Fraud & its linkages to Money Laundering

FRAUD AND FORENSIC CONCLAVE 2009

September, 2009

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Content Outline

About Money Laundering & Modus Operandi

Genesis of Money Laundering

- The term "**money laundering**" is said to have **originated from the Mafia ownership of Laundromats (a self-service laundry (service mark Laundromat)** 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 and thus the word '**Laundering'**

- 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.

- *In Black's Law of Lexicon "the term laundering is being referred to as investment or other transfer of money flowing from racketeering, drug transactions and other sources (illegal sources) into legitimate channels so that its original source cannot be traced."*

- In common parlance **Money laundering is the process** by which the **proceeds of the crime, and the true ownership of those proceeds, are concealed or made opaque** so that the **proceeds appear to come from a legitimate source** thus making **"dirty" money appear "clean**

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Sources of Illegal Money

Money laundering **washes the dirt from off** **the money / proceeds or profits generated from:**

- **Black money from real estate deals**
- **Drug trafficking**
- **People smuggling**
- **Arms, antique, gold smuggling**
- **Prostitution rings**
- **Financial frauds**
- **Corruption, or**
- **Illegal sale of wild life products and other specified predicate offences**

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Money Laundering … Modus Operandi

Stages in ML:

a. Placement: The first stage is of disposing the physical cash received through illegal activity.

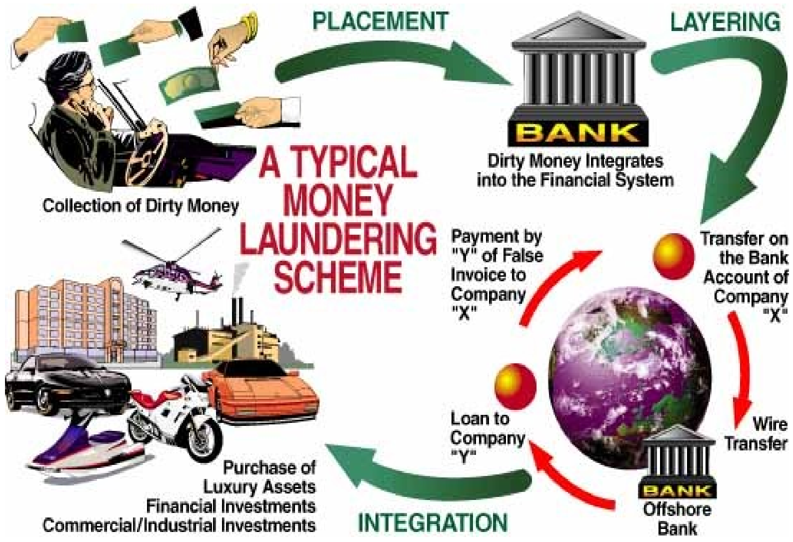
Typical Maneuver : This is accomplished by placing money into traditional or non-traditional financial institutions. Launderer may breakup money into smaller transactions to evade reporting called as *" Smurfing"*

b. Layering: The second stage concentrates on separation of proceeds from criminal activity

Typical Maneuver : Accomplished through creation of various layers of complex monetary transactions concealing the trail and provides anonymity.

c. Integration: "Integration" refers to the re injection of the laundered proceeds back into the economy in such a way that they re-enter the financial system as normal business funds.

Typical Maneuver : purchasing of property and co-mingling of money in bank accounts, creation of false invoices for goods exported.

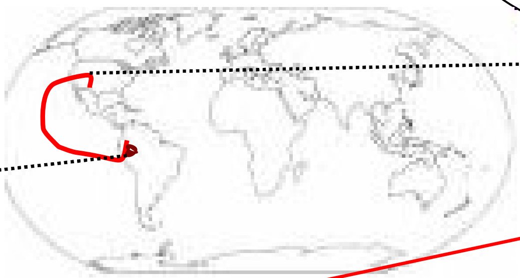


Money Laundering … Modus Operandi

1

Create Geographical Distance from the place of Crime (Say Drug Sale in Columbia and transfer of funds to the US)

Use of Shell Companies, Trusts, Off shore bank accounts, Money Transfer agents, etc



Placement Destination

Place of Origin

2

Create Distance in time (say 24 months)

