

THE ASSESSMENT OF ANTI MONEY LAUNDERING (AML) ACTIVITIES WITH SPECIAL REFERENCE TO THE HSBC BANK AND AML INVESTIGATION CONDUCTED BY THE USA: A BRIEF REVIEW.

V. P. NEDUNCHEZHIAN AND A. KALYANI

Associate Professor
Research Scholar

Department of Defence and Strategic Studies and Research Centre Guru Nanak College, Chennai.

Abstract:

Post 9/11 terrorist attacks on World Trade Centre, the US Government and its agencies took a series of diversified efforts to combat terrorism. In this process, special attention has been provided to money laundering and terror financing. In response to it, the vulnerabilities of money laundering was exposed by the 9/11 terrorist attack and a stronger anti money laundering (AML) laws were included in the Patriot Act of 2002.

KEYWORDS:

Anti Money Laundering , AML Investigation , combat terrorism , strengthened.

INTRODUCTION

As a result of these tougher laws, over the past ten years, U.S. banks substantially strengthened their AML controls. At the same time, the money laundering risks associated with correspondent banking (CB) have not fully been eliminated.

To examine the current money laundering and terrorist financing threats associated with correspondent banking, Permanent Subcommittee on Investigations (PSOI) selected HSBC Bank USA (HBUS) as a case study. It has to be noted here is that this investigation took a fresh look - post introduction of sturdy AML laws.

The PSOI made its HBUS case study investigation report globally available on 17th July 2012. The above report examines the vulnerabilities created by a correspondent bank and also offers recommendations to strengthen correspondent AML controls to combat money laundering, drug trafficking, and terrorist financing.

HSBC the parent company of HBUS also agreed to pay \$1.9billion as penalties in a settlement over money laundering failures

1.Aim of this Paper

This paper aims to find out the key points/strategies/ideas/regulatory mechanisms from the Report of PSOI that may be of use to control money laundering and terrorist financing in other countries like India.

2.Link between Money Laundering, Correspondent Banking, Terror Financing

3. 1.Money Laundering

The goal of a large number of criminal acts is to generate money. Money laundering is the processing of these criminal proceeds to disguise their illegal origin. This process is of critical importance, as it enables the criminals to enjoy these profits without jeopardising their source. In short money laundering is legitimising or legalising the ill-gotten money. This is done by disguising the sources, changing the form, or moving the funds to a place where they are less likely to attract attention and so on.

Please cite this Article as : V. P. NEDUNCHEZHIAN AND A. KALYANI , THE ASSESSMENT OF ANTI MONEY LAUNDERING (AML) ACTIVITIES WITH SPECIAL REFERENCE TO THE HSBC BANK AND AML INVESTIGATION CONDUCTED BY THE USA: A BRIEF REVIEW. : Tactful Management Research Journal (Sept ; 2013)

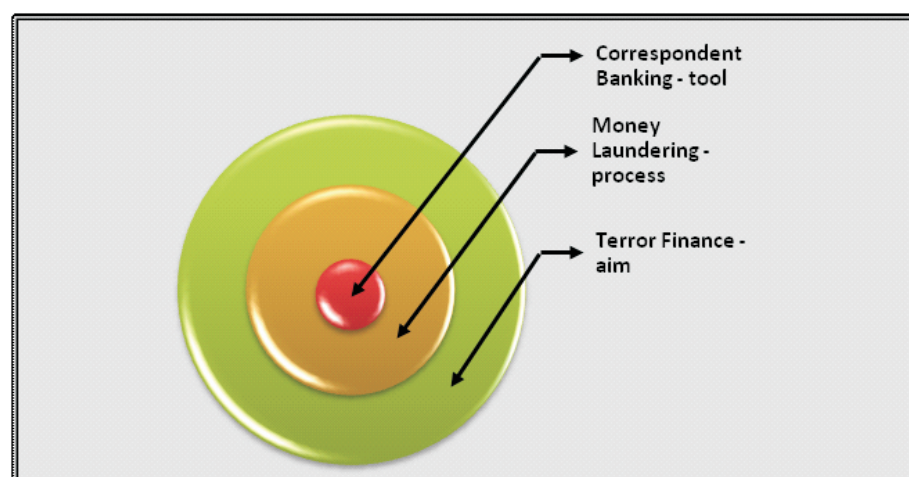
3.2.Terror Financing

Terror Financing is a process by which terror groups raise funds for their terror and related activities. It is to be remembered that the activity can be legal as it is very much complying with the laws of the country, but the funds can be used for terror activities. This point makes the terror finance a complex one.

