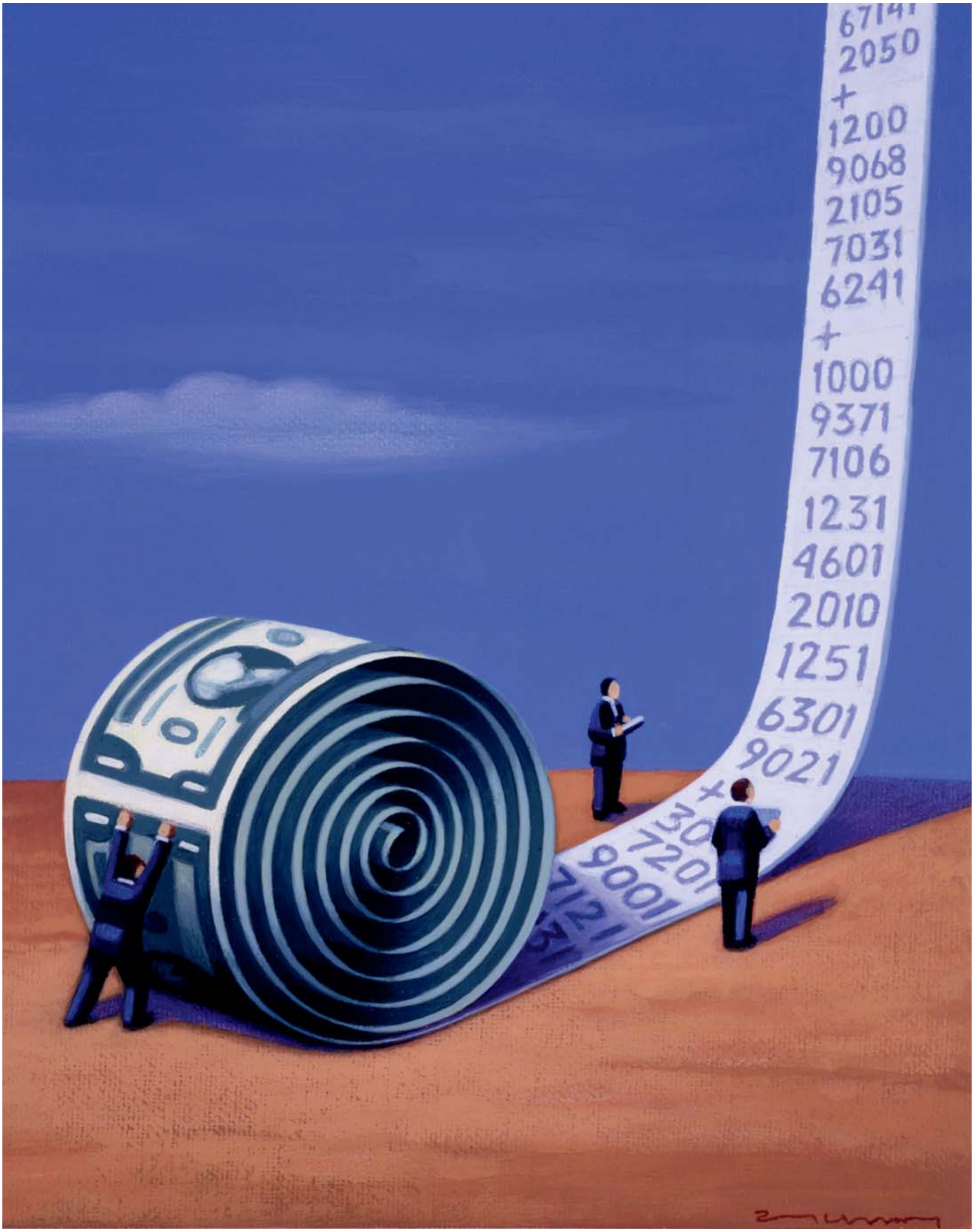
Future PROSPECTS for the PREVENTION of MONEY LAUNDERING

JAIME GÓMEZ-FERRER RINCÓN
Insurance Examiner

1 Introduction and current situation of the insurance market

The insurance market is now busily bringing its procedures into line with the new requirements not only of Solvency II but also a clutch of new legislation designed to make its component organisations more professional, such as the criminal liability of legal persons, in force since 23 December 2010, the upcoming legislation on packaged retail investment products (PRIPS), the future Directive on



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insurance mediation, payment services legislation, etc. All these measures pose a stern challenge for the industry and call for a smartening up of its managerial procedures.