Use of legitimate businesses, bank accounts, people, professionals, etc

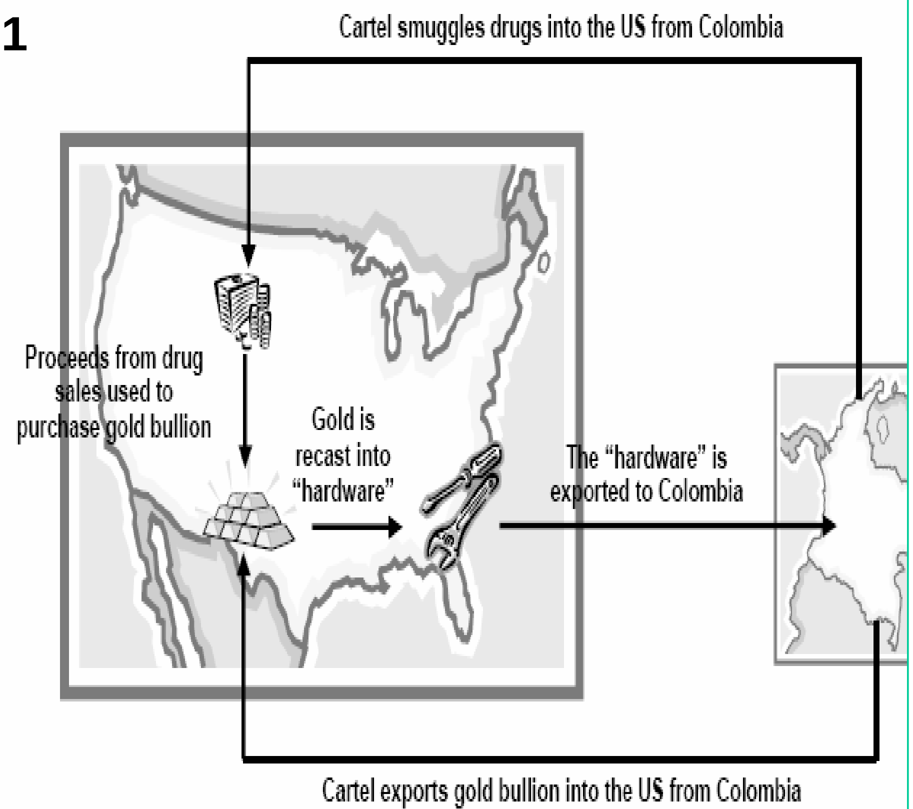
Trade Mispricing/ Collusion of Traders

Criminal Proceeds/ Commercial Smuggling

Mispriced Asset Swaps – Cashless

Money Laundering … Modus Operandi

1



Source: Information provided by the United States.

2

Examples of cash couriers related to terrorism

Bali (Indonesia) Bombing **Joint investigation by the AFP and Indonesian police revealed that the money was originated from robbery of jewelry and gold products, and donation from Extremist Groups. An amount of cash between 255 million and 290 million Rupiah was delivered through cash couriers**

Madrid Train Bombing **Investigators found that most of the fund for the bombing was donated by non-profit organizations and some profit organizations and some was raised by illegal activities. Part of was raised by illegal activities. Part of the fund was physically transferred in cash or in kind from 'donors" to "coordinators.**

Money Laundering - It gets bigger all the time

- The size of ML is often cited as 2.5% of the global economy. The IMF has said that between $600 billion and $1.5 trillion of illicit money is laundered annually, equal to 2% to 5% of global economic output.
- Today, offshore is where most of the world's is allegedly laundered, estimated at up to $500 billion a year, more than the total income of the world's poorest 20%.
- UK - £20 billion is generated annually by organised crime.
- USA - 9% of GDP
- Germany - 10% of GDP, while Italy, Greece and Spain are believed to have black economies amounting to approximately 25% of their GDPs
- In Russia and Central and Eastern Europe, it is anticipated that the black economy could amount to as much as 50% of GDP
- More money is stolen from the African continent every year than is donated in aid.
- Tax Havens have 1.2% of the world's population and hold 26% of the world's wealth, including 31% of the net profits of US MNCs United States multinationals.

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Money Laundering - Facilitators

Fraud trends and recession go hand in hand

The analysis of fraud trends during the first quarter of 2009 by the UK's Fraud Prevention Service - reveals some particularly alarming patterns. Of particular note are:

- A massive 40% increase in people being impersonated compared with the same period in 2008,
- An increase of 78% in facility takeover frauds, and
- A surge in false insurance claims by 44%

"FRAUD THRIVES IN A RECESSION, SO INSURERS ARE INTENSIFYING THEIR CRACKDOWN ON INSURANCE CHEATS," SAID NICK STARLING, THE ABI'S DIRECTOR OF INSURANCE.