3.3.Correspondent Banking

As earlier mentioned, correspondent is an agreement between two banking entities to provide certain facilities like clearance, money transfer etc. Globally terror groups extensively use money laundering to transfer funds and also to change the identity (illegal to legal) of funds. Through the layers of shell entities, multiple account transfers, cross border movements, involvement of numerous currencies, money laundering for terror activities is carried out. The facility of correspondent banking provides one more layer to this complex relationship. In other words, the aim of terror financing is met through the process of money laundering by using correspondent banking as a tool. This point is explained in the subsequent diagram.

Figure Relationship between Money Laundering, Correspondent Banking & Terror Financing



1.Need to Focus on Money Laundering and Terror Financing

Any anti-terror strategy is incomplete without concentrating on terror financing. In reality very limited attention is provided to terror financing. The war on terrorism can move to new dimension with increased activities to reduce if not stop the flow of funds to terror groups.

For a county like India which is facing terrorist and related problems for a very long time, it is high time to take concrete steps in terror financing. By restricting the money laundering activities, flow of funds to terror activities can be disturbed to a great extent.

Not only for terror activities, as previously mentioned, money laundering is also used for the funds generated through illegal and criminal activities. The check on money laundering may have its impact on both illegal and criminal activities taking place in the country. Thus focusing on money laundering is beneficial for the society, economy and country as a whole. As correspondent banking is a widely used tool for money laundering, any recommendations for AML focus on CB also.

2.Key Learning

The key learning to India from the report of PSOI is listed out as follows. Some of them can be related to regulators, few can be to do with the legal system etc. The entire learning is listed out initially and in the end they are classified based on the area of application. It has to be remembered that fighting against terrorism is an overall activity with participation from multiple agencies/bodies/departments of the government. Even though CB is mostly related to financial services and banking domain, an overall approach to terror finance will provide improved results.

1.AML Deficiencies will expose the Country

Any AML deficiency however small it is and even if it has occurred only once, it will expose the country to money laundering, drug trafficking, and terrorist financing risks. This is the most important

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learning for India. This point focuses on importance of AML programme.

2.Don't take the institutions for Granted

The reputation and public image of institutions in general and financial institutions in particular are not to be considered while dealing with financial terrorism. In case of HBUS, the PSOI initiated the examinations because of its weak AML programme.

There were ineffective methods for identifying suspicious activities, failure to file timely Suspicious Activity Reports with U.S. law enforcement, failure to conduct any due diligence before opening correspondent accounts, poor procedures for assigning country and client risk ratings, inadequate and unqualified AML staffing; inadequate AML resources; AML leadership problems etc., For a MNC (multinational corporation) financial institution like HSBC (HSBC Group is one of the largest financial institutions in the world, with over \$2.5 trillion in assets, 89 million customers, and 2011 profits of nearly \$22 billion and got offices in over 80 countries) such deficiencies are shocking yet it is the fact.

3.Continuous Information Sharing Among Various Agencies

Various agencies dealing with AML, terror financing are to share information routinely among themselves. This can be extended to all agencies involved in combating against terrorism.

4.Better late than ever

HBUS' severe AML deficiencies did not happen overnight; they accumulated over a period of time. It's always better to start now and improve the security measures not only relating to AML but with regard to all anti-terror measures.

5.Coordination at multiple levels in dealing with AML problems

Coordination between various regulating agencies, between various divisions of the regulator (like audit, supervision, enforcement legal), between various departments of financial institution (training, policy formulation, inspection, audit etc) is needed in dealing with AML problems.

6.Problems with International Banks

HSBC group like other international banks presents itself with a number of AML challenges. A few of these challenges are listed as follows.

