

# Strategic Management to Prevent Money Laundering: The Role of Effective Communication

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*Financial institutions take precautions to avoid money-laundering and financial crimes. Public became aware of the sanctions when HSBC has agreed to pay \$1.92 billion dollars to state authorities in 2012 for transferring dollars illegally into US. Banks apply “Know Your Customer” procedures to avoid such risks. In relation with sanctions, SWIFT system will be defined, with application namely ‘KYC Registry’ which gives information about the customers in international trade, through cross borders. The reasons why this application must be used, how risk will be mitigated, by sharing information with maximum transparency and SWIFT’s new KYC application will be defined.*

*Keywords: money laundering, SWIFT, risks, AML, Know Your Customer, KYC registry*

## INTRODUCTION

Globalization has increased integration and interaction between countries and companies located in different countries. Through integration the flow of goods has increased between different countries. In other words, international trade has increased as well. As trade increased, international trade finance, payment of goods, services between countries has increased, which required different currencies of payments to be transferred all over the world. Financial communication has increased as well. Along with the advantages, international trade risks and financial communication volume has also increased. Globalization has triggered money laundering activities through financial systems as well. This led international institutions, state officials and financial officials to take precautions to avoid money laundering, which can be defined as anti-money laundering process.

This paper aims to investigate the financial communication system, which is named as SWIFT system and the anti-money laundering procedure to avoid money laundering risks.

## BACKGROUND

### **Society for Worldwide Interbank Financial Telecommunications (SWIFT)**

The main system which is used by all financial institutions is called Society for Worldwide Interbank Financial Telecommunications (SWIFT). SWIFT is a non-state organization in the form of a cooperative serving financial sector for forty years, which enables a safe and secure system, where financial institutions can communicate with each other, transmitting payment orders and issuing letter of guarantees, letter of credits etc. via standardized SWIFT message types. SWIFT is a network, which is accepted as the most secure and trusted network system all over the world used not only by banks,

securities institutions and by corporate customers as well (Scott, Zachariadis, 2017). Today SWIFT is an integral part of financial system infrastructure. SWIFT has been established in 1973 to replace the telex system. The telex/telegram system was not automated and was not standardized. It required a lot of manual work, considering the ten thousand telex messages per day (Kuk, 2016) which is an average of 29.3 million FIN messages per day as of August 2018 and with total of 7.1 billion messages in 2017 (Swift.com, 2018). SWIFT had a large effect on profitability and performance of banks (Scott, Van Reenen, Zachariadis, 2017).

SWIFT has been established in 1973. In 1973 international trade volume increased to a total of 1 173 billion dollars. With total export volume 579 billion dollars and total import volume of 594 billion dollars as per World Trade Organisation statistics (World Trade Organisation, 2017). International trade volume was only 321 billion dollars in 1963. With total export volume 157 billion dollars and total import volume 164 billion dollars. Total international trade volume is 31 263 billion dollars covering 15 464 billion dollars of export and 15 799 billion dollars of import as of 2016.

With the increase in international trade, financial communication between financial institutions has increased accordingly. Along with the standardization of international trade rules set by international organisations like ICC, like Incoterms, payment terms etc to facilitate international trade with standard rules and to avoid risks like documentary risk in international trade (Meral, 2018). Globalization affected international trade positively. With the increase in international volume, an automated, secure system network which is in compliance with the international trade standard rules was a necessity for financial institutions. SWIFT was an innovative solution to all. It is a nongovernmental institution, can be defined as a cooperative of financial institutions, replaced the telex system which was previously used. Establishment of SWIFT emerged from the increase in international trade, which forced the system to replace it with a modern, innovated, automated, safe and secure system infrastructure. SWIFT has a cooperative status, located in Belgium, working with membership of financial institutions, provides a secure service system to financial institutions.

SWIFT, in compliance with the international trade rules has set standards for SWIFT messages as well. SWIFT has categorized all message types used in financial communication by financial institutions into 10 main categories as follows (Swift.com, 2018):

- Category 1 - Customer Payments and Cheques
- Category 2 - Financial Institution Transfers
- Category 3 - Treasury Markets - Foreign Exchange, Money Markets and Derivatives
- Category 4 - Collections and Cash Letters
- Category 5 - Securities Markets
- Category 6 - Reference Data
- Category 6 - Treasury Markets - Commodities
- Category 7 - Documentary Credits and Guarantees/Standby Letters of Credit
- Category 8 - Travellers Cheques
- Category 9 - Cash Management and Customer Status
- Category n - Common Group Messages

The categorized messages, for instance category 1 messages starting with 1, cover only customer payments and related cheques messages, whereelse category 2 messages starting with 2 are used only in bank to bank payments, in other words financial institution payments among each other. For example, category 4 messages starting with 4 are about collections and cash letters only and messages created under this category are automatically subject to ICC Uniform Rules for Collections, latest version, currently ICC Publication No. 522E, 1995 Edition. Hence category 7 messages, starting with 7 messages cover letter of credit (documentary credits), guarantees and standby letters of credit. They are automatically subject to the latest version of ICC Uniform Customs and Practice for Documentary Credits, currently UCP 600 ICC Publication No. 600E, 2006 Edition. SWIFT cooperates with International Chamber of Commerce and other international organisations for applying new standard rules of international trade.