The recently approved legislation on the prevention of money laundering and terrorist financing, developing the «third money laundering directive», is applicable to insurance companies and insurance brokers when operating with life insurance or other investment-related services and also to pension fund managers. It is now entering a new phase in terms of its implementation by the insurance market. The future development regulations will flesh out questions that are slightly woolly in the law itself and which impinge directly on the insurance sector's operational-, legal-, reputation- and underwriting-risks. These aspects of any company are directly bound up with Solvency II and the future approval of internal models. The legislation slows down the financial market with the introduction of new bureaucratic obligations, most of them useful, but all in urgent need of clearer and more detailed specification in the coming regulation to bring them into line with the real situation.

There is no longer any doubt about the need to develop such aspects as corporate governance, internal control, risk management and the internal auditing of sector companies to improve and streamline the management and control of the abovementioned questions. Supervision of insurance companies has shown up to now the following shortfalls:

–Failure to keep applicable legislation up to date or complete.

–Lack of a minimum internal control structure for the development of legally established obligations.
–Inadequate procedures manual.
–Lack of a specific client admissions policy.
–Lack of any tools for dealing with politically exposed persons (PEPs).
–Lack of any definition and development of procedures (literal transcription of the obligations to be met).
–Lack of any information and management tools for pinpointing clients of a higher risk before accepting them.

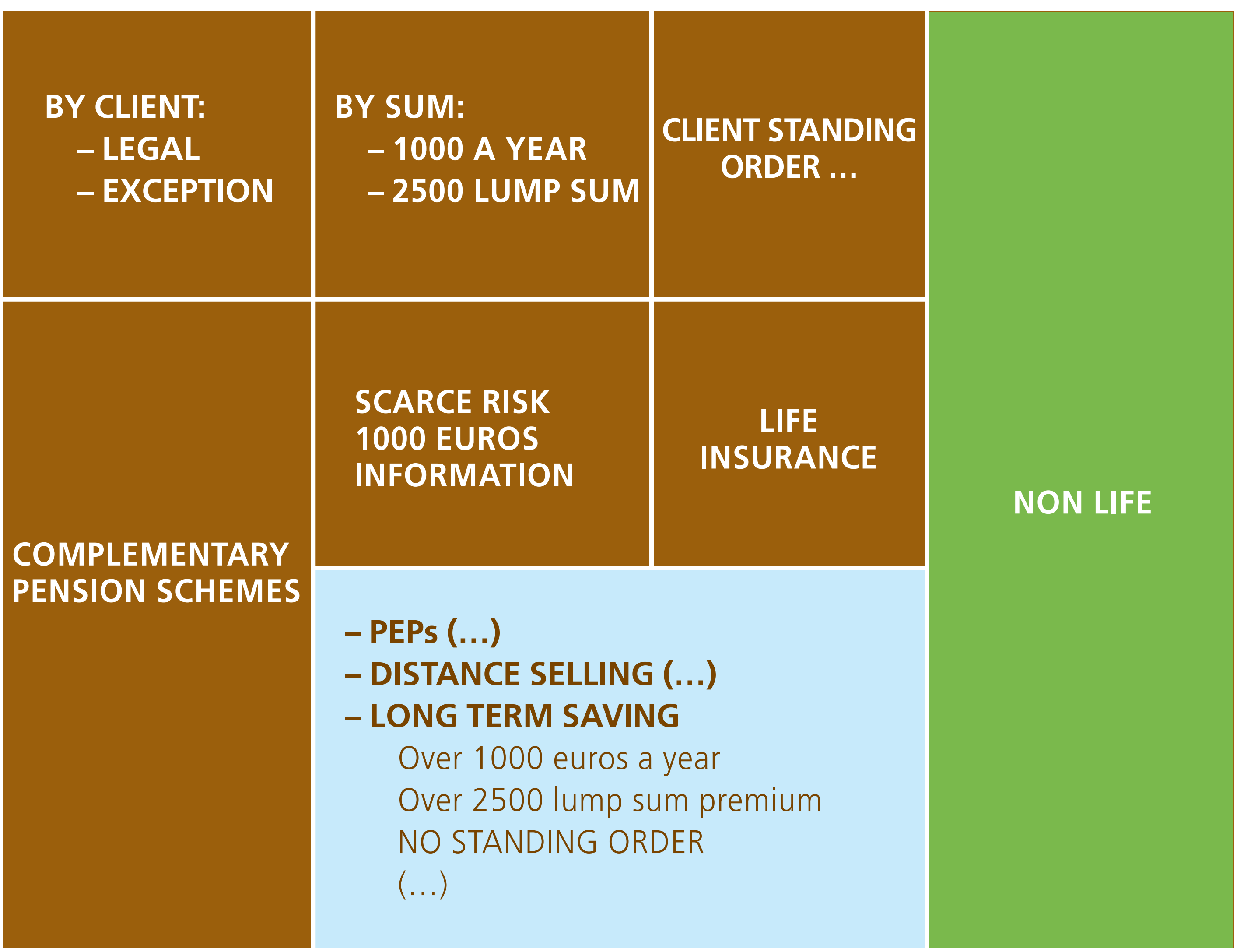
THE FUTURE DEVELOPMENT REGULATIONS WILL FLESH OUT QUESTIONS THAT ARE SLIGHTLY WOOLLY IN THE LAW ITSELF AND WHICH IMPINGE DIRECTLY ON THE INSURANCE SECTOR'S OPERATIONAL-, LEGAL-, REPUTATION- AND UNDERWRITING- RISKS