- a.The HSBC group is not based on any particular country but on attracting business from all parts of the world by showing its presence in particular country,
- b.HSBC affiliates operates in a number of jurisdictions which face huge AML risks from terrorist financing, drug trafficking, tax evasion, and other law enforcement problems,
- c.The HSBC Group is also one of the largest participants in international wire transfer systems and a leader among global banks in moving large amounts of physical currency around the world, with all the attendant AML risks inherent in large cash transactions, and
- d.HSBC also handles numerous high risk clients and high risk products.

How the Indian financial system is going to handle these complex natured institutions is an important question.

7.Legal obligation of the Financial Institutions

PSOI observes that global financial institutions like HSBC have strong presence in many countries confronting terrorist threats. If the safeguard systems followed by these institutions are lacking, it offers a gateway for terrorists to gain access to the financial system of other countries. Hence it's the legal obligation of these banks to take reasonable steps to ensure they are not dealing any institution that may have links to or facilitate terrorist financing. Indian regulators can also consider this valuable point.

8.Objective of AML Programme

Any AML programme has to safeguard the financial system of the county and the nation as a whole. In any conflict that arises between AML programme and protection of the customers of the financial institution, then priority should be given to the AML programme only. Financial institutions in India are in a stage to check their AML programme against this point.

9.Objective for providing Correspondent Banking Facility

International banks like HSBC use CB facility to attract new clients from various geographies. A senior HSBC executive told the PSOI that HSBC acquired its U.S. affiliate, not just to compete with other

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U.S. banks for U.S. clients, but primarily to provide a U.S. platform to its non-U.S. clients and to use its U.S. platform as a selling point to attract still more non-U.S. clients.

In a global economy, most of the multinational companies may have hidden objectives and operate in many countries. Our regulatory mechanism to be fine tuned to identify and discourage any of such hidden objectives that are against the welfare of the country. In spite of the regulatory mechanisms that are followed in US, the HBUS was misused for the illegal activities.

10.Dos and Don'ts for CB

An AML programme with written standards, knowledgeable and adequate staff, the infrastructure needed to monitor account and wire transfer activity for suspicious transactions, effective training, and a compliance culture that values obtaining accurate client information is need of the hour. It has to be noted that this programme has to be monitored and updated regularly.

Opening correspondent accounts for high risk affiliates without conducting due diligence, facilitating transactions that hinder efforts to stop terrorists, providing correspondent services to banks with links to terrorism, clearing bulk U.S. dollar travellers cheques despite signs of suspicious activity and offering high risk bearer share corporate accounts may be avoided.

11.Continuous Monitoring is needed

It is spoken and insisted everywhere that regulatory measures need continuous monitoring. In reality it is a question of how long the monitoring is needed, from the report of PSOI it can be said that it has to be continuous and not to be stopped.

In the report of PSOI it has been observed that HBUS announced promising AML reforms in 2003, when confronted with an AML enforcement action by the Federal Reserve Bank of New York and New York State Banking Department. Even before 2006, HBUS' AML programmes deteriorated. Any laps in the implementation of AML programmes have to be noted and Regulators to issue notifications to the financial institutions. This will help in preventing the building up of small violations and becoming serious threats to AML.

12.Correspondent Accounts – Regular Risk Assessment

It is said and discussed that before opening a CA, risk assessment has to be carried out. But the fact of periodic risk assessment of current CA has been provided with lesser attention. The existing correspondent accounts also need a regular risk assessment to find out how riskier they are in relation to present situation. The risk assessment to be carried out considering

- a.The country of operation(s)
- b.Nature of clientele
- c.Types of products and services provided by CB

Our AML rules to be updated in this regard.

13.Correct treatment to AML Failure

U.S. Office of the Comptroller of the Currency (OCC) the primary regulator for HBUS treated HBUS' AML problems as consumer compliance matters rather than safety and soundness problems, failing to make timely use of formal and informal enforcement actions to compel AML reforms at the bank and focusing on AML issues in specific HBUS banking units without also viewing them on an institution-wide basis. If the AML violations at HBUS had been treated as safety problem then the extent and magnitude of damage can be minimised. Indian financial sector is to focus on AML violations on an institution basis and the entire system has to be observed in this regard.