FRAUD IS MORE OF A TEMPTATION DURING RECESSION

In India, the story is similar as cash crunch, slow growth, scale of unemployment, job cuts, regional divides have resulted in massive frauds:

- Satyam/Maytas may not have come to light had it not been the earnings pressure and global recession
- The trend of suspicious activity published by FIU, GoI in last couple of years shows almost a 100% growth trend

While cutting costs in a Recessionary environment - Management teams should not make the seminal mistake of diluting Control design effectiveness which will expose the company to high value frauds and in turn lead to business disruption

Is Corruption a key facilitator for Money Laundering?

Corruption Barometer 2009 – Transparency International

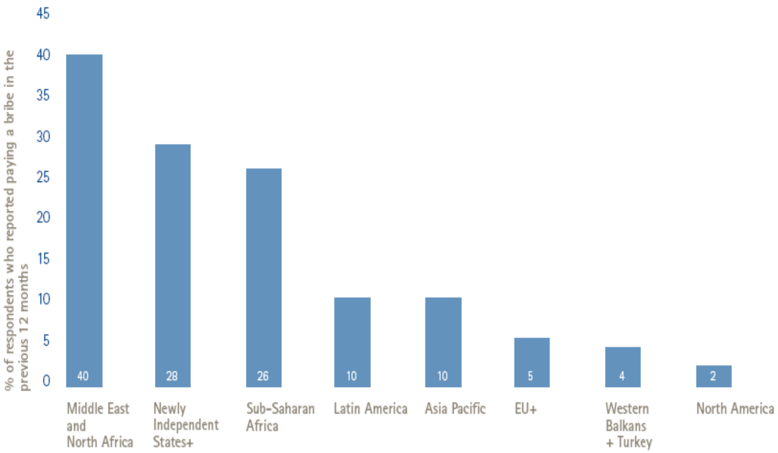
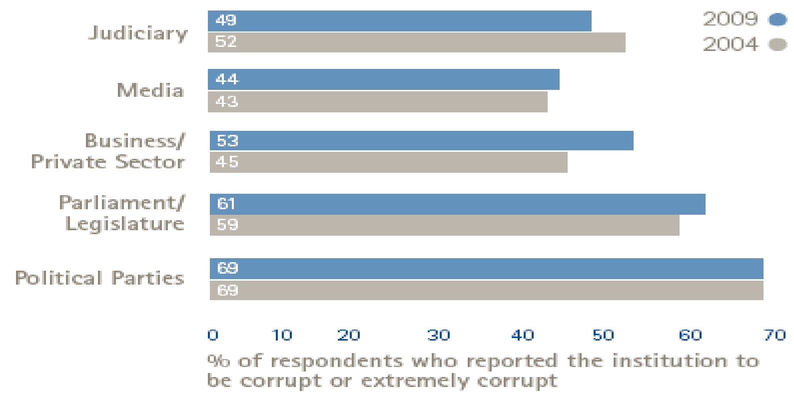


Figure 3 PERCENTAGE OF PEOPLE WHO REPORTED PAYING BRIBES IN THE PREVIOUS 12 MONTHS, BY REGION

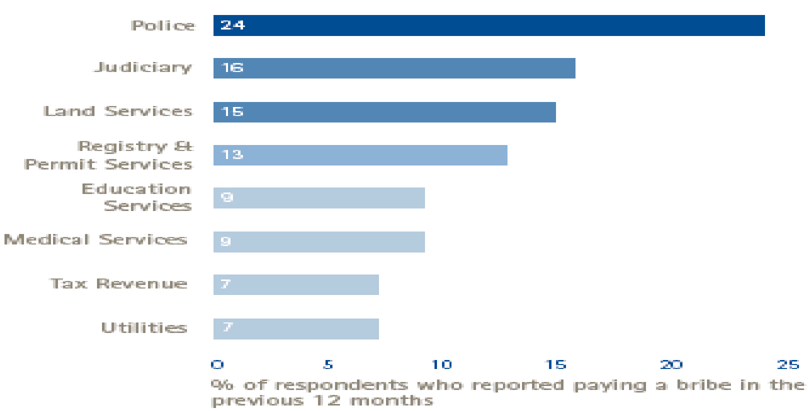
Source: Transparency International Global Corruption Barometer 2009. Percentages are weighted.