Some references to fines imposed on financial institutions can be found in the Judgement of 17 July 2009 of the *Audiencia Nacional* (National Appellate Court) (JUR\2009\362506), the Judgement of 3 June 2008 of the *Audiencia Nacional* and the Judgement of 23 April 2010 of the *Tribunal Supremo* (Supreme Court), the Judgement of 30 April 2007 of the *Tribunal Supremo* (RJ 2007\5807) and the Judgement of 9 October 2008 of the *Audiencia Nacional* (JUR 2008\367116).

The main obligations laid down by the current legislation for the insurance sector are the following:

- Formal identification of clients.
- Real identification of the data subject.
- Accreditation of the professional or business activity of the clients and the purpose and type of the insurance relation.
- Systematic reporting and communication of suspicious signs.
- Setting up a liaison body with SEPBLAC.
- Record keeping.
- The report of the external expert.
- Training.
- Other questions.

The due diligence obligations of the covered subject in the insurance market break down as follows:



In this map the green area is excluded from the scope of the Act, the brown part comes under the simplified due diligence procedures, while the light blue area comes under the full and sometimes enhanced due diligence procedure.

2 Grey areas in the application of the legislation and hopes for the coming regulation

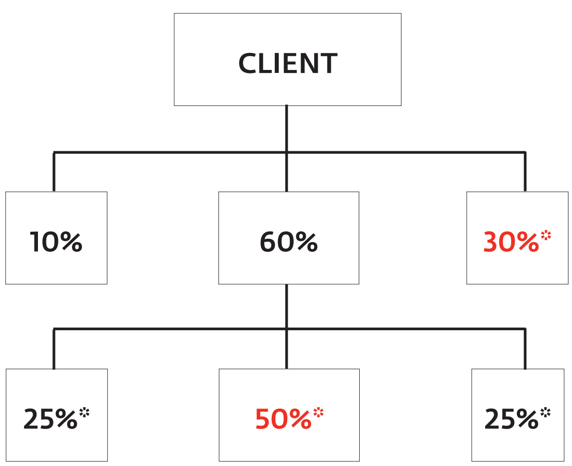
Although the Act in theory aims to explain the anti money laundering procedures, in practice it raises considerable doubts and confusion about such questions as the identification and verification of the client under article 3 of the Act, how to deal with politically exposed persons (PEPs), updating of existing portfolio information or distance selling. The main questions posing these doubts in practice are the following:

