overseas have come under regulatory scrutiny for the lapses in their AML programs:

- 1) In the Office of the Controller of the Currency's (OCC) 2010 cease and desist order against HSBC Bank USA N.A.,² the OCC cited the bank with "inadequate collection and analysis of CDD information, including inadequate monitoring of PEPs." HSBC did not "appropriately [designate] customers as 'high-risk' for purposes of BSA/AML monitoring, even where a customer's association with politically-exposed persons (PEPs) could harm the Bank's reputation."
- 2) In January 2014, Financial Conduct Authority (FCA) fined Standard Chartered Bank PLC £7,640,400³ for deficiencies related to its AML program over corporate customers connections to PEPs. From December 2007 through July 2011, Standard Chartered Bank PLC failed to "carry out adequate EDD measures before establishing business relationships with corporate customers that had connections with PEPs and conduct the appropriate level of ongoing monitoring for existing business relationships by keeping customer due diligence up to date."

Refusing a business relationship with a PEP simply based on the determination that the client is a PEP is contrary to the letter and spirit of FATF Recommendation 12,⁴ but rather to address risks associated with PEPs, financial institutions implement measures to prevent the misuse of the financial system by PEPs, and to detect such potential abuse if and when it occurs.

In September 2014, the OCC finalized a set of 'Heightened Expectations'⁵ "to enhance our supervision and strengthen the governance and risk management practices of large national banks." The guidance expects banks to "establish and implement a Framework for managing and controlling the bank's risk taking."

But just because a particular customer may be considered high risk does not mean that it is "unbankable" and it certainly does not make an entire category of customers unbankable. Banks and other financial institutions have the ability to manage high-risk customer relationships.

Jennifer Shasky Calvery
Director, FinCEN

² OCC Issues Cease and Desist Order Against HSBC Bank USA, NA <http://www.occ.gov/news-issuances/news-releases/2010/nr-occ-2010-121a.pdf>

³ Standard Bank PLC fined £7.6m for failures in its anti-money laundering controls <http://www.fca.org.uk/news/standard-bank-plc-fined-for-failures-in-its-antimoney-laundering-controls>

⁴ FATF PEP Recommendations 12 & 22 <http://www.fatf-gafi.org/media/fatf/documents/recommendations/guidance-pep-rec12-22.pdf>

⁵ Heightened Expectations <http://www.occ.gov/news-issuances/news-releases/2014/nr-occ-2014-117a.pdf>

4.0 PEP Identification

The identification of PEPs is a critical component to any bank's AML program. If a financial institution fails to identify prospective customers as PEPs, the institution may not deploy the appropriate controls to monitor those accounts. The account opening or onboarding process is the most effective time to obtain the required due diligence information needed to open and maintain an account for a PEP. Due to the nature of their duties, PEPs often travel or may not be stationed in the U.S. If the required identification documentation and due diligence information is not obtained at account opening or prior to the account being made available for use, a financial institution may have a challenging time obtaining this information in a timely manner. Even if your financial institution employs third-party screening to aid in the PEP identification process, vendor databases do not contain an all-inclusive listing of every PEP and should not be solely relied upon.

5.0 PEPs as Ultimate Beneficial Owners

PEPs trying to obscure their identity will often go through financial service providers such as lawyers, accountants and escrow agents to act on their behalf and establish accounts using trusts or other legal entities. In some cases, complicated corporate structures are established to provide anonymity to the PEP and allow them to transact undetected.

PEPs also may ask family, friends and associates to open banking relationships, but the true beneficiary is the PEP. In this sense, the PEP instructs the individual to carry out transactions on his/her behalf. To a lesser extent there are instances where the individual opens the account then hands over the account information to the PEP and the PEP is the one actually carrying out the transactions.

6.0 Traditional Audit Approach

A traditional audit approach would examine the financial institution's compliance with their documented policies and procedures, which could result in missing gaps in key controls. All too easily testing can become a check the box exercise without evaluating the know your customer/enhanced due diligence (KYC/EDD) information on file as well as comparing that information to the PEPs transaction activity. As a result, anomalies may go undetected.

