Money Laundering in Insurance Business

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The rampant spread of money laundering is evident from the International Monetary Fund's estimations that the aggregate of money laundering in the world could be somewhere between two and five per cent of the world's gross domestic product. The Insurance Sector is one of the most vulnerable when it comes to money laundering and terrorist financing. The article provides an insight into the concept.

The '9/11' showed to the world how barbarous terrorism can be. But the attack on World Trade Centre and Pentagon in the US in 2001 is just one of the many dreadful acts of the million-headed monster called terrorism. Such acts of terror require a steady source of high level, efficiently concealed funding mechanisms. While terrorist organisations may be funded by contributions and gifts, criminal acts may also contribute to a steady influx of operational capital for their nefarious designs.

Ever since 9/11, the international concern over terrorists having wealthy backers and a sprawling global network of funds has grown manifold. Such dirty money from crime is turned clean by putting it through some process, which disguises its origin in a series of transactions, and this is money laundering.

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What is Money Laundering?

The process of creating an appearance that large amounts of money obtained from serious crimes, such as drug trafficking or terrorist activity, originated from a legitimate source.

Where Does Money Laundering Occur?

Generally, money launderers tend to seek out areas in which there is a low risk of detection due to weak or ineffective anti-money laundering programmes. Because the objective of money laundering is to get the illegal funds back to the individual who generated them, launderers usually prefer to move funds through areas with stable financial systems. Money laundering is a threat to the good functioning of a financial system. However, it can also be the Achilles heel for criminal activities.

Origin of the Concept

The term "money laundering" is said to have originated from the Mafia ownership of Laundromats (a self-service laundry (service mark Laundromat) where coin-operated washing machines are available to individual customers) in the United States.

Gangsters there were showing the illegally earned money from a legitimate source by purchasing outwardly legitimate businesses and to mix their illicit earnings with the legitimate earnings they received from these businesses. Laundromats were chosen by these gangsters because they were cash businesses. One Al Capone, prosecuted and convicted in October 1931 for tax evasion, is presumed to be the first launderer of money using Laundromats.

Meyer Lansky (affectionately called 'the Mob's Accountant') had discovered the first real laundering technique, by the use of the 'loan-back' concept, which meant that hitherto illegal money could now be disguised by 'loans' provided by compliant foreign banks, which could be declared to the 'revenue'

if necessary, and a tax-deduction obtained into the bargain.

Money Laundering in Present Form

'Money laundering' as an expression is one of fairly recent origin. The original sighting was in newspapers reporting the Watergate scandal in the United States in 1973. The expression first appeared in a judicial or legal context in 1982 in America essentially within a drug trafficking context.

Stages of Money Laundering

There are three common stages of money laundering during which their numerous transactions can be made by the launderers.

(a) **Placement** wherein cash proceeds from illegal activity is disposed physically.
(b) **Layering** wherein illicit proceeds are separated from their source by creating complex layers of financial transactions
(c) **Integration** wherein an impression is created of apparent legitimacy to criminally derived wealth.

If the layering process has succeeded, integration schemes place the laundered proceeds back into the economy in such a way that they re-enter the financial system appearing to be normal business funds.

A simple example can be used to understand the intricacies of money laundering. Suppose a person has made large sums of cash through drug trafficking, without getting caught. If he was to make large deposits into his bank account, some regulator might notice the unusually large deposits, thereby increasing the chances of getting caught. To launder the money, the criminal might simply use the cash to make purchases (placement) and then resell the items (Layering) in a legitimate market. The revenue gained from these sales is 'cleaner' and the criminal is drawing less attention to himself (Integration).

Investigators like to "follow the money" and that was difficult in the days when transactions were performed in cash.

International Dimension of Money Laundering

The international dimension of money laundering was evident in a study of Canadian money laundering police files. They revealed that over 80 per cent of all laundering schemes had an international dimension. "Operation Green Ice" (1992) showed the essentially transnational nature of modern money laundering.