–Processing authenticated documents for identification and verification of article 3: Here there are several woolly areas that will hopefully be cleared up by the regulations:

- Specifying the difference between the identification of article 3.1 and the verification of article 3.2. What does it mean to identify someone? Must a copy of the National Identity Document (DNI in Spanish initials) be kept in digital medium or the like? In any case or only with the verification? Which documents are deemed to be authenticated? Act in hand, the sense of article 3.1 would seem to refer to visual identification and checks rather than keeping identity documents, whereas the verification of article 3.2 refers to the products to which simplified measures are not applied and therefore calling for conservation and verification of the identification document. There is a doubt in the insurance market, however, about whether a copy needs to be kept in any case. This would seem to be fairly reasonable and necessary to vouch for the fact that the identification has actually been made.
- Clarification about whether or not it is necessary to ask the client for repeat accreditation of his/her identity post-transaction for the mere fact, for example, of his/her DNI having run out of date. This would entail a human and economic cost without hardly inputting any added value to the prevention of money laundering, which is, in the final analysis, what the Act and sector seek.

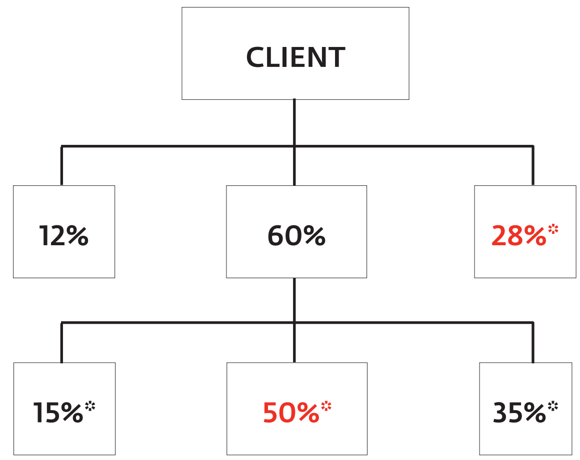
- How to deal with an existing portfolio containing standing-order premium-payment arrangements set up when the policyholder's identity was not originally checked under the exception provided for by the law at that time.
- Problems in relation to distance marketing and identification, to be dealt with below.

–Ultimate beneficial owner: How can the real identification of the client be effected? Here there are no uniform criteria about how to take into account the participation percentages. Take the following example[1]:



In the first example it will be those that top 25% directly or indirectly. The direct 30% stake and the 50% share of the 60%= 30%. In short, natural persons in red.

[1]Those marked with an asterisk are assumed to be natural persons



In the second example the percentages are not pooled. Hence the natural person who holds 35% of the 60% has a 60% share for the purposes of the law. An investigation would therefore have to be made of the property-holding structure. I put forward a couple of suggestions, not meant to be at all exhaustive, about what the law's criteria should be in terms of delimiting the covered subject's tasks.

–Study of life insurance: It is now a bit late to exclude insurance policies of this type from the obligations of the Act. Probably it should never have been included in the first place, since laundering money through products of this type, where the mean premium is about 94 euros and the death of someone is a prerequisite, would seem to be a bit tricky. A combination of the articles of the Act might mitigate this due diligence, applying, on the one hand, simplified due diligence measures (limiting the identification obligation of article 3.1) to contracts of this type, when the premium is over 1000 euros, and, on the other,

THE ACT RAISES CONSIDERABLE DOUBTS AND CONFUSION ABOUT SUCH QUESTIONS AS THE IDENTIFICATION AND VERIFICATION OF THE CLIENT UNDER ARTICLE 3 OF THE ACT, HOW TO DEAL WITH 'PEPS', UPDATING OF EXISTING PORTFOLIO INFORMATION OR DISTANCE SELLING

excluding the application of any due diligence measure under article 10.3 for all life risk contracts with a premium under 1000 euros, i.e., the vast majority. Thus, article 10.3 would exclude life insurance policies worth under 1000 euros, overriding application of the simplified measures of article 10.1.a). Another possibility would be to include certain life insurance products, whatever may be their value, in simplified measures, such as mortgage linked insurance, though the usefulness of this procedure for anti money laundering purposes would be at best dubious.