Figure 2 CORRUPTION AFFECTING KEY INSTITUTIONS/ SECTORS 2004, TO 2009 COMPARISON, OVERALL RESULTS



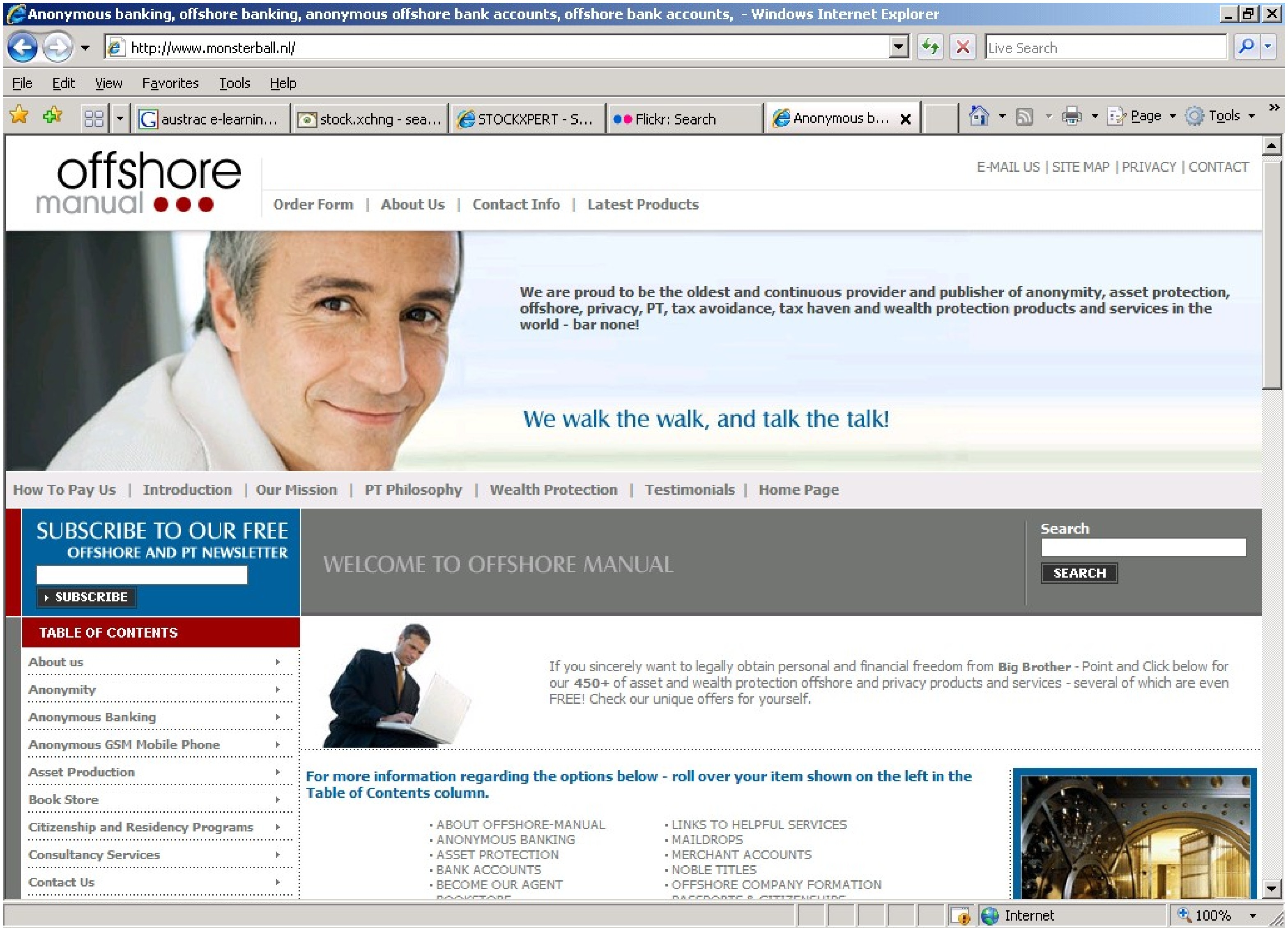
Source: Transparency International Global Corruption Barometer 2004 and 2009. Percentages are weighted. Only countries included in both editions are used in the analysis.

Figure 5 PERCENTAGE OF PEOPLE WHO REPORTED PAYING BRIBES IN THE PREVIOUS 12 MONTHS, BY SERVICE



Source: Transparency International Global Corruption Barometer 2009. Percentages are weighted and calculated for respondents who came in contact with the services listed. Colours indicate that there is a statistical difference between services.