In Operation Green Ice, law enforcement from Italy, Colombia, the United Kingdom, Canada, Spain, Costa Rica, the Cayman Islands, and the United States co-operated together to expose the financial infrastructure of the Cali mafia wherein they could seize over $66 million in cash and property, 14, 000 pounds of cocaine, 16 pounds of heroin, arrest almost 240 people world-wide

In 1998 the Geneva Convention recommended the establishment of an effective money laundering enforcement programme. Action at the international level to combat money laundering began in 1988 with two important initiatives— The Basel Committee on Banking Regulations and Supervisory Practices and the United Nations Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances, which has now been ratified by over 140 countries.

Financial Action Task Force (FATF)

Financial Action Task Force (FATF) an intergovernmental body was formed in 1989 by the G7-summit at Paris, with the purpose to develop and promote the policies, both at national and international levels, to combat money laundering and terrorist financing. It is a "policy-making body" that works to generate the necessary political will to bring about legislative and regulatory reforms in these areas. The membership has now steadily grown to encompass 33 nations, most of them from the Organisation for Economic Co-operation and Development (OECD). Over the years, the FATF has developed about 40 recommendations to guide states in their attempts to strengthen their financial systems that have come to be regarded as world standards. Since 2001, the FATF has also expanded its activities to include the financing of terrorism and as a result, there are now nine special recommendations.

The recommendations set minimum standards for action for countries to implement the detail according to their particular circumstances and constitutional frameworks.

Who Can be a Member of FATF?

A Country can be a member of FATF if it is:

- A strategically important country which is a full and active member of FATF-style Regional Body;
- With a letter from an appropriate Minister or person of equivalent political level making a political commitment to implement the FATF recommendations within a reasonable time-

frame and to undergo the mutual evaluation process; and

- Effectively criminalise money laundering and terrorist financing;
- Make it mandatory for financial institutions to identify their customers, to keep customer records and to report suspicious transactions; and
- Establish an effective FIU (Financial Intelligence Unit), so that the country will be assessed fully or largely compliant with recommendations;

Anti Money Laundering in India

India has criminalised money laundering under two parts of legislation in line with Recommendation 1 of the FATF. Section 8A of Narcotics and Psychotropic Substance Act (NDPS), 1985 and section 3 of the PMLA 2002 and is an active member of Asia/Pacific Group (APG) on Money Laundering— a style regional body of FATF. It is in the process of gaining observer status closely following China, which was awarded the same in January 2005. The purpose of the APG on Money Laundering is to facilitate the adoption, implementation and enforcement of internationally accepted standards against money laundering and the financing of terrorism.

Vulnerability of the Insurance Sector

The worldwide insurance industry generates premiums in the range of USD 2.4 to 2.6 trillion and is highly vulnerable to money laundering and terrorist financing. The vulnerability is more for life insurance and less for general insurance as a result of which anti-money laundering rules have generally focused on the former in countries like USA. In some of the countries like Luxembourg, Mauritius and Hong Kong, AML guidelines in insurance sector applies even to non-life insurance companies.

The most common form of money laundering that insurance institutions will encounter takes the form of a proposal to enter into a single premium contract, lump sum top-ups to an existing life contract. These contracts in themselves may be merely one part of a sophisticated web of complex transactions, which will often have their origins elsewhere in the financial services sector.

Money laundering is confused to the fraudulent practices prevalent in industry like fraudulent claims. It is also thought to be relatable to foreign exchange transactions, and both of these are some of the misconceptions about money laundering. They may be merely one of the stages of laundering money.

International Association of Insurance Supervisors (IAIS)

The 40+9 recommendations of FATF are applicable to all the financial institutions, which include insurance institutions. The need to implement these recommendations in the insurance industry is strongly realised by insurance supervisors around the world who have emphasised the importance of combating the financing of terrorism and money laundering.

The IAIS has given anti-money laundering and combating the financing of terrorism high priority. New Insurance Core Principles (ICP) 28 was introduced, dealing specifically with anti-money laundering and combating the financing of terrorism. According to it, recommendations of the FATF applicable to the insurance sector and to insurance supervision must be satisfied to reach this objective.

One of the new elements of the recommendations is the concept of Customer Due Diligence (CDD). One aim of the guidance paper is to give guidance with respect to CDD tailored to the specific features of the insurance industry and its supervision. The guidance paper offers a range of possible measures, procedures and best practices from which the supervisor should select those most appropriate to deal effectively and efficiently with the risks.