–**Standing order:** Under the previous law there was no need to identify the client in this case. Under the present law, however, the payment of life insurance premiums by bank transfer, standing order or registered cheque from a credit institution based in Spain, in the European Union or in equivalent third countries are exempted only from the obligation of ongoing monitoring of the business relation. This means that the organisations benefiting therefrom (about 85% of the transactions are effected by standing order) will be bound to bring their portfolio information into line with the law within five years. This measure has a high human and technological cost deriving from a new legal obligation applicable to past economic events, as we will see later.

–**Application of the measures to existing clients:** It could turn out to be very difficult and time consuming to cull all the necessary

information on savings products, for example over 40 years, when the insurance company has practically no contact at all with the policyholder. Take the case of savings policies taken out 25-30 years ago or policies that did not initially form part of my portfolio, in which cases the insurance company's biggest concern will be to ascertain who will be the beneficiary before the benefit is paid out.

–**Proxy policyholder:** As well as the special treatment of article 10.1.c) for outsourced group insurance, there is also the case of non-pension-based group insurance in which the policyholder is, for example, a financial institution or travel agency, etc., marketing life insurance. Take the case, for example, of life insurance policies tied in with the taking out of a salary account, credit cards or travel insurance covering accidental death. The idiosyncrasy of these insurance arrangements is that the policyholder is different from the insured and beneficiary. In some cases the insurance cost is taken on by the policyholder as a «gift»; in others the insured defrays the cost, albeit with another person as the proxy policyholder. Some

JUST AS THE ACT PROVIDES FOR THE CREATION OF CENTRALISED PREVENTION BODIES FOR COLLEGIATE PROFESSIONS (ARTICLE 27), SOME SORT OF SOLUTION COULD HAVE BEEN SOUGHT FOR DEALING WITH 'PEPS' GLOBALLY, GREATLY CUTTING DOWN THE COST THEREOF

markets have tried to cater for this situation by making a legal distinction between the insurance subscriber (the financial institution taking out the group insurance) and the insurance policyholder, corresponding to each one of the insureds and holding hold tenure over the policy and the corresponding individual insurance certificate. It therefore has all the policyholder's rights and obligations as recognised under law. From the point of view of the prevention of money laundering, however, this begs two questions. Firstly, whether the thresholds for application of simplified measures (1000 and 2500 euros) should be applied in relation to each insured. Secondly, whether the measures are applied to the «subscriber» e.g., financial institution or in view of this particular feature in group insurance, to each of the insureds, since under certain insurance arrangements it is they who make the payment even though another person is acting as proxy policyholder (the financial institution, travel agency, etc).

–**Covered subjects (subjects bound under the Act):** Article 2.1.b) lays down the possibility of excluding some covered subjects of the insurance sector. Take the example of mutual insurance companies that have not applied for increased benefits. Although this would limit money laundering possibilities it is unlikely to be provided for in the law on the grounds that it would «open a breach» in the prevention of money laundering and terrorism funding from the covered subject point of view. The Act already allows for diverse simplified measures to soften the brunt. Another moot point here is the possible simplification or exclusion of the internal control measures of article 26, which might affect, depending on size, plan managers and insurance brokers. This is unlikely to hold water either. Although plan managers do involve decentralised management of complementary pension products, there would be no input of value from exclusion from the obligation of keeping an anti-money laundering manual, client admission policy, etc. Quite the contrary. Firstly, there are already simplified measures for complementary pension schemes; secondly, there would still be a need for keeping a manual recording such matters as the organisation, the treatment of PEPs or the operation of distance business; thirdly, even though there are almost pure managers with very few employees, there are over 1500 insurance brokers working with only two or three employees who nonetheless clock up commissions worth about 70,000 euros and no claim is made for their exclusion since this would be discriminatory *vis-à-vis* the large brokers. In short, it would seem that the obligations of article 26 should be applied across the board to all covered subjects of the insurance market to ensure evenhandedness and to be able to continue developing internal control legislation for the insurance and pension plan sector. Lastly, we need to bear in mind here the latest judgements recording the use of pension schemes as yet another money laundering tool (E.g.: Judgement of the *Tribunal Supremo* 1345/2009, 29 December, Judgement of the *Audiencia Provincial de Cantabria* (Cantabrian Provincial Appeal Court) 1/2010, 18 January).