Off Shore Accounts and Money Laundering



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Money Laundering Places of Origin and Targets

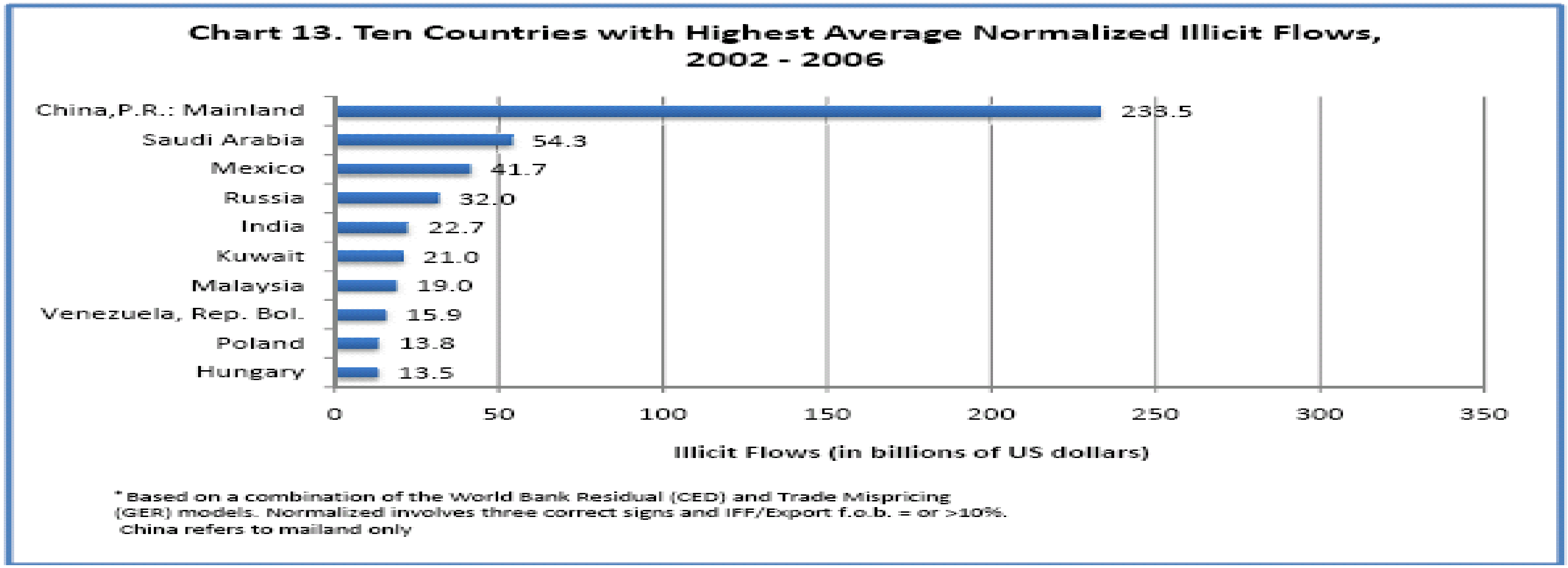
Vulnerable Targets

- Banks and Financial Institutions
- Commodity Traders
- Stock and Real estate brokers
- Casinos
- Currency exchange houses
- Trusts
- Money transmitters
- Postal systems
- Investment companies
- Loan and finance companies
- Importers/Exporters
- Insurance Companies

Asia-Pacific – High Levels of Drug related Money Laundering

- Thailand
- Burma
- Afghanistan
- Pakistan
- Laos
- China
- India
- Vietnam
- Kazakhstan
- Cambodia
- Indonesia
- North Korea
- Philippines

Illicit Flows/Flight of Capital Source: GFI findings



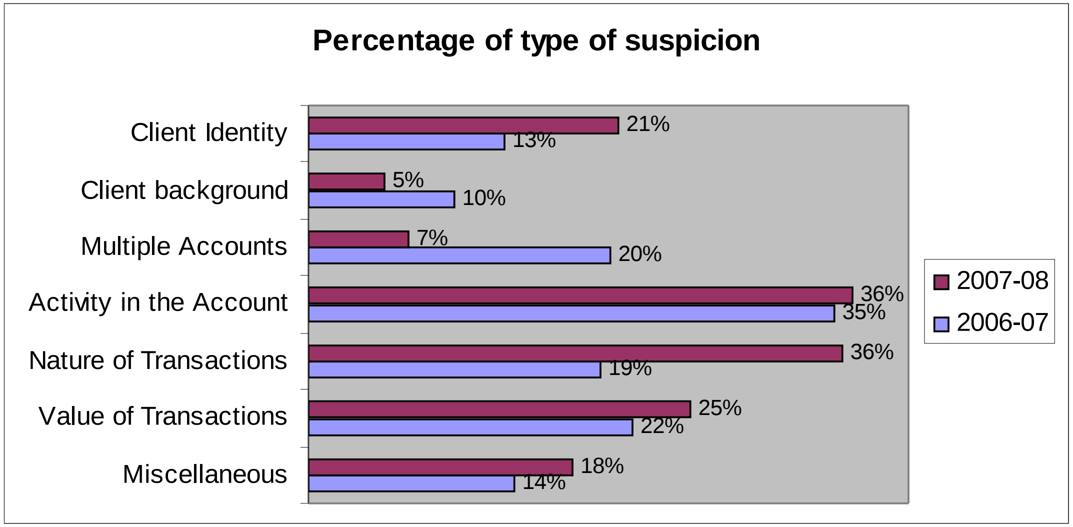
- Motivation to shelter one's wealth from the country of origin (say a high tax regime, where there are rising fiscal deficits, political instability, etc).
- Developing economies such as China, Russia and India have a thriving "second hands goods market" where goods and services such as Cars, real estate, consulting, show business, retail trade, etc are typically exchanged via "Black Money". Transactions involving black money are seldom recorded and deviate sharply from the prices prevailing in the free markets.
- Near Border exchange of goods and services which go unnoticed by Customs authorities