Traditional testing typically consists of obtaining a listing of PEP customers to determine if the required KYC is on file and periodic reviews are being performed in accordance with the financial institution's periodic review schedule. In the past, internal auditors did not have the AML knowledge to understand who PEPs are, the types of financial and reputational risks they present as well as behavior and transaction red flags. What is usually missed is the internal auditor's analysis over KYC/EDD information

on file together with potential negative media that may not be vetted on the customer, transactional activity that may not have been captured as a part of a periodic review, and activity that is explained away without obtaining sufficient information to collaborate the reasoning for the observed transactions.

In today's FCC landscape, a traditional audit approach is no longer adequate in ensuring key controls are in place to manage high-risk customer types like PEPs. Financial institutions are expected to have members of their internal auditor staff with AML expertise who can develop testing that consider inherent FCC and reputational risks presented by an institutions' PEP population, then assess whether those controls are properly designed, implemented and working effectively.

7.0 Advanced Audit Approach

7.1 Audit Testing on PEP Identification

7.1.1 Identification Documents

At account opening/onboarding, government identification used to open an account from may indicate on the ID that the customer or prospective customer is a PEP. PEPs that have diplomatic duties in the U.S. or outside their home country are issued diplomatic passports if one is in circulation by their home country.

Even if a country, does not have a diplomatic passport, PEPs who are stationed in the U.S. or are coming to the U.S. for official duties need to obtain A-1 or A-2 visa prior to coming to the U.S. The diagram below depicts which visa is required depending on the PEPs political position.

Diplomats and Officials Requiring A-1 Visas - Examples: —	Officials and Employees Requiring A-2 Visas – Examples: —
<ul style="list-style-type: none">▪ Head of State or Government, regardless of the purpose of travel▪ Official coming to serve at a foreign embassy or consulate in the United States, such as an ambassador or consul▪ Government minister or cabinet member coming for official activities▪ European Union (EU) and African Union (AU) delegation representatives▪ Immediate family members of an A-1 visa holder	<ul style="list-style-type: none">▪ Full-time employee assigned by that government, coming only to work at a foreign embassy or consulate in the United States, to perform duties which take place at an embassy▪ Government official representing your government, coming to the United States based on written request of your country to perform official, government related duties▪ Foreign military members stationed at a U.S. military base or assigned to a foreign embassy or consulate in the United States▪ Staff of European (EU) and African Union (AU) delegation representatives▪ Immediate family members of an A-2 visa holder

⁶Source: U.S. Department of State

Within the passport itself or within the attached visa, additional information may also be contained such as the bearer's diplomatic title and employer name. Passports may also contain the names of family members accompanying the PEP. The passports/visas of immediate family members generally also

⁶ U.S. Department of State <http://travel.state.gov/content/visas/english/other/diplomat-foreign-government-official.html>

contain information that identifies them as a PEP. For example, a visa may state the bearer is the wife of the Ambassador to Chile to the United Nations along with the Ambassador's full name.

By taking a sample of nonresident alien (NRA) accounts opened, internal audit can test whether identification taken at account opening indicated the individual holds a diplomatic title or is an immediate family member of an individual who holds diplomatic title. These individuals should have been identified by first line staff and reviewed to determine if they meet the financial institution's definition of a PEP.

7.1.2 Customer Screening

Many large financial institutions employ third-party vendors (e.g., Dow Jones, RDC and World-Check) to conduct ongoing PEP screening against their customer base to alert them to potential PEP matches. These potential matches are reviewed to determine if:

- The individual is a match to your customer, and
- The political positions listed past/present and if the authority the individual holds in those positions meets your financial institution's definition of a PEP.

By taking a sample of the alerts that were cleared—therefore deeming the customer to either not be a match or not meet the institution's definition of a PEP—internal audit can evaluate whether the correct decisions are being made and customers ultimately deemed to not be a PEP are in fact not a PEP by the institution's definitional standards.