14.Establishment and periodic Increase of AML Resources

Resources like full time director for AML, qualified AML staff, implement an effective AML monitoring system for account and wire transfer activities and other suitable resources to be created and periodically enhanced at all financial institutions.

15.Overall approach in AML examination

When a financial institution's AML programme has been examined and assessed then it may cover all units of the financial institution. The entire AML programme needs to be understood as a whole. The examination can detect systematic problems and also provide a holistic view. In other words examination need not be narrowly focused. A narrowly focused programme will provided narrow corrective actions,

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allowing more systemic problems to go unaddressed for years.

16. Understanding the cross references of AML problems

Understanding the cross references of AML problems is crucial. For example if the country risk assessment method is inappropriate then

- a. All the earlier assessments have to be corrected.
 - b. Wherever possible corrective actions to be taken immediately.
 - c. The potential loss and damage has to be assessed and
 - d. To assess the reason behind such an inappropriate method of assessment has been adopted has to be identified and rectified.
- So not with just identifying the problems, its cross reference and magnitude has to be evaluated.

17. Addressing the AML problems on broader scale

The AML problems have to be addressed on a broader scale than as fragmented individual problems. For example inadequate staff, no proper training to staff etc., to be addressed as a single AML issue of staffing issue. Under it, sub groupings can also be done. This helps to address the issue on its bull's eye.

18. AML deficiencies to be treated as matter of violation

AML deficiencies are to be treated as matter of violation of laws. Treating AML drawbacks as issues to be corrected or matters require corrective actions can end up misleading a financial institution about the seriousness of an AML deficiency, delay remedial action, and allow an AML problem to fester.

Citing a financial institution for noncompliance with the law, on the other hand, carries more severe consequences if left unaddressed. It also sends a stronger message to the concerned management about the need for prompt corrective action, and lends more weight to any subsequent formal or informal enforcement action in the event the problem continues.

19. How money laundering suspicious activity is identified?

One of the objectives of AML programme is to identify and stop any suspicious activity of money transfer. The techniques used for this identification are important. These techniques are to be effective, adequate and more importantly to be automated (not to be manually monitoring) to ensure timely alerts on AML are generated.

20. Staffing and AML

Staffing is one of the key requirements for the success of AML programme. A lot has been said and discussed on the quality and availability of staffing in AML team. But if the financial institution has an objective of minimise the staffing cost then it is very difficult to achieve success of AML programme. Of course this objective cannot be explicitly found in the records of the financial institution. It can be found during the examination and discussion with the financial institution's key members. Another point to be considered is that the AML staffing to match with the numbers and value of transactions.

21. How the financial institution responds to its AML problems?

AML problems can be identified by the Regulator or through internal studies. Whether the institution is proactive in identifying the AML problems or have they taken a reactive posture to the issues identified by the Regulator is a key point.

The next point in the reaction to AML problem is whether the institution is correcting only specific deficiencies or taking comprehensive action to correct all deficiencies in the overall AML programme. Any narrow focused approach to correct AML problems will not help in improving the system but it will lead to overall deterioration of AML programme and cause dramatic failures.

22. Lessons for the Indian Regulator

There are certain issues from the Regulator side (Office of the Comptroller of the Currency - OCC) that has intensified the AML issues at HBUS. It gives a valuable learning that the Regulator has to update itself to control money laundering. In other words any small error or deviation on the part of the Regulator will have multi folded impact in controlling money laundering and it calls for costly actions to correct this small deviation. AML oversight from the Regulator (OCC in case of HBUS) can be from any direction right from approaches, decisions, practises, focus, timing, tone etc. Overall these oversights can be either omission of right things and commission of unwanted actions.

23. Corrective actions by the Regulator

Once AML deficiencies are identified, the Regulator has to take corrective actions. A variety of corrective actions are available for the Regulator. But the Regulator has to see the underlying causes for the AML violation. And the corrective actions imposed by the Regulator have match with the causes. For example if the financial institution's staff has not complied with the AML requirements wilfully then the Regulator can take disciplinary actions or impose penalties against the bank and or the staff as well as dismiss the staff and ban them from working in the financial industry.