–**Accreditation of the client's professional activity:** The market will have to get used to compliance with this requisite in the marketing of insurance products. Policyholders are often loathe to come up with this information, for example certain executive policies, but they will have to get used to it in the short term, helped by the whole set of sector companies. All of them, either through direct management or through their various outlets, are now bound to ask for this information under a global market agreement to ensure a level playing field for all and head off any «drain» of clients to defaulting companies. Companies, regulators and supervisors will all have to work together to change consumer perception and establish this routine in policy contracting procedures.

- **Purpose and type of business relation:** A Collaboration Agreement is needed between insurance companies and the General Social Security Treasury (*Tesorería General de la Seguridad Social*: TGSS) on the assignment of information on professional activity. This would be similar to the collaboration agreement taken out on 17 January 2008 between the Directorate General TGSS of the Ministry of Work and Social Affairs and the Spanish Banking Association (*Asociación Española de Banca: AEB*), CECA (Spanish Confederation of Savings Banks) and the National Union of Credit Cooperatives (*Unión Nacional de Cooperativas de Crédito*).
- **Liability and supervision agreement between covered subjects through subsidiaries and associates:** The conclusion of a written agreement between an insurance company and an Associated Bank-Insurance Operator (whether the credit institution itself or one of its subsidiaries or investee companies) has to meet the requisites laid down in article 8 of Act 10/2010 in terms of the application of due diligence measures by third parties. This article speaks of a «written agreement between the covered subject and third party». Nonetheless, several forums have voiced the obligatory nature of these agreements between two subjects bound under the Act. From one point of view this would be logical since the end in view, from the risk point of view, is to establish where the buck stops liability wise, in this case the insurance company and the credit institute vis-à-vis the Associated Bank-Insurance Operator. On the other hand, however, it balks operations, slowing down the agreements with the indispensable distribution outlets for the insurance sector. Not only does it duplicate the existing contractual relation by means of an agency contract, joint venture, etc. with the Associated Bank-Insurance Operator but also adds on another relation for regulating the liabilities deriving from any breach of the Act. This problem could be solved by application of the Private Insurance Mediation Act 26/2006 (*Ley de Mediación en Seguros Privados*). Furthermore, it is also clear that, despite using distribution third parties (other than brokers, who are independent subjects directly bound under the Act), the insurance company will retain full liability. Quite another question is the marketing of pension plans, which stray beyond the scope of the Act, as already pointed out.
- **Discretionary application of the due diligence in terms of the client concerned (article 7):** This article, as worded, grants discretionary powers to the covered subject in terms of applying the due diligence measures. It lays it down that the covered subjects «will be entitled to determine the degree of application» of the measures. Perhaps the regulation should lay down some limit, otherwise the company might cunningly word its client admission policy to justify a zero application of the measures, i.e. no measure at all. It would seem obvious that a lower threshold to this leniency has to be set in terms of obligatory compliance at least with the identification requisites of article 3.1.
- **Products with low money laundering risk:** A saving products category could have been drawn up, subject only to simplified measures,

although the sheer diversity of these products might make this difficult. Active collaboration by delegation with the insurance supervisor, along the lines of some South American countries, through a circular, order or other legal instrument, could prove to be a good development mechanism in the future.

–**Enhanced due diligence measures:** Certain types of products, such as unit link or some of those already categorised as prone to money-laundering use, could be subjected to higher control measures, just as others only have to abide by simplified due diligence measures.