7.1.3 Geographic Locations

Certain geographic areas within the U.S. may have an increased concentration of PEPs working and/or living within an area. Financial institutions close to these geographic areas where there is access to branches or locations where first line staff open accounts, may have an increased likelihood that a PEP customer will come into their institution to establish an account. Generally, this may include financial institutions with locations in a geographic area where there is the presence of an international governmental organization, a country's diplomatic representation, U.S. military bases, or areas where PEPs and their families are widely known to reside. Within the context of the U.S., examples of the aforementioned organizations include:

- United Nations (U.N.) – Located in New York City, PEPs will often visit the U.N. for official business and meetings. During this time, PEPs may establish a U.S. banking relationship. The peak season to observe an influx of new PEP banking relationships runs from mid-August through mid-October. This is due to diplomats arriving in New York in August and September in preparation for the United Nations General Assembly (UNGA), which typically spans two weeks during September.
- Embassies – Located in Washington, D.C., PEPs stationed at their home country's embassy will need to establish a U.S. banking relationship for their daily living needs and local expenses. In addition to Washington, D.C., surrounding areas in Virginia and Maryland are

commonly known areas where these PEPs reside, therefore, accounts may also be established at institutions close to their residence.

- Missions to the U.N. – Located in New York City, PEPs stationed at their home country’s Permanent Mission to the U.N. will need to establish a U.S. banking relationship for their daily living needs and local expenses. While it is most common for PEPs to reside in New York City, particularly in midtown east and Randall’s Island, it would not be uncommon for PEPs to reside in other downstate areas of New York including Westchester County and lower Connecticut.
- Consulates – Located throughout the U.S., PEPs stationed at their home country’s consulate will need to establish a U.S. banking relationship for their daily living needs and local expenses. Specific research should be conducted to understand if your institution’s branches are located near a foreign consulate.
- Military bases – Various domestic military bases (e.g., Wright-Patterson Air Force Base near Dayton Ohio) are located throughout the U.S. Senior foreign military personnel may come on assignment for an extended period of time for training, generally ranging from a few months to a couple of years. Specific research should be conducted to understand if your institution’s branches are located near a military base that provides education and training to members of a foreign military.

By understanding your financial institution’s geographic footprint, internal audit can sample new accounts established in branches that may have a higher probability of opening PEP relationships. This will enable internal audit to evaluate the institution’s ability to correctly identify and document PEPs.

7.1.4 Periodic Review

During the course of the relationship, existing PEPs may open additional accounts with new signers or add new signers to existing accounts. Generally, all signers on a personal account held jointly with a PEP may meet your financial institutions definition of a PEP. Depending on your financial institution’s risk-based approach, business/commercial relationships may need further review to determine if any of the signers meet the institution’s definition of a PEP and therefore be subject to the same EDD requirements.

At the time of the periodic review determine if all customers who sign on the relationship have been reviewed in accordance with your institution’s definition of a PEP. For example, it is common for existing PEPs to open new accounts with their children or add a spouse to an existing account. Also, since PEPs travel often, they may appoint a power of attorney (POA) on their account to act on their behalf. When reviewing a customer’s profile, it may not always be apparent that there is a POA on the relationship. A review of the signature card would indicate if there’s a POA on the relationship.

7.1.5 Keyword Searches

Some financial institution’s second line of defense conduct keyword searches as a control gap to capture potential PEPs not identified by vendor screening or other PEP identification processes either at account opening or during the lifecycle of the customer.