AML - Suspicious Activity Trends & Indicators

Trend of suspicious transactions in India

- The Prevention of Money Laundering Act, 2002, requires all financial institutions, banks and intermediaries like merchant bankers, foreign institutional investors and stock brokers to submit reports on suspicious transactions.
- Brokers and other financial entities have to submit such reports directly to the director of Financial Intelligence Unit (FIU)
- According to FIU's annual report for 2007- 08 (the latest available), different types of suspicion for which Suspicious Transactions Report (STRs) were submitted are as under

Type of Suspicion	2006-07	2007-08
Client Identity	107	395
Client background	79	97
Multiple Accounts	164	129
Activity in the Account	287	695
Nature of Transactions	159	682
Value of Transactions	176	488
Miscellaneous	112	338
Total*	**817**	**1916**



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Money Laundering – Suspicious Activity Indicators

Identity of Client
- False identification documents
- Identification documents which could not be verified within reasonable time
- Non-face to face client
- Doubt over the real beneficiary of the account
- Accounts opened with names very close to other established business entities

Suspicious Background
- Suspicious background or links with known criminals

Multiple Accounts
- Large number of accounts having a common account holder, introducer or authorized signatory with no rationale
- Unexplained transfers between multiple accounts with no rationale

Activity in Accounts
- Unusual activity compared to past transactions
- Use of different accounts by client alternatively
- Sudden activity in dormant accounts
- Activity inconsistent with what would be expected from declared business
- Account used for circular trading

Money Laundering – Suspicious Activity Indicators

Nature of Transactions

- Unusual or unjustified complexity
- No economic rationale or bonafide purpose
- Source of funds is doubtful
- Appears to be case of insider trading
- Investment proceeds transferred to a third party
- Transactions reflect likely market manipulations
- Suspicious off market transactions

Value of Transactions

- Value just under the reporting threshold amount in an apparent attempt
- to avoid reporting
- Large sums being transferred from overseas for making payments
- Inconsistent with the clients apparent financial standing
- Inconsistency in the payment pattern by client
- Block deal which is not at market price or prices appear to be artificially inflated/deflated

Linkage between Fraud & Money Laundering

Money Laundering and Fraud … A Linkage

- Fraud is a precursor to Money Laundering and both crimes are closely interconnected. Fraud **often generates money laundering**, businesses are subject to fraud through simple and complex deceptions by both insiders--employees, agents--and by outsiders.

- Fraud **generates illegal / illegitimate proceeds which get addressed through anti-money** laundering its acts like the source for Money Laundering Activities.

- Fraud can occur through credit cards, smart cards, stored value cards, e-money, e-commerce, corporate scandals, investment and tax frauds, false invoicing and financial fraud (bank fraud, credit card fraud, advance fee fraud, bankruptcy fraud, embezzlement, misappropriation, insurance fraud, the proceeds generated through **fraud create the incentive to legitimize the 'ill gotten' funds through Money Laundering.**