## ANTI-MONEY LAUNDERING (AML)

### Money Laundering

Money laundering can be defined as enabling illegal money to enter financial system by covering up the illegal source. Although the term has been started to be recently used frequently, it is not a new process. Chinese merchants have concealed their wealth from the emperors. Along with concealing they also moved their wealth out of the country by investing in far cities or in other countries to avoid confiscation (Seagrave, 1995).

According to US Senate, US\$ 500 billion to US\$ 1 trillion criminal income are laundered via banks annually of which half of the amount is through American Banks (US Senate, Nov. 1999) and (US Senate, 2001). Financial crime is increasing in UK financial institutions (Logic CMG Report, 2003). For example, it is claimed that in Russia, 400 banks and 47 exchange bureau are controlled by criminal groups. Russians worked with The Financial Action Task Force to apply effective international standard regulations to prevent money laundering (Agarwal, 2004). The Financial Action Task Force has declared that Mexican bank drafts, peso exchange market and electronic transfers were used as a technique to out bound currency smuggling to launder dirty money (FATF, 1988).

The word laundry comes from the 'Dry Era', the period of 'Prohibition of Alcohol' in United States between the years of 1929-1933. During the 'Dry Era' period, labor union of laundry services was controlled by bootleggers (Michigan History, 2016). For example, Detroit, a city with a border to Canada, which has started the prohibition earlier than the other states, has learnt bootlegging earlier than the other states. Al Capone, who claimed earning 100 million dollars annually from casinos and speakeasies claimed himself as a 'businessman' was sentenced for tax evasion after killing Chicago rival mafia members and died in prison (The Guardian, 2012). Al Capone owned a laundry services chain company which worked with cash only. Dirty money from bootlegging and mafia were added to legal income from laundry services. Illegal money was legalised through laundry services. This prohibition of alcohol period, namely 'Dry Era' caused corruption with the illegal money from bootlegging (Lerner, 2018). Bootlegging created so much money that gangsters along with bootlegging, had other criminal activities like narcotics, morphine, cocaine, heroine, gambling and organized crime of racket (Haller, 1990) and (Russo, 2001).

Mafia had so much income from illegal activities of organized crime, that it had a political and economic destructive effect on social and corporate life. Money laundering can be defined as the entry of the illegal, dirty money into the financial system as if it is earned legally. The amount of money laundered differs in the literature. For example, Agarwal has estimated that one trillion US Dollar is laundered annually (Agarwal, 2004), Stamp and Walker has estimated as 4.5 billion US dollars for Australia only and estimated that money laundering total might be US\$ 3 trillion per annum since 2000 (Stamp, Walker, 2007). Unger estimated money laundered in Netherlands from 18 billion Euro to 25 billion Euro for 2004 and 2005 (Unger et al., 2006). Schneider's estimate for 2016 is that organized crime value turnover is US\$ 790 billion (Schneider, 2008). However, Reuter has disagreed with estimates available due to vagueness of such estimates although accepting laundry of hundred billions dollars per annum (Reuter, 2007). Baker has estimated illegal amount from US\$ 1 trillion to 1.6 trillion per annum (Baker, 2007).

Such large amounts earned via illegal, criminal activities, including from terrorism, affects all countries, not only economically, security wise as well. It threatens the world. Criminal underworld activities are found in all countries. Money laundering involves all the countries. Money laundering is defined as transferring the illegal, criminal money into the legal financial system via money laundering by concealing the source which might be drugs, smuggling, gambling, racket, kidnapping, robbery, procurement of women and children.

Money laundering can be defined as the entry of the illegal income usually cash namely black money, dirty money, illicit money earned from illegal transactions into the financial system by concealing the source of the income. Dirty money is different than grey-economy where there is tax evasion only. However with money laundering, dirty money, black money, illicit money from illegal activities is legalised. The criminal, i.e. money launderer conceals, hides the illegal crime income from the authorities and tries to legalise the dirty money by trying to show the origin different. With the money laundering,

the dirty money enters into the financial system. Once the entry to the financial system is succeeded then the dirty money is legalised. The main reason of money laundering is to be able to use the illegal money from criminal activities within the economic system.

### **Money Laundering Methods**

Money laundering methods can be summarized as smurfing method, structuring method, Shell banks, off shore centers, fake or shell corporations, dummy companies (companies which use cash), loan back (auto finance) system, exchange bureaus, casinos, false invoice/fictitious export and to move cash physically out of the country (Şekerbank, 2010).

#### *Smurfing*

In smurfing the dirty money is divided into small pieces, the aim is to lower the amount under the compulsory declaration amount in countries where applicable. The divided small amounts are distributed to a lot of people (smurf). People who received the small amounts after division deposit the cash into different branches of different banks. The distribution of money and spread into different parts are included into the financial system by losing its trace.

#### *Structuring*

Structuring method resembles smurfing method. It may not be possible to find too many people after dividing the large amount of money into smaller pieces. Then transactions numbers are increased. The large sum is divided into pieces and deposited into different branches of different banks with many transactions of small amounts.