Whether or not the financial institution’s second line of defense conducts keywords searches, internal audit can perform a keyword search to determine the effectiveness of the financial institution’s existing PEP identification processes. Keyword searches can be performed on a variety of fields depending on your institution’s source systems data fields. With that said, the following are examples of data fields that may be the most commonly searched for keywords:

- Address
- Employer
- Occupation

While this is not an exhaustive list, below is an example of keywords search terms:

Keyword Search Examples			
Ambassador	Diplomat	Minister	Queen
Cabinet Member	Embassy	Ministry	Royal Family
Congress	Government	Mission	Senate
Consul General	Governor	Parliament	Senator
Consulate	King	Prince	State
Delegate	Mayor	Princess	Supreme Court

*Keep in mind the foreign language equivalents when preparing your list of terms.

8.0 Audit Testing for Refresh of KYC

8.1 Periodic Reviews

Financial institutions are required to periodically refresh KYC information on PEPs. While KYC information can be updated at any time, the periodic review process (also known by some institutions as renewals, relationship reviews or recertifications) allows the analyst to take a holistic review over the relationship. Internal audit should select a sample of completed periodic reviews over a specified time period (e.g., last 12 months).

In order to evaluate whether due diligence information is on file and up-to-date, internal audit should at a minimum take a multifaceted approach.

1. Independently conduct Internet research on the PEP to determine if there have been any changes in the PEP’s political position or any other information that may affect the status of the

KYC information on file. Additionally, if vendor software (examples mentioned previously) is an available resource at your financial institution, internal audit should check to see if the PEP was re-screened which may also reveal changes in the PEP's political position. Also the aforementioned search methods are useful when reviewing publicly available media to determine if there is any credible negative media on the PEP that should have been identified during the periodic review.

2. A review of the PEP's underlining transactional activity should be conducted not only to determine if anticipated activity is in line with actual activity, but to also determine if there has been a change in the PEP's circumstances. For example, if the PEP's last known position was as the Ambassador to the Embassy of Argentina in the U.S. and activity previously observed revealed direct deposit credits from the Embassy for payroll and normal living expenses around the D.C. area, then during the periodic review, the activity observed reveals this activity has ceased and new activity observed consists of incoming wires received from the Ministry of Argentina and no local expenses; this would be an indication that the PEP's term in the U.S. has ended, therefore, the KYC information requires updating. The analyst should be reviewing the activity to determine if it is reasonable and expected for the customer compared to the KYC information.
3. Since not all PEPs present the same level of risk, financial institutions have the ability to take a risk-based approach when risk rating their PEP customers. This risk will vary depending on numerous factors, including the PEP's geographic location, industry, or sector, position, and level or nature of influence or authority. Risk may also vary depending on factors such as the purpose of the account, the actual or anticipated activity, products and services used, and size or complexity of the account relationship.⁷ If your institution takes a risk-based approach when risk rating PEP customers, determine if the risk rating is still appropriate for the relationship. This should be a factor when conducting your testing.

9.0 Audit Testing for Transaction Monitoring

Ongoing risk-based transaction monitoring of a PEP accounts is critical to ensuring that the accounts are being used as expected.⁸ Internal audit should obtain a listing of the institution's PEP population and confirm PEP customers are appropriately flagged for specialized monitoring. If a PEP is not flagged appropriately, transactions that may need to be reviewed can go undetected.

Internal audit should take a sample of alerts generated on PEP customers. A common audit approach entails taking two samples from the alert population, thereby having one sample of PEP alerts that resulted in a SAR decision and one sample of alerts that did not result in a SAR. The two samples ensures internal audit they have chosen an adequate sample of alerts to review. The investigations should be

⁷ FFIEC BSA/AML Manual http://www.ffiec.gov/bsa_aml_infobase/documents/BSA_AML_Man_2014.pdf

⁸ FFIEC BSA/AML Manual http://www.ffiec.gov/bsa_aml_infobase/documents/BSA_AML_Man_2014.pdf

reviewed to at a minimum determine if the investigator took the appropriate actions, the financial institution still knows who their customer is, the narrative makes sense the specific PEP customer compared to the observed activity.