24. Profits over fight against terrorism

HBUS has provided wide range of banking services to Al Rajhi Bank. After the 9-11 terrorist attack on the United States, evidence began to emerge that Al Rajhi Bank and some of its owners had links to organizations associated with financing terrorism, including that one of the bank's founders was an early financial benefactor of al Qaeda. Upon this discovery, supplying U.S. dollars to Al Rajhi Bank has been stopped. But on December 1, 2006, despite concern that there is “no smoke without fire,” HBUS AML Compliance agreed to allow HBUS to reinstate the relationship and resume supplying U.S. dollars to Al Rajhi Bank.

Earlier, Al Rajhi Bank had threatened to pull all of its business from HSBC Network if the U.S. banknotes business were not restored, while HSBC personnel estimated that restoring the U.S. banknotes business would produce annual revenues of at least \$100,000. In 2010 HSBC Network decided on a global basis to exit the U.S. banknotes business, until this decision, U.S. dollars were supplied to Al Rajhi Bank. This clearly demonstrates the bank's attitude of profits over the fights against terrorism.

25. So obvious still did not stop the CB services

Financial institutions rarely carry explicit links to terrorist financing. But in the case of three banks namely Al Rajhi Bank, Islami Bank and Social Islami Bank for whom HBUS provided CB and US dollar services, variety of facts available in public domain identified their relationship to terrorist financing. In each case, HBUS and HSBC personnel were aware of the information, but approved or maintained the accounts anyway. The bank personal calculated upon how much revenue an account would produce and did not consider national security.

26. Continued Interest in dealing with Iran

Iran has been identified as the country supporting terrorism and most of the countries across the world have reduced if not stopped their dealings with Iran. But From 2001 until 2005, the two HSBC affiliates frequently discussed processing Iranian U.S. dollar transactions for various Iranian financial institutions and entities through their HBUS correspondent accounts. Numerous emails among HSBC affiliates in Europe, Middle East, U.S.A and HSBC Headquarters discuss whether HBUS would be willing to process Iranian U-turn transactions and, if so, how ?. At the same time, HSBC Europe, Middle East and HSBC HQ were pushing to expand contacts with Iran.

The Senior Payments Manager in HBUS reported being told in a July 2001 conference call that the HSBC Group, with backing from the Chairman, was seeking to “significantly grow our presence in Iran.” In 2003, an HSBC Middle East business proposal estimated that processing 700 U.S. dollar payments for Iranian banks per day using U-turn transactions would produce income of \$4 million, while failing to process them would threaten HSBC's current Iranian business which produced annual bank income of \$2 million. It also noted that it already had a “number of existing USD accounts for Iranian banks. These points clearly explain the interest of the bank to earn revenue than ensuring safety of the financial system.

27. Basic problems in Country Risk Rating

It is a well known fact that Mexico is one of a primary country of money laundering and attracts higher money laundering country risk rating. And it is also expected that any financial institution part of HSBC network to have same money laundering country risk. Both these points are contrary in the case of HBUS and HSBC.

From 2000 until 2009, HSBC Group and HBUS gave Mexico their lowest money laundering risk rating, despite overwhelming information indicating that Mexico was a high risk jurisdiction for drug trafficking and money laundering. But in May 2009, HBUS suddenly increased its risk rating for Mexico by three points, from its lowest to its highest risk level. It is natural to expect the same risk rating from the HSBC parent company. But the HSBC Group raised its risk rating for Mexico from “cautionary” to “high risk in 2012 only. All these basic problems in country risk rating do intensify the AML issues and in fact sometimes questions the basic purpose of AML programme itself.

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28.Impacts of Wrong Country Risk Rating.

As HBUS policy, clients risk rating is directly related to their country risk rating unless the client is rated as Special Category Client (SCC). For example, with respect to Mexico, due to its low risk rating, all clients based in Mexico were considered low risk, unless rated an SCC. This has been viewed as a critical AML deficiency as high risk clients residing in low risk countries routinely escape from due diligence and account monitoring.