#### *Shell Banks*

Shell banks are used for money laundering as well. Shell banks are banks without any service office in a country. They are only web based banks with a web site. They are not subject to supervision of any official authority or subject to official permission for registry for their banking transactions. Transactions via these shell banks make it difficult to follow the trace like shell companies.

#### *Off Shores*

Off shores is another method of money laundering. Off shore banks are subject to the laws of the countries where they are located. Other countries can not follow the partnership structure, organisation and transactions of off shore banks. Therefore money laundering investigation can not go further than reaching these countries. The off shore, tax havens provide confidentiality, politic stabilization, no taxation or very low taxation, freedom in capital movement, essential infrastructure for telecommunication, transportation and accomodation), specialized personnel or institution (consultant, lawyer etc).

#### *Shell Companies*

Shell companies are used to legalize dirty money by showing as if profit was made and by paying tax of the fictitious income the dirty money could be laundered. Shell companies might by valuable or invaluable estate or paper and might show higher revaluation with deliberate speculation. The shell companies, do not run any trade, production transactions. They are usually established off shore. They are not real companies, companies only on paper. During layering process, the money transfers are made through the shell companies. They are different than fictitious companies because the fictitious companies are also established for money laundering purposes but although the main aim is to money launder, there is a legal activity and a premise where it is located. However shell companies are only on paper. In other words although there is no commercial activity, they are shown as if they drive profit and dirty money from crime is injected into profit. After payment of income tax, the dirty money is transferred into the financial system. Only a few hundred dollars is sufficient to establish an off shore center.

### *Fictitious Companies*

Fictitious companies are preferred to be in sectors where there is intense cash flow is like hamburger shop, gas station etc. Although a couple of legal transactions are done per week or per month, the dirty money is deposited into the company's cash account. With this method the legal fund is mixed with the illegal dirty money and dirty money is concealed. It is not important for the launderers to earn money from these fictitious companies, in contrary it is preferred not to earn because as the companies legal earnings increase the laundered amount of money percent will decrease. As it is difficult to detect to find out how much sale was affected and accounting control is difficult in these sectors, it is possible to transfer dirty money via mixing with legal money.

### *Loan-back (Auto Finance) Method*

Loan-back is another method of money laundering, also named as auto finance. In this method, dirty money which is already transferred to an off shore bank is used as collateral. In other words, after having transferred the dirty money to off shore banks, they apply to a bank for a loan by requesting the off shore bank to guarantee repayment of the loan, by using dirty money as collateral. After having received the loan, does not repay the loan and the bank requests payment of collateral from off shore bank. With this way the dirty money layered and transferred to off shore bank is returned back to the country's financial system being laundered.

### *Foreign Exchange Office*

Foreign exchange offices are also used for money laundering. Exchange offices can separate partially the dirty money from its original source. Small amounts of cash can be converted into big amounts of cash or other currencies. Some cash instruments like travellers cheques or personal cheques can be obtained through these offices. In some countries, foreign exchange offices can transfer funds. By changing the currency of the dirty money to another currency, the dirty money is moved away from the illegal origin. It is easier to integrate it to the financial system with changed bank notes. Against cash, other money instruments can be used. It is easier for exchange offices to transfer money. Exchange offices are not subject to strict supervision, therefore they are preferred for money laundering.

### *Casinos*

Casinos are authorized to disburse loans, to extend maturity dates, to provide safe deposit boxes and endorse cheques etc. Money launderers can place the dirty money into casinos and might request not to declare. After this stage the dirty money can be withdrawn anytime through casino cheques or might be transferred. The launderer buys tokens with dirty money. After gambling for a while, then returns tokens and receives bank cheque from casino, with this method the source of the dirty money can be shown as casinos.

### *Associations*

Associations are another method of money laundering. Although they transfer large amounts of money, because they collect money for donation, they are not questioned. It is difficult to find out the origin/source of the fund. Donation transfers are not closely investigated as other transfers. Therefore it is easier for them to conceal the source of the illegal money via associations established for donations.

### *Fake Invoice/Fictitious Export*

To use this method of payment, the launderer must be able to control a few companies in different countries. One of the launderer's company will buy product or service with exaggerated price from another company of the launderer. With this transaction, the exaggerative price will be laundered. Overpriced payment of transfers are used to conceal or to launder dirty money.

### *Funds Physically Transferred Out of the Country*

The dirty money is physically transferred to other countries where there is not strict control. Money is usually carried by special courriers with suitcases. Although it is subject to either declaration or limited amount of cash is allowed to carry, illegally cash is carried with suitcases which are allowed in cabin are used for carrying cash outside the country physically to launder dirty money.

### *Banks and Financial Institutions*

Banks and financial institutions are used for money laundering. Although banks have precautions to avoid money laundering, they are still used for money laundering. With the globalization and movement of goods and services, money transfer, movement of money between countries has increased too. With the technologic innovation, via swift system, it is much more easier to transfer money. In seventeen seconds via swift system, the transfer message is sent to the bank in the other country. Therefore banks are used for money laundering.