10.0 Audit Testing for Reputation Risks

PEPs inherently pose a reputational risk to a financial institution by the nature and prominence of their roles. If material negative media is uncovered on the institution's PEP customer, it can open the financial institution to criticisms and possibly financial crime risk depending on the nature of the media. Internal audit should conduct ongoing continuous monitoring and conduct periodic testing over negative media events against the PEP population. By doing this type of testing, internal audit can evaluate whether the second line of defense has the appropriate controls in place to alert them of negative media events.

11.0 How long is a PEP considered a PEP?

The adage many major large financial institutions take is: "Once a PEP, always a PEP." With that said, in the last couple of years there appears to be somewhat more flexibility with that statement. According to FATF Recommendation 12,⁹ "the handling of a client who is no longer entrusted with a prominent public function should be based on an assessment of risk and not on prescribed time limits." It is not a regulatory requirement to tag a customer as, "Once a PEP, always a PEP," however, the main reason most banks adopt this principal is because once a PEP leaves office, arguably they still have a lot of the same connections they had while in office and still present a risk to the financial institution. It is also quite normal for a PEP to not have their next post—whether elected or appointed—lined up once they leave their current office. In some instances a period of time may pass before they run for office or are nominated/appointed (granted sometimes unsuccessful in their pursuit) to another senior position. This also includes PEPs who have retired but then a few years later re-enter politics (think of professional athletes—they retire then they return to continue playing). Due to these reasons, financial institutions find it challenging and risky to downgrade their PEP status. Financial institutions do not have the controls or resources to constantly check if PEPs who have left office have truly left office and be timely informed if they re-enter politics.

⁹ FATF PEP Recommendations 12 & 22

<http://www.fatf-gafi.org/media/fatf/documents/recommendations/guidance-pep-rec12-22.pdf>

12.0 Conclusion

Weaknesses in a financial institution's AML program can have an adverse effect on the overall consumer perceptions of the bank by bringing in to question safety and soundness concerns. These weakness can have a negative impact on an institutions credit rating.¹⁰ In 2012, after the Senate Permanent Subcommittee on Investigations (PSI) published its report on HSBC, Standard & Poor downgraded their outlook on the bank from stable to negative due to the AML lapses that were cited.

PEPs are going to continue to open U.S. banking relationships and may be using products or services from your institution whether directly or indirectly banking with the institution. Even from a de-risking approach, financial institutions are still going to need to use monetary and human capital resources to identify potential PEPs and implement mitigating controls. Instead of de-risking higher risk customer types, a strong AML program across the three lines of defense is the best way to fend off potential abuses of financial resources and criticisms by our U.S. regulators.

¹⁰ The AML Challenges Just Keep Coming by John Atkinson – December 2012
<http://www.aba.com/Products/bankcompliance/Documents/Nov-Dec12coverstory.pdf>

13.0 Resources

1. FATF PEP Recommendations 12 & 22
<http://www.fatf-gafi.org/media/fatf/documents/recommendations/guidance-pep-rec12-22.pdf>
2. U.S. Department of State
<http://travel.state.gov/content/visas/english/other/diplomat-foreign-government-official.html>
3. Heightened Expectations
<http://www.occ.gov/news-issuances/news-releases/2014/nr-occ-2014-117a.pdf>
4. 2014 Federal Financial Institution Examination Council (FFIEC) Bank Secrecy Act/Anti-Money Laundering (BSA/AML) Examination Manual
http://www.ffiec.gov/bsa_aml_infobase/documents/BSA_AML_Man_2014.pdf
5. The AML Challenges Just Keep Coming by John Atkinson – December 2012
<http://www.aba.com/Products/bankcompliance/Documents/Nov-Dec12coverstory.pdf>
6. OCC Issues Cease and Desist Order Against HSBC Bank USA, NA <http://www.occ.gov/news-issuances/news-releases/2010/nr-occ-2010-121a.pdf>
7. Standard Bank PLC fined £7.6m for failures in its anti-money laundering controls
<http://www.fca.org.uk/news/standard-bank-plc-fined-for-failures-in-its-antimoney-laundering-controls>