–**Distance selling:** Remember Alex de la Iglesia's words in the Goya prize-giving ceremony, claiming that internet is not the future but the present. How true those words are. The Act lays down enhanced or strengthened due diligence measures for distance business. But what happens when we take out a life insurance or other policy on the net? Which arrangement of the Act is overriding here? The application of simplified or enhanced measures? At present this is not a burning issue since most of the online platforms currently existing run alongside the normal telephone procedures, sending the potential policyholder the documentation by mail and asking for the necessary information. However, this is a crucial area because it will not be long before the market really taps into the social networking services to set up genuine online sales platforms for financial products of all types. This will beg many questions about data processing, use of the electronic signature, management of the obligations laid down by this Act and other laws for the covered subject. Now is therefore the moment to deal with the loopholes in this law, where certain products are subjected to simplified measures for face-to-face selling and enhanced measures for distance selling. I have already pointed out elsewhere the Act's faintheartedness in trying to control certain life insurance products with this whole array of obligations. The Act chimes in with the European standard, asking for use of the electronic signature, etc., but due arrangements really need to be made now for when distance selling becomes the mainstay of insurance business in the not too distant future. The exception on grounds of the nature of the product should override enhancement of measures due to the distribution outlet used.

–**Reinsurance:** The reinsurer-insurer relation is outside the insurance contract and ipso facto the application of measures such as KYC (Know your customer). In this case it is not a question of prevention by the covered subject but rather the use of reinsurance companies for laundering money, which would be dealt with as a criminal procedure. There are some signs, especially in the American market, of connivance between insurers and reinsurers in carrying out certain transactions outside market prices.

–**PEPs:** I believe that this obligation should be dealt with in its own right, apart from the other obligations of the Act. Compliance with PEPs should be distinguished from compliance with other obligations due to its cost and idiosyncrasy. This will be dealt with below.

NOW IS THEREFORE THE MOMENT TO DEAL WITH THE LOOPHOLES IN THIS LAW, WHERE CERTAIN PRODUCTS ARE SUBJECTED TO SIMPLIFIED MEASURES FOR FACE-TO-FACE SELLING AND ENHANCED MEASURES FOR DISTANCE SELLING

3 PEPs and identification of the client

The covered subject's database can receive feedback from several sources:

- Lists drawn up by the group companies, or
- Deriving from agreements as per article 33 of the Act,
- List of the Foreign Assets Control Office (*Oficina de Control de Activos Extranjeros*),
- List of the EU, including members of terrorist groups.

It also seems that access will also be needed to the PEPs database of one of the service providers, even though the law does not explicitly spell out this obligation. These have now been operating in the market for some years and are now entering the insurance market in response to the obligations laid down in the Act. The problem arises because the Act was drawn up at breakneck speed to comply with the Directive's requirement of contracting these services tendered by two or three providers. These providers turned this situation and need to their own account; indeed it seemed the Act had «set them up in business», as one sector colleague put it. The fact is that, under the insurance legislation, the companies had no such obligation; moreover these service providers were already up and running in many other sectors before made obligatory under the Act. It is therefore not the provider's fault but rather the current wording of the Act, which prompts companies to wonder why on earth they should defray such a proportionately high cost just to comply with legislation when it does not even affect their business directly. At most it applies only to part of their business. Neither can they even trust in the total reliability of the service provider since the Act includes persons such as the «next of kin» as PEPs. It is hard to justify this when we are talking about thousands of covered subjects in the insurance market (brokers, insurers, management bodies) and the overall cost runs to several millions of euros without any very practical preventive purpose other than deterrence. In fact, I do believe deterrence to be the main aim in view of the growing number of corruption cases worldwide, the growth of underground economies, fiscal fraud and opaque financial structures.

It is clear that any PEP who wishes to «launder money» will use front companies or another type of interposed organisation rather than waltzing in the front door and paying for products in cash. Maybe this is an extreme case but there does need to be a principal of proportionality here between due enforcement of the law by the covered subject and, where necessary, application of any penalising power (Judgement of the *Tribunal Supremo, contencioso-administrativo* [judicial review], 21 November 2007: «…any fines or penalties imposed by the authority must bear due proportion to the ends in view. This involves striking a due balance between, on the one hand, the content and purpose of the decision taken by the Authority and, on the other, the substantial forfeiture of rights by the penalised citizen …») . For instance, just as the Act provides for the creation of centralised prevention bodies for collegiate professions (article 27), some sort of solution could