In summary, with the above methods, dirty money laundry can be classified under three main phases with an example of washing the dirty clothes with the washing machine example. First phase is placement method (placing the dirty clothes into the washing machine). The dirty money is transferred by placement, that is where money is inserted into the financial system, by all means like transfers, wire, deposits etc. Second phase is layering (dirty clothes are washed in the washing machine). In other words separating, or layering is where dirty money is concealed from its criminal source via many transactions. Last phase of the laundering method is integration phase (the washed and cleaned clothes are taken out of the washing machine to be used), where people find a reasonable explanation for dirty money to be transferred into the financial system via investment/acquisition of goods or assets.

### **Effects of Money Laundering**

Money laundering is harmful for all countries. Money laundering effect economy and society negatively.

### *Economic Effects*

Money laundering is harmful for economies of countries. First of all money laundering creates inconsistency of money demand in the country. Growth rate –especially in developing countries- is inconsistent. Due to illegal, dirty money income, income distribution is not effected fairly. Income tax decreases and creates other problems.

### *Effects on Banking Sector*

Banks have liabilities to be in compliance with anti-money laundering regulations. Along with the legal risks banks have reputation risks as well. Therefore money laundering has an important effect on banking sector. For example money laundering has an effect on deposit accounts, banks must forbid opening accounts without identifications which might result in decrease of deposit accounts. Also off shore accounts, known as anonymous accounts are also used for money laundering (Doğan, Er, 2016). For these reasons banks must avoid such transactions to avoid money laundering.

### *Increase in Inflation*

Money laundering increases inflation in countries. Budget deficits triggers inflation. As money laundering transactions increase, it will also create budget deficits. As budget deficits increase, it will create inflation rate increase. Money laundering increases inflation because it increases grey economy as well. Furthermore for economic consistency and low inflation an efficient economic politics is required. If money laundering is low an efficient money politics and management is possible however if money laundering is high it is not possible to have an effective economic politics management. Therefore in countries where money laundering is low it will be easier to manage economic politics effectly which will lead to low inflation. However in countries where money laundering is high it will not be possible to

manage effective economic politics, therefore it will cause high inflation, along with inconsistency (Us, 2004).

### *Social Effects*

Money laundering affects social structure negatively and lastly the financial institutions activities are not effective or paused because of money laundering. As control on capital movements decrease, it will make money laundering easier. Money laundering will have social effects as well. Large amounts of dirty money from illegal activities will at the same cause corruption culture in the society. The society will be used to illegal activities with dirty money. The interaction between corruption and money laundering caused European Union, United Nations, World Bank etc to cooperate and to take necessary precautions to prevent money laundering. The relationship between corruption in the society and the unfair large income of dirty money from illegal activities have increased such organisations to increase their efforts to avoid money laundering all over the World (Miynat and Duramaz, 2012).

### *Financing Terrorism*

Corruption will increase and with corruption terrorism finance and drugs traffic will increase. The most important effect of money laundering is that financing terrorism. Money laundering is used for terrorism financing as well. The precautions for money laundering was not sufficient to stop money laundering (Miynat and Duramaz, 2012). Only after September 11 terrorist attack, anti-money laundering efforts have increased. After the interaction between illegal, dirty money created from illegal activities and terrorism finance was realised. The sanctions, standard rules to avoid money laundering have been set.

International organisations like world bank, united nations, european union and all other related organisations along with countries must try their best to avoid money laundering and must cooperative with other countries for anti-money laundering processes.

### **Anti-Money Laundering**

Following September 11, 2001 terrorist attack, anti-money laundering precautions have increased against money laundering. The dirty money which is earned via illegal activities is laundered by different methods as mentioned above. Money laundering is helping criminals to conceal their illegal source of income knowing that the good or income is created by a criminal, illegal method (The Financial Action Task Force, 2018). The dirty money is used in terrorist financing as well.

Anti-money laundering is very important for all countries. If money laundering can not be prevented, then it will threaten the country. Anti-money laundering is very important in preventing drug smuggling and crimes as well. The anti-money laundering precautions can be grouped under four basic groups. 1- Know your customer 2- List of suspects 3-To identify the customer 4- Other obligations (banks, private finance institutions, financing companies, leasing companies, joint ventures etc). Money laundering has become a global problem related with terrorism and drugs smuggling. Therefore anti-money laundering to combat with terrorism finance and illegal income from smuggling drugs etc has to be processed in cooperation with all the countries.

Tax income is another important factor for countries welfare. With money laundering countries lose their income tax as well. This is another reason for anti-money laundering. As money laundering increases, income tax decreases. Income tax is collected from legal income. Illegal income from smuggling means decrease of income taxes, decrease of customs duties and import taxes as well. Anti-money laundering success depends on cooperation between countries all over the world. International cooperation will increase success of anti-money laundering.

Anti-money laundering includes official regulations in financial system covering all parties involved including banks, financial institutions, securities dealers and all businesses which include money services. Not in compliance with anti-money laundering legal requirements might end up with sanction and punishments. The financial system had to pay large amounts of charges because they did not take the necessary actions to prevent anti-money laundering. According to Association of Certified Anti-Money

Laundering Specialists (ACAMS), the charges has increased from \$26.6 million dollars as of 2011 to \$3.5 billion as of 2012. Some of the charges paid for not in compliance of money laundering regulations by the financial institutions are; MoneyGram Intl, \$100 million in 2012, First Bank of Delaware, \$15 million for violating AML laws in 2012. TD Bank NA was charged for \$37.5 million in 2013, JP Morgan Chase Bank, was charged for \$461 million for violations and deficiencies of AML compliance programs in 2014. Coutts & Company had to pay charges totaling £8.75 million between 2007 and 2010 (Bankers Online, 2010). ING bank paid \$619 million for violating U.S. sanctions in 2012 (Reuters, 2012).