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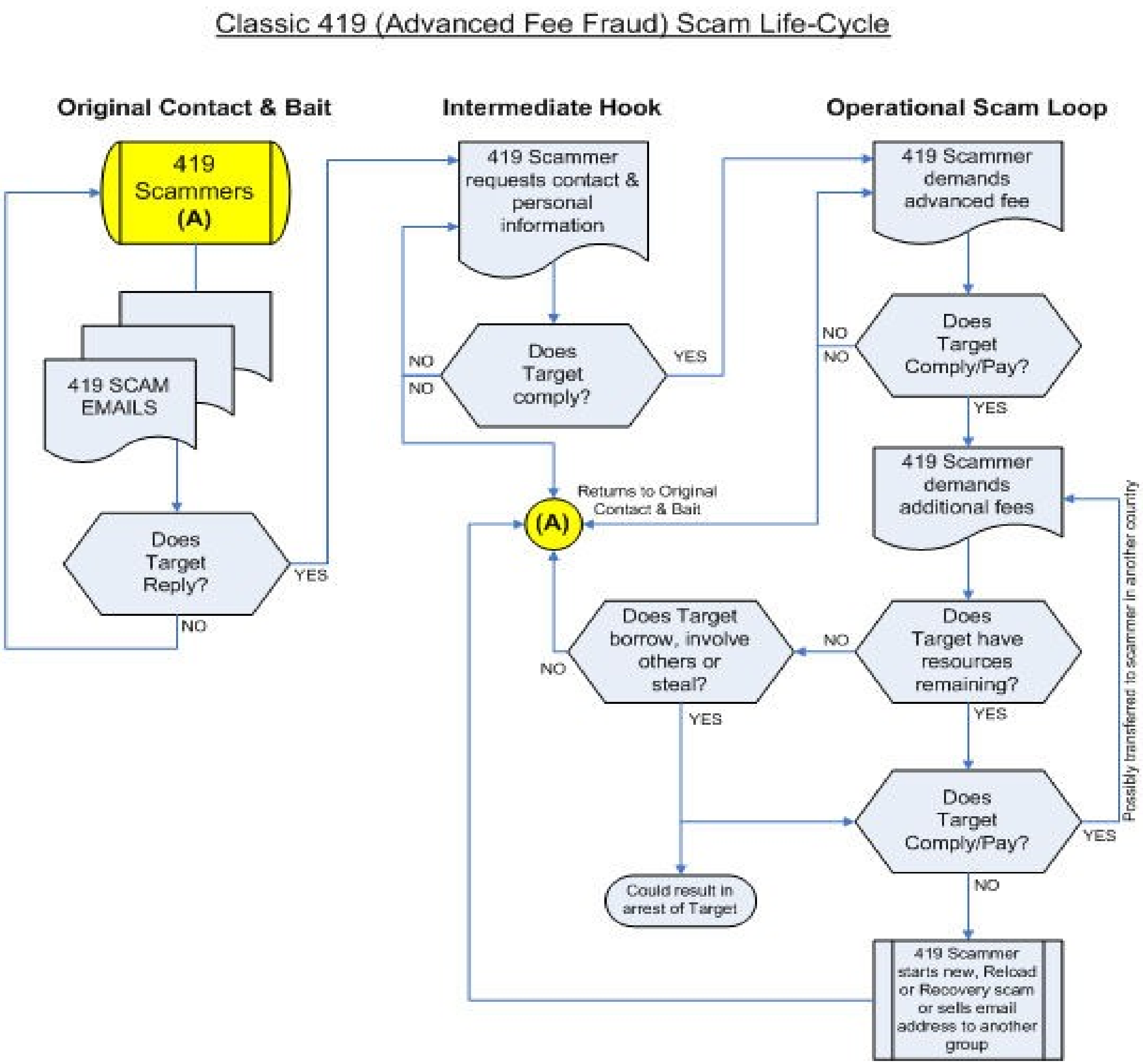
The Nigerian Scam (or 419 Advance Fee Fraud).

Remember the Rich relative of yours who died in Africa **leaving millions of dollars unclaimed** – only for you to claim it with the help of an African "lawyer" who wants you to inherit – millions of Dollars

but

you first have to pay fees via Western Union



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Case Study – I

Background of the Company

- The Company was a Germen based leading multinational having presence in 5 continents and around 80 countries. The core business of the company was into manufacturing and supplier of printing consumables like printing rollers, Dust removal chemicals, etc.

- In India, the Company started its operations from December, 2004 with head office at Delhi (gurgaon) and three other branches across the India, viz, Mumbai, Calcutta and Chennai. The company was lead by Mr. XX who was appointed by germen based parent company with the objective to perform function relating to the operations of the company in India.

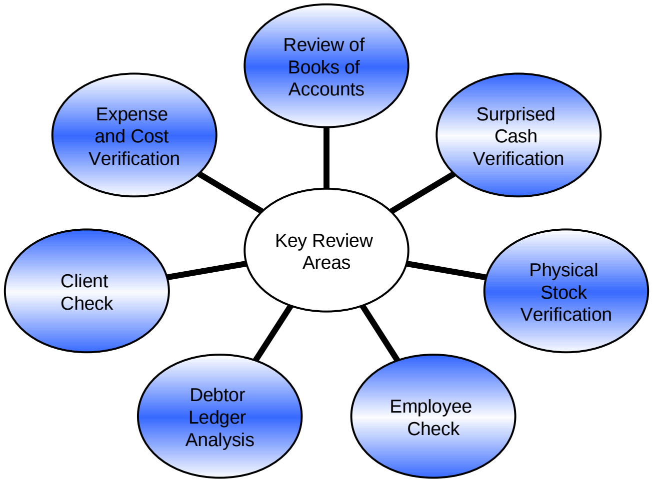
- Over the period of time, the turnover of the company has increased drastically and the same was unparallel with the growth of the companies in other countries which has given a rise of doubt in the mind of CFO of parent company.