29.CB and other services provided to HSBC Mexico (HBMX)

HSBC Mexico had longstanding and widespread AML deficiencies. HSBC HQ knows about these deficiencies. Still HBUS were allowed to provide services like processing U.S. dollar wire transfers, clearing U.S. dollar travellers' cheques, and opening U.S. dollar accounts to HBMX. Again and again the objective of revenue over fighting against terrorism has been proved. HBUS was not informed of the extent of AML problems at HBMX. HBUS was left in the dark by its own colleagues about the extensive AML and compliance problems at HBMX. In addition, in conformance with HSBC Group policy and practice, HBUS conducted no due diligence assessment of HBMX, did not evaluate its riskiness, did not review its audit findings, and did not monitor its wire transfers, cash letter activity, or banknotes transactions for suspicious activity. HBUS had rendered itself blind to the fact that it was servicing a high risk financial institution

SUMMARY TABLE

Key Learning	Applicable to
1. AML Deficiencies will expose the Country.	Financial Sector.
2. Don't take the institutions for Granted.	All departments/agencies/bodies.
3. Continuous Information Sharing Among Various Agencies.	All departments/agencies/bodies.
4. Better late than ever.	All departments/agencies/bodies.
5. Coordination at multiple levels in dealing with AML problems.	Financial Sector.
6. Problems with international banks.	Financial Sector.
7. Legal obligation of the Financial Institutions	Financial Sector.
8. Objective of AML Programme.	Financial Sector.
9. Objective for providing Correspondent Banking Facility.	Financial Sector.
10. Dos and Don'ts for Correspondent Banking.	Financial Sector.
11. Continuous Monitoring.	All departments/agencies/bodies.
12. Regular Risk Assessment.	Financial Sector.
13. Correct treatment to AML Failure.	Financial Sector.
14. Establishment and periodic Increase of AML Resources.	Financial Sector.

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1. Overall approach in AML examination.	Financial Sector.
2. Understanding the cross references of AML problems.	Financial Sector.
3. Addressing the AML problems on broader scale.	Financial Sector.
4. AML deficiencies to be treated as matter of violation.	Financial Sector.
5. How money laundering suspicious activity is identified?	Financial Sector.
6. Staffing and AML.	Financial Sector.
7. How the financial institution responds to its AML problems?	Financial Sector.
8. Lessons for the Indian Regulator	Financial Sector.
9. Corrective actions by the Regulator	Financial Sector.
10. Profits over fight against terrorism	Financial Sector.
11. So obvious still did not stop the services	Financial Sector.
12. Continued Interest in dealing with Iran	Financial Sector.
13. Basic problems in Country Risk Rating	Financial Sector.
14. Impacts of Wrong Country Risk Rating	Financial Sector.
15. CB and other services provided to HSBC Mexico	Financial Sector.

The most of the key learning are applicable to financial sector.

CONCLUSION

A proactive multi agency joint approach is need in India's combat against terrorism. Along with this, observing the anti-terror approaches of other Nations and adopting the suitable approaches is also needed.

HSBC operates in India also through its subsidiary HSBC India. The detailed investigation and heavy penalties imposed on HSBC USA has few effects in India. Neither the regulatory mechanism nor the public interest has taken up any investigation in this regard. Even if some of the key learning from the PSOI study are considered and incorporated into India's fight against terrorism, we can see considerable improvements.

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END NOTES

Correspondent banking is the provision of banking services like cash/funds management, international wire transfers, drawing arrangements for demand drafts and mail transfers, payable-through-accounts, cheques clearing facilities by one bank (called as Correspondent bank) to another bank (called as Respondent bank). Source: RBI Circular No RBI/ 2009-10/73 DBOD. AML. BC. No. 2/14 .01.001/2009-10.

Permanent Subcommittee On Investigations (PSOI) is one of the five sub-committee of the Committee on Homeland Security and Governmental Affairs (HSGAC). HSGAC is the Senate's primary oversight committee with broad jurisdiction over the Department of Homeland Security of United States of America Source: <http://www.bbc.co.uk/news/business-20673466>

Source: Financial Action Task Force.

U-turn" transactions are those transactions that are initiated offshore as a dollar-denominated transaction by order of a foreign bank's customer; it then becomes a transfer from a correspondent account held by a domestic bank for the foreign bank to a correspondent account held by a domestic bank for another foreign bank; and it ends up offshore as a transfer to a dollar-denominated account of the second foreign bank's customer.