### **HSBC Case**

The London based HSBC declared in their annual report of 2018 that they might have to pay an amount of exceeding \$1.5 billion penalty again for Swiss private banking helping their customers to avoid taxes. The bank has already paid French authorities \$370 million dollars for charges of tax evasion, following \$ 100 million payment of charges to American Justice Department for currency transactions (Bloomberg, 2018). The bank has paid \$1.92 billion punishment in U.S. for money laundering of drug money in 2012 (Reuters, 2012). Having paid all these charges, HSBC declared that they have taken the necessary precautions by implementing global standards and with financial controls to protect the bank, they have invested \$1 billion in their IT infrastructure with the new systems to find out financial crime (Monroe, 2018).

## **MITIGATING ANTI-MONEY LAUNDERING RISK**

### **De-Risking**

De-risk is defined by Cambridge dictionary as ‘making something safer by reducing the possibility that something bad will happen and that money will be lost (Cambridge Dictionary, 2018). The World Bank defines ‘de-risking’ is termination of business relationships with small local banks and money service businesses by global financial institutions. For example, HSBC, having paid \$1.9 billion for not in compliance of money laundering in 2012 has started de-risking program, and closed MSBs (money service businesses) with 30 days prior notice.

Barclays Bank Plc, having paid \$298 million in 2010 for violations of Iran, North Korea, Myanmar or the sanctioned areas of Sudan (The Telegraph, 2010) and \$2.5 million in 2016 for violations of Zimbabwe sanctions (European Sanctions, 2016), has terminated relationships with money service businesses in May 2013. The de-risking practise included Dahabshiil in Somalia as well. Somalia’s banking industry, due to the civil war, was not functioning. Therefore annual transfer of \$1 billion to \$2 billion was effected via transfer kiosks. Dahabshiil had a long term 15 year account relationship with Barclays. They exited for AML compliance from money transfer companies as de-risking practice (International Compliance Training, 2014). However, Dahabshiil Transfer Services, stopped termination by an interim injunction from High Court against Barclays. Dahabshiil’s request for a transation period to find an alternative arrangement before ending the relationship with Barclays was accepted (Dahabshiil, 2013).

De-risking practices can be summarized as mass customer exit programs, global banks terminating relationships or certain businesses to avoid money laundering. De-risking practices force local banks and money service businesses out of the financial system. This practice might end up cutting off them from access to financial services in some areas. For example Caribbean was one of the most severely affected regions with 69 percent of decline in Correspondent Banking Relationship terminations (World Bank, 2015). The underlying reason of de-risking is avoiding risk and to comply with anti-money laundering rules however it might result as forcing transactions of small banks and money service businesses from regulated channels to unregulated channels (World Bank, 2016).

The Financial Action Task Force forty recommendations published in October 2016 cited supervisory penalties, changes in banks’ financial risk appetites and anti-money laundering (AML) compliance costs as key drivers of de-risking (The Financial Action Task Force, 2016). After having paid large amounts of money for non compliance with The Financial Action Task Force rules, global banks like HSBC, Barclays have terminated their correspondent banking contracts with small countries. However these small local



banks of small countries do not have another option other than the legal system. The correspondent banking relationship for them is very important to enable them to effect international payments.

Following the de-risking practices, the World Bank Group and Association of Certified Anti-Money Laundering (ACAMS) published a report with the recommendations summarized as: greater clarity and consistency about regulations, greater transparency on regulators dealing with noncompliance and standard regulations for global compliance. Furthermore, they have proposed to have a direct communication between compliance departments of banks and that global banks should be transparent about their reasons of terminating their correspondent banking relationships with local small banks and money service businesses (World Bank, 2016).

However global banks had their own reasons to apply de-risking practices. The Financial Action Task Force's guidance published in October 2016 about Correspondent Banking Services, had severe penalties for banks in anti-money laundering (AML) and compliance costs triggered de-risking practices (The Financial Action Task Force, 2016). After publication of The Financial Action Task Force guidance in October, the Basel Committee, revised a consultative document note, proposing revision on 'Management of Risks Related to Money Laundering and Financing of Terrorism', where they warned that a decline in correspondent banking with de-risking practices might affect international payments, which might result by payments to be effected via underground (Basel Committee on Banking Supervision, 2016).

As a result, as per the World Bank and Basel Committee on Banking Supervision suggestions, it can be said that mass de-risking practises, like customer exit programs for anti-money laundering are not solving the problem. By termination of the correspondent banking or relationship the risk does not disappear, only moves into alternative methods. So global banks must take into consideration of World Bank and Basel Committee on Banking Supervision advices about de-risking practices and instead look for alternative solutions like Risk-Based Approach and Know Your Customer.

