

Defining a PEP: High Risk Customers and Politically Exposed Persons - September 2011

The announced closure of the Financial Services Authority (FSA) will undoubtedly refocus the debate over the rigor and effectiveness of the UK's financial regulation. Coupled with increasingly unpredictable regime change across a number of jurisdictions in the Middle East and North Africa, this should encourage financial services firms to re-assess the robustness of their client on boarding procedures when dealing with Politically Exposed Persons (PEPs).

Defining a PEP

In June 2011 the FSA [issued](#) a range of guidelines relating to the prevention of financial crime including "a thematic review of how banks manage their money laundering risks, particularly around their management of high risk customers including Politically Exposed Persons (PEPs)".

The FSA defines a PEP as "individuals who are or have, at any time in the preceding year, been entrusted with a prominent public function by a non-UK country, the European Community or an international body" with the definition extending to an individuals' immediate family members and close associates. While most financial institutions use a variation of this definition to assess who they classify as politically exposed, the FSA noted that "some banks' PEP definition did not fully reflect the risk of corruption posed by PEP customers, and...revealed significant gaps by excluding positions associated with significant corruption risks".

This thematic review highlights the grey areas surrounding the definition of PEPs. The FSA used the example of an unnamed bank who included "Russian Oligarchs" as a PEP risk, but excluded "oligarch-type customers from other countries". Similar issues of consistency and context will apply when assessing the political exposure that customers from Tunisia, Egypt and Libya may pose. Banks will likely have to look beyond the "at any time in the preceding year" guideline for individuals' political exposure to provide the context they require. While the regimes of Ben Ali, Mubarak and Gaddafi will all have been out of power for well over 12 months by the end of 2012, many potential clients from Tunisia, Egypt and Libya will have had exposure to these deposed regimes, and may have potentially gained their wealth illegitimately through the siphoning of state assets.

The Connection between PEPs and AML Risk

Kim-Kwang Raymond Choo, of the Australian Institute of Criminology in Canberra, [suggested](#) in 2010 that PEPs "present a higher money laundering risk and, hence, require greater scrutiny" than non-PEP clients. Another FSA concern raised in the thematic review was that a third of banks visited by the regulator "failed to give due consideration to certain political connections", such as the wider families of PEPs. The FSA stated that this meant certain customers who may not fall within the money laundering regulations definition of a PEP, might "still have need to be treated as high risk and subject to enhanced due diligence". The FSA have already [stated](#) that "two

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banks have been referred to enforcement following the identification of apparent serious weaknesses in their systems and controls for managing high risk customers including PEPs”.

The Importance of Ongoing Assessment – Three Key Issues

The FSA thematic review and recent global events have highlighted three key issues that financial institutions may wish to consider further in order to mitigate their exposure to PEPs and when considering the PEP definition.

Firstly, the Arab Spring has shown that geopolitical situations change rapidly, and the PEPs associated with certain regimes, as well as their status, change with them. For example, individuals associated with the former Gaddafi administration in Libya who may have been deemed lower AML risk during client on boarding during the West’s détente with the regime in the 2000s, may now in fact be deemed a *persona non grata*. This suggests that following the initial client on boarding process, PEP reviews should equally be event-driven as much as part of an annual review process. Similarly, individuals associated with the new regime in Libya may in the future become clients of UK financial institutions. Many may previously have been anonymous teachers, civil servants, or businessmen. However, their previous low profile roles make thorough background checks of these individuals a priority for banks.

Secondly, the FSA thematic review highlighted that many banks fail to “analyse additional due diligence information properly and reflect the findings in their risk assessment”. This includes, for example, a quarter of banks where “adverse information about customers was often easily dismissed as political slurs”, or alternatively “simply ignored without appropriate further investigation”. However, this analysis fails to account for the context of the jurisdiction in which many PEPs operate. Most notably in Nigeria and Russia, both printed and social media are often controlled by rival political or business factions and can be both polemic and libellous. Similarly, many banks treated the “absence of criminal convictions as sufficient reason not to act on corruption allegations, even where these came from reputable sources often repeatedly and over a sustained period of time”. In fact, the paucity of criminal convictions in jurisdictions with highly corrupt legal systems is often the reason behind this absence, with PEPs able to expunge records or avoid facing court all together.

Thirdly, the FSA highlighted that it is concerned at where the costs of conducting due diligence within a bank falls, and how this could adversely impact on whether Anti Money Laundering (AML) procedures are correctly followed in financial institutions. This emphasises the need for a graduated and cost-effective approach by due diligence providers, a risk-based approach also supported by the “adequate procedures” provision in the UK Bribery Act.

Going Forward

The disbanding of the FSA may provide an opportunity for the new regulator to become stricter with financial institutions over their AML and PEP procedures. This is likely to be tested by a wave of newly-designated PEPs from the Middle East and North Africa who will soon be looking to UK financial institutions for their investment needs.

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