ICP 28 Anti-Money laundering combating the financing of terrorism (AML/CFT)

The supervisory authority requires insurers and intermediaries, at least those insurers and intermediaries offering life insurance products or other investment related insurance, to take effective measures to deter, detect and report money laundering and the financing of terrorism consistent with the recommendations of the Financial Action Task Force on money laundering (FATF).

It also requires them to comply with the provisions of AML/CFT requirements, which are consistent with the FATF recommendations applicable to the insurance sector including:

- Performing the necessary Customer Due Diligence (CDD) on customers, beneficial owners and beneficiaries
- Taking enhanced measures with respect to higher risk customers
- Maintaining full business and transaction records, including CDD data for at least 5 years
- Monitoring the complex, unusual large transactions, or unusual patterns of transactions,

that have no apparent or visible economic or lawful purpose

- Reporting suspicious transaction to the FIU
- Developing internal programmes (including training), procedures, controls and audit functions to combat money laundering and terrorist financing
- Ensuring that their foreign branches and subsidiaries observe appropriate AML/CFT measures consistent with the home jurisdiction requirements.

Indian Scenario

In an effort to adopt and implement measures designed to counter the use of the financial system by criminals, India is implementing the 40+9 recommendations of FATF in AML/CFT.

As per FATF's Recommendation 26, the Financial Intelligence Unit-India (FIU-IND) has been set up at New Delhi with a view to coordinate and strengthen collection and sharing of financial intelligence through an effective national, regional and global network to combat money laundering and related crimes. The FIU-IND, a multi-disciplinary unit for establishing links between suspicious or unusual financial transactions and underlying criminal activities and a central national agency is responsible for receiving, processing, analysing and disseminating information relating to suspect financial transactions.

While Anti-Money Laundering programmes are already in place in case of banks, Insurance sector has recently laid down programme to combat money laundering in India (as required by FATF Recommendation 25)

In India, it is a statutory duty of any person in insurance sector, who knows or suspects that any property in whole or in part, directly or indirectly represents the proceeds of drug trafficking or of an indictable offence, or was or is intended to be used in that connection, to make a disclosure to the Director, FIU-IND.

In order to discharge the statutory responsibility to detect possible attempts of money laundering or financing of terrorism, every insurer needs to have an AML programme, which should, at a minimum, include the following as per FATF Recommendation 15:

- The development of internal policies, procedures and controls, including appropriate compliance management arrangements, and adequate screening procedures to ensure high standards when hiring employees.
- An ongoing 'employee training programme'.
- An audit function to test the system.

Insurance Regulatory and Development Authority (IRDA) has issued guidelines on Anti-Money Laundering to insurers, which require insurers to implement AML programme from 1st August 2006. According to these guidelines, companies that offer standalone medical/health insurance, reinsurance and retrocession contracts, group insurance business, term life insurance contracts where the business is less vulnerable to laundering of money do not presently come under the ambit of AML guidelines.

According to it, each company should have an AML policy and file a copy with IRDA. These guidelines are in accordance with ICP 28 and also the various recommendations of FATF. Here are some areas vis-à-vis the recommendations:

1. *FATF Recommendation 5:* Due diligence would be exercised based on the sources of funds of the customer and a threshold premium of Rs. 1 lakh per annum. Due diligence would also be carried on existing customers from 01.04.2004
2. *FATF Recommendation 6:* Risk categorisation based on the customer profile and the product profile, to exercise due diligence.
3. *FATF Recommendation 8:* Exercise of due diligence in case of non-face to face transactions within 15 days of issue of policy.
4. *FATF Recommendation 9:* The obligation to establish an anti-money laundering programme applies to an insurance company, and not its agents or brokers
5. *FATF Recommendation 10:* It emphasises the need for record keeping and the need for employee/agent training programmes
6. *FATF Recommendation 11:* It emphasis proper documentation of the customer profile, to have record of sources of funds.
7. *FATF Recommendation 13:* It defines suspicious transactions and impose a duty to report to FIU-IND
8. *FATF Recommendation 14:* Protection under law for lawful disclosures.

India is keen in combating money laundering and terrorist financing. It is taking progressive steps in the process of implementing AML/CTF programmes in all the financial institutions. With systems and procedures taking good shape, let us hope to be one of the member countries of FATF and join our hands in the international efforts to combat money laundering and terrorist financing. ❐