### **International Sanctions and Compliance**

#### *The Financial Action Task Force (FATF)*

The Financial Action Task Force (FATF), has been established in 1989 within OECD organisation by G-7 countries that is United States, Japan, Germany, France, United Kingdom, Italy and Canada, to prevent money laundering globally. Following September 11, 2001 terrorist attack it has included to their mission to combat against terrorism as well. The Financial Action Task Force is an international inter-governmental institution which sets international anti-money laundering standards and counter-terrorist financing measures. The Financial Action Task Force has 32 member countries as follows; Australia, Austria, Belgium, Brazil, China, Denmark, Finland, France, Germany, Greece, Ireland, Netherlands, Spain, Sweden, Switzerland, Italy, Iceland, Japan, Canada, Luxembourg, Switzerland, Mexico, Norway, Portugal, Russia, Singapore, Turkey, New Zealand, Greece, the European Commission, the Gulf Cooperation Council. The Financial Action Task Force periodically audits and evaluates member countries for their moneylaundering and terrorism finance precautions systems. The Financial Action Task Force (FATF) has set standard rules in financial crimes. The standards are known as the FATF Forty Recommendations. The standard forty recommendation are accepted by all member countries.

#### *The FATF Forty Recommendations - International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation - the FATF Recommendations*

The Financial Action Task Force has developed international standards to prevent money laundering and finance terrorism publication, "International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation - the FATF Recommendations". The Financial Action Task Force publication "The FATF Forty Recommendations" was first published in 1990 and revised from time to time to update as per the progress, latest version is published in 2012 (The Financial Action Task Force, 2012). The first version was published in 1990 to combat against drug money laundering. The revision in 1996 covered international money laundering standards accepted more than 130 countries. The last version covered counter-terrorist financing standard rules. Terrorism financing and money laundering

combat requires systems to be monitored regularly and evaluated as per the international standard rules set by The Financial Action Task Force.

The 'Forty Recommendations' standards set by The Financial Action Task Force are universal, standard rules which are recommended to be applied all over the world. The Financial Action Task Force periodically evaluates member countries' systems for precautions of money laundering and terrorist financing. The evaluation process generally covers; whether the member country's system of combating money laundering and terrorism financing are in compliance with the Forty Recommendation and AML (anti-money laundering) and CTF (counter-terrorist financing) standard rules. Following The Financial Action Task Force's regular site visit of the member country is followed up regularly. If any non-compliance issues with the The Financial Action Task Force Forty Recommendation standard rules are found during the regular visit and if the said country does not make the necessary amendments to comply with the FATF Forty Recommendations compliance issues, the membership might be suspended or even ended by FATF (Financial Action Task Force, 2018).

The Financial Action Task Force Forty Recommendations, Standard Rules are accepted globally, have been recognized by IMF (International Monetary Fund) and the World Bank as well. The international standards to combat money laundering and terrorism financing can be classified under four main groups. 1. First group covers rules of Legal Systems; The Scope of Laundering Crime, Temporary measures and confiscation. 2. Second group, covers measures to be taken by financial institutions and non-financial occupations; Customer Recognition and Storage of Records, Suspicious Transaction Notice and Compliance, Laundering and Other Measures to Prevent Terrorism Financing, Measures to be taken towards The Financial Action Task Force Recommendations (not enough), Regulation and Control. 3. The third group, covering Corporate and Other Measures for Combating Money Laundering and Terrorism Financing; Competent Authorities, Duties and Resources, Transparency of legal entities and arrangements in this respect. 4. The last group of standard rules cover International Cooperation; Mutual Legal Assistance and Return of Criminals, and other forms of cooperation. The revised version covers the additional eight special recommendation about terrorist financing along with Forty Recommendations of money laundering. The Forty Recommendations set standards for all countries, covering all members to measure their criminal and regulations systems, to take the necessary actions to prevent money laundering and terrorist financing. These precautions are to be taken by financial institutions, other related businesses and international co-operation.

#### *The Office of Foreign Assets Control (OFAC)*

The Office of Foreign Assets Control (OFAC) has been established in 1950 in US Treasury. Previously named as Office of Foreign Funds Control (FFC) was established just prior to WWII in 1940 for preventing Nazis to use occupied countries' belongings. The Office of Foreign Assets Control is established to implement and manage economic sanctions against countries or groups identified as being in the traffic of terrorist or narcotic activities. These sanctions may vary from such as the blocking of economic assets of these persons or countries and the application of restrictions on their trade. Many countries and international organizations need to take various measures, in particular to control money laundering and terrorist resources. They have also been in close cooperation in this field and have made serious contributions.

Although the Office of Foreign Assets Control is US based, it must be considered it is based on the framework of United Nations sanctions applications. Many countries that support these practices are also monitoring the work that can be done with those who are included in this list. Traders will be able to see what kind of applications are done if it is in the list of objectionable countries, persons or institutions, by clicking on the sanctions section under the resource-center (The Financial Action Task Force Treasury, 2018).

#### *The Office of Foreign Assets Control (OFAC) Sanctions Lists*

The Office of Foreign Assets Control (OFAC) publishes an updated list of Specially Designated Nationals and Blocked Persons List (SDN) on the web page. The list consists of not only companies

individuals as well who are acting on behalf of targeted countries. The list covers not only the countries, terrorists and narcotics smugglers as well. If detected, their assets are blocked. As per the TWEA (Trade with the Enemy Act) Law, U.S. citizens are prohibited dealing with them. The sanctions list are mainly based on United Nations and created with multinationally with allied governments.