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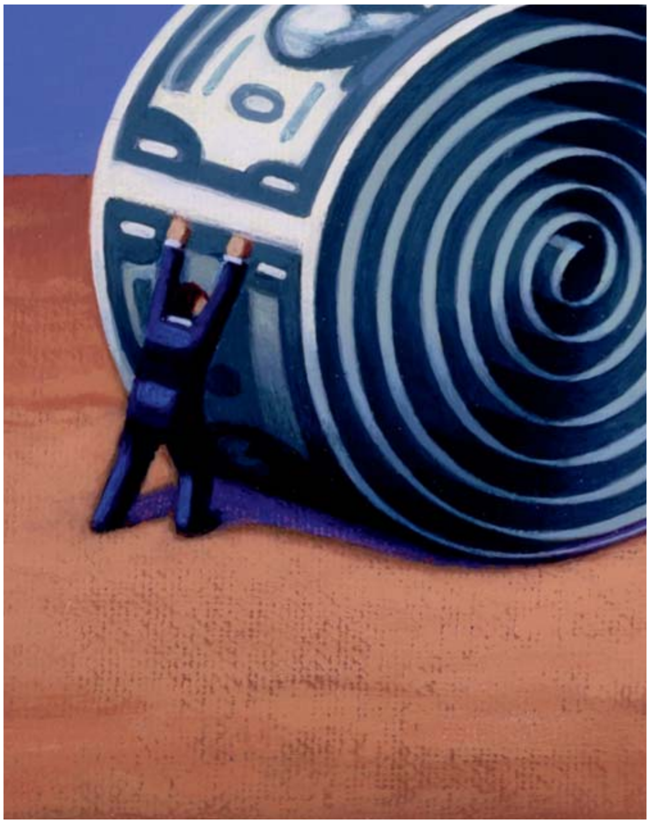

have been sought for dealing with PEPs globally, greatly cutting down the cost thereof. Under the present situation the companies' only options seem to be either to foot the bill for contracting a provider or hope not to be supervised, because the penalising system under the current Act is ostensibly complete, harsh and with no room for appeal.

The situation is trickier in the case of brokers, as a result of the sector's inexplicable lack of concentration. More than one with a very small life portfolio will be forced to decide whether to continue with it, become an associated agent or seek an «elder brother» and work as an auxiliary in this class of insurance. The consultancy and assistance agreements reached to date come across as a necessary but not sufficient condition for compliance with the law.

The Act brings such a varied trawl of subjects into the concept of covered subjects that it becomes an almost impossible proposition to work out their aetiologic relationship and fit them into the legislation. As new legislation crops up there is seen to be a need for greater efficiency and a more professional attitude among the organisations trading in the financial markets. This impression is unanimous among all market stakeholders, regulators themselves and all parties involved in any way. On certain occasions, however, the legislation separates the regulation from reality and undermines its usefulness, courting rejection from, among others, the financial sector. The prevention of money laundering and terrorist financing should try to take into account the particular circumstances and idiosyncrasies of each market the different covered subjects form part of, thereby achieving an overwhelming acceptance on the strength of its usefulness. To do so it needs to specify certain aspects that are difficult to apply in the day to day operations of the covered subject, otherwise it runs the risk of turning a useful law into an overly confiscatory mechanism (Judgement 1066 of the *Tribunal Superior de Justicia* [Higher Justice Court] of Madrid, lowering the fine for breach of the law by a natural person from 242,190 euros to 1200 euros) that is widely rejected. I trust that the regulation or other future legal instruments of at least equal ranking will allow for the particular traits of the insurance sector.

Finally, to reiterate the particular importance of this legislation, in part, in relation to compliance with national and international scope (cross border Situations) but also compliance in relation to other legislation such as the criminal liability of legal persons (art.31.1.bis C.P.) among others, for committing the money laundering crime, novelty in the Spanish legal system, which includes the possibility of committing the reckless offense (including employees) by neglecting certain obligations under the Act, both the insurer, as the distribution channels, which is responsible. An Act that will be talking about in the immediate future. ❚