### *SWIFT and Sanctions Screening*

Financial communication among financial institutions has increased so much that it is nearly impossible to control millions of transactions per day manually. The SWIFT system has an online sanctions screening service for all types of incoming and outgoing messages, cross checking with sanctions lists including OFAC and European Union as well. Financial Conduct Authority has recommended companies to have procedures to customer due diligence and monitoring as well (Financial Conduct Authority, 2018) and has advised the following factors to keep into consideration for anti-money laundering precautions. First of all jurisdiction, The Financial Action Task Force (FATF) lists of jurisdictions with weak money laundering controls and lists of territories where no national laws on combating money laundering. These countries/territories are known as non-cooperative territories/regions. Second factor is the political status, also is a potential high risk customer because they are potentially involve in corruption, covers their families and their colleagues as well. Also institutions frequently in media are also potentially in higher risk for financial institutions. Third factor is the industry type, FATF forty recommendations the industries of dealers in precious metals and stones, trust and company service providers, embassies, money service businesses, casinos and internet-based payment services as potential money laundering sectors. They must be considered as high risk customer by the banks. The fourth and the last factor is the product type, that is some products are also in high risk group and these clients dealing with these products must be closely watched. The products with high risk are foreign correspondent banking, remote deposit capture, prepaid cards, electronic funds transfer and private banking. Swift offers online sanctions screening (Society for Worldwide Interbank Financial Telecommunication, 2018) for incoming and outgoing swift messages. Online sanctions screening covers 30 sanctions list, including OFAC, United Nations, Europe etc.

### **Know Your Customer Regulation**

Financial Service Authority (FSA) in their paper 'Banks' Management of High Money-Laundering Risk Situations in June, 2011 (Financial Service Authority, 2011) stated the three main points as follows: First, some banks did not want to exit profitable business relationships, some banks were willing to accept money laundering risks. Second, half of the banks visited by Financial Service Authority (FSA) could not provide identify/record information about customer, one third of them and some of the banks did not have sufficient anti-money laundering risk assessments neither. As per Financial Service Authority Report, financial institutions must know their customer to control money laundering. Financial Service Authority advised the banks that the best way to control money laundering was that to know their customer, by obtaining customer information and second advice was to assess products and services of their customers' to identify money laundering activities (Financial Service Authority, 2003).

Especially after September 11, terrorist attack, The Financial Action Task Force's priority was to prevent international money laundering and counter-terrorist financing. Banks were alarmed with the reports and tried to prevent money laundering by using The Financial Action Task Force standard rules. Financial institutions use SWIFT service for wire transfer messages, therefore The Financial Action Task Force's standard rules are important for transferring funds all over the world via SWIFT system as well. Due to legal requirements of banking legislation like data protection acts etc it is not easy to have access to information. Therefore access to communications always created a tension between telecoms companies and intelligence communities (Diffie and Landau, 2010).

SWIFT is an international cooperation establishment reflecting at the same time avoidance of dependence on US power (Sinclair, 2012). With globalization, it is discussed that world organisations rule our world and being and international organization SWIFT is also used as 'the glue for capitalism and the stick for sanctions enforcement' (Weiss, 2013) and (Willke, 2007).

Following September 11, The Financial Action Task Force authorities wanted to cooperate with SWIFT about money laundering of illegal money to find out illegal activities via financial communication through SWIFT messages. US officials requested to investigate track of funds transferred via SWIFT under the Terrorist Finance Tracking Program (US Treasury, 2018) and (European Commission Home Affairs, 2018), however although SWIFT had refused that they were not allowed to share bank data to third parties, they had to share it when the data was requested with subpoenas from court. SWIFT news sharing data was published on newspapers (New York Times, 2006), (Wall Street Journal, 2006), (Los Angeles Times, 2006), and (Washington Post, 2006) dated 23 June 2006. Following this, SWIFT tried hard and in 2007 succeeded with Safe Harbor status which was agreed between the US Department of Commerce and the EU, for US organizations to comply with the EU Privacy Directive (US Department of Commerce, 2018).

Furthermore, SWIFT by developing SWIFT's global messaging infrastructure in 2007, for customer contract transparency. Agreed the messaging infrastructure is to be divided into two different data zones, enabling messages for Euro zone only, for European swift centers, and the second one for US and Europe operating center. With this method, messages within Europe never entered US Jurisdiction area (Society for Worldwide Interbank Financial Telecommunication, 2007). By 2010, dual-zone messaging implementation was completed as agreed in 2007 (Society for Worldwide Interbank Financial Telecommunication, 2010). At the end of November, 2010, the European Council of Ministers agreed an interim arrangement to allow continuing transfer of European data to the US (Taylor, 2010) and (EU Council, 2009). However it was not accepted in European Parliament in February 2010 (European Parliament, 2010) and (The New York Times, 2010).

EU and US agreed on a revised EU-US Terrorist Finance Tracking Program (TFTP) Agreement, in July 2010 (Society for Worldwide Interbank Financial Telecommunication, 2010). The revised agreement which came into force as of 1 August 2010 (US Treasury, 2010) allowed Europol to review and control the transfer of data, an EU representative in the US to monitor data processing, a prohibition on data mining or the like, a right of redress for European citizens, and rules about data retention and deletion (European Parliament, 2010).

#### *SWIFT and Know Your Customer (KYC)*

Dirty money is mainly laundered via banks. Anti-money laundering process must cover all financial institutions and especially banks. Basel Committee on Banking Supervision (BCBS,) has advised all banks the KYC standards and implementation in their report of 2001 (Basel Committee on Banking Supervision, 2001). Banks must make the necessary arrangements for anti-money laundering. The most important method as advised by Basel Committee on Banking Supervision is Know Your Customer (KYC) standards and implementation of a systematic control in Banking System. Along with Basel Committee on Banking Supervision, the Financial Conduct Authority, has also defined that 'Know Your Customer (KYC) procedures and ongoing monitoring application is the most effective way for Anti-Money Laundering (Financial Conduct Authority, 2016).

SWIFT has implemented a new application which enables banks to be able to use the system. The SWIFT has implemented a Know Your Customer (KYC) Registry system. The system is run by SWIFT. Anti-money laundering can be avoided by strict precautions in the financial system. Banks can upload a standardized set of documents for due diligence. Due diligence is defined as "The detailed examination of a company and its financial records, done before becoming involved in a business agreement with it." (Cambridge Dictionary, 2018). The information after being checked and validated by SWIFT the information is shared with approved users. Currently the SWIFT KYC Registry system is used by the majority of the banks, that is who create 70 percent of swift message. The system is said to be mitigating financial crimes list with an affordable cost and work load (Bank of America, 2018). The SWIFT KYC Registry system might be of assistance for correspondent banking relationships as well as after September, 11 terrorist attack global banks had to terminate their correspondent banking contracts in certain regions. However, this precaution might cause other problems like the conversion of the transfers to other methods of which there is no control.

## Solutions and Recommendations

Combating Money Laundering and the Financing of Terrorism and Proliferation is a not only the member countries' problem, there are more than two hundred countries and only 32 of them are members of The Financial Task Force (FATF) member. All the countries must accept the FATF-forty Recommendations to succeed in combating money laundering and terrorism finance. The necessary precautions including the technical infrastructure investment and using SWIFT's financial crime compliance applications will help to reduce money laundering and terrorism finance.

## FUTURE RESEARCH DIRECTIONS

Financial communication has increased with the international trade volume increase all over the world. As technology facilitated movement of goods, services and money money laundering has also increased. The amount of money laundered varies in the literature. With the precautions, compliance standard rules and sanctions it is expected that the amount of money laundered will decrease. Future researches about the effect of the precautions might help. Further research about the reasons of not applying international standard rules of compliance in some reasons and countries will also help future researches.

## CONCLUSION

Financial communication system used by financial institution is called SWIFT. As international organisations set standard rules to facilitate international trade to increase international trade volume, financial communication has also increased withing the financial system. At the same time, international organisations are trying hard to set standard rules for combating illegal, dirty money earned from illegal activities, to enter the financial system, that is money laundering and terrorist financing. To take necessary actions for precautions and to comply with the international rules and to avoid sanctions is very important for financial institutions. To avoid sanctions and high penalties of millions of dollars, global banks cancelled correspondent bank relationship contracts by mass exiting from certain areas, to de-risk. However to cancel the correspondent banking contracts for anti-money laundering purposes has a further risk of the fund transfers to be effected which is not controlled at all. Therefore the Basel Committee, experts recommend all banks to apply international standart rules and precaution methods like online sanctions screens, Know Your Customer Regulation to avoid anti money laundering and terrorist finance. Therefore it is recommended that non member countries should also apply FATF Forty Recommendations and financial institutions, especially banks and all other institutions dealing with money transfers, goverments must invest for technologic infrastructure, including SWIFT sanctions screening and to apply for Know Your Customer utility, to comply with sanctions and to be successful in combating Anti-Money Laundering and Terrorist Financing. Furthermore international organisations like World Bank financing such infrastructure, technical investments might help the countries which are still not using these international standards.

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## APPENDIX

### Key Terms and Definitions

**AML:** Anti-Money Laundering are the precautions to avoid money laundering

**DE-RISK:** Global banks practices of mass exit or termination of Correspondent Banking Services for Anti-Money Laundering purposes.

**FATF:** Financial Action Task Force, set standard Anti Money Laundering, known with the publication of ‘International Standards on Combating Money Laundering and The Financing of Terrorism & Profileration’ The FATF Recommendations (the FATF 40 Recommendations)

**KYC:** Know Your Customer Regulation is the most important precaution method of Anti Money Laundering, banks must know their customer very well, to justify the income and otherthings to avoid money laundering.

**OFAC:** Office of Foreign Assets Control

**SANCTIONS:** FATF lists countries with weak Anti Money Laundering regimes and identifies jurisdictions to combat moneylaundersing and terrorist financing.

**SWIFT:** Society for Worldwide Interbank Financial Telecommunication, financial communication system used by financial system, all the banks, has a cooperative status, based in Belgium, sets international swift message rules with related parties involved.

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