- The CFO has approached professional firm to conduct preliminary scrutiny of the books of account with the objective of forming a preliminary opinion on the affairs of the Indian Subsidiaries and thereby to determine any fraudulent activity within the company.

Case Study – A Fraud Case

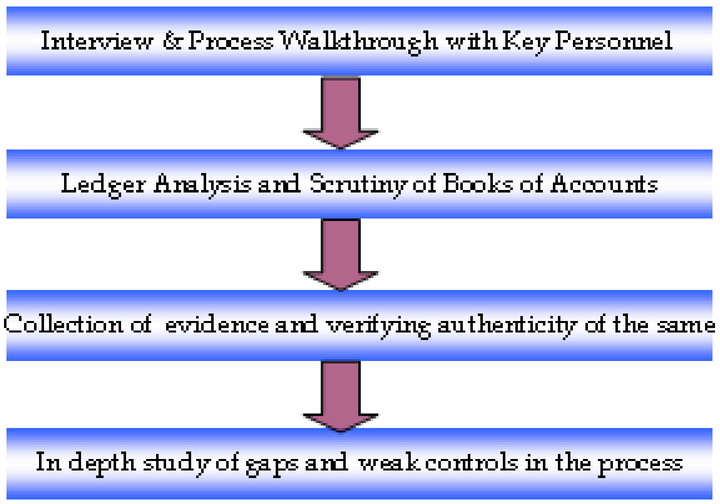
Target Areas

- The target of the assignment was to find the authenticity of the unparalleled growth of Indian Subsidiaries and to confirm whether there are any fraudulent activities going on or not.
- The Scope and Objective of the assignment was to ascertain the health of internal controls at the Corporate Office and the branches of the company and determine whether there are any internal control lapses or controls override.



Approach

- Preliminary scrutiny of the books of account for two days along with the senior representative from parent company (Germany) was done with the objective of forming a preliminary opinion on the affairs of the Indian Subsidiary
- On the basis of opinion of the preliminary scrutiny, in-depth scrutiny was held at all the Indian Subsidiaries.
- Above assignment was carried out into several phases such as planning, compliance & substantive review across business segment and interview & collection of necessary information



Case Study – A Fraud Case

Key Findings

- Inflation of sales / turnover by to get the performance incentive and later on sales return
- Cash amounting Rs. 24.50 Lacs was withdrawn by the Country MD for his personal benefit by way of salary and allowances, which were in excess of his allowable remuneration as per the term of his contract letter
- Non existence of customer and transactions of Rs 74 Lacs thereof
- Debtor's ledger was artificially inflated by Rs 5.15 Lacs
- Non existence of Delhi warehouse and transactions thereof
- Other Warehouse and leasehold properties were owned by the Country MD and rent charged to these properties were double than the prevailing market rates
- Unauthorized discount / commission to the customers
- Shortage of physical stocks as compared to shown in the books at Guagaon, Bhiwadi and Mumbai Warehouses.

Conclusion / Action Taken

- The company's business operations were lacking on good and control governance practices as everything revolves around the Country MD.
- The CFO and accounting custodians has not played the expected roles and acted as mere facilitators to the Country MD whereas they should and must have the ability to raise red flags when matters concerning internal controls are overlooked.
- Our findings clearly indicate that the company was a "One Man Show" operation which has led to poor organisation of internal control environment and financial indiscipline.
- Company has terminated the employment of the CFO on the basis of our findings and appoint a new finance and account management.
- Company has taken a legal actions against the country MD against fraudulent activities done by him.

Case Study – II

Background

- Audit Committee of a large public sector bank appointed a firm to conduct investigation of a case which apparently had staff accountability aspects.
- SSR was heading Bandra (West) Branch of a leading commercial bank. As Officiating Asst. General Manager, he was entitled to exercise all the financial powers in advances and general matters as that of the Asst. General Manager of the branch.
- SSR surpassed his authorities and conducted fraudulent activities at the bank in collusion with SSP, a trusted customer of the bank for over two decades.
- SSP had ambitious business plans and was involved in contracting business for Government entities and Public Sector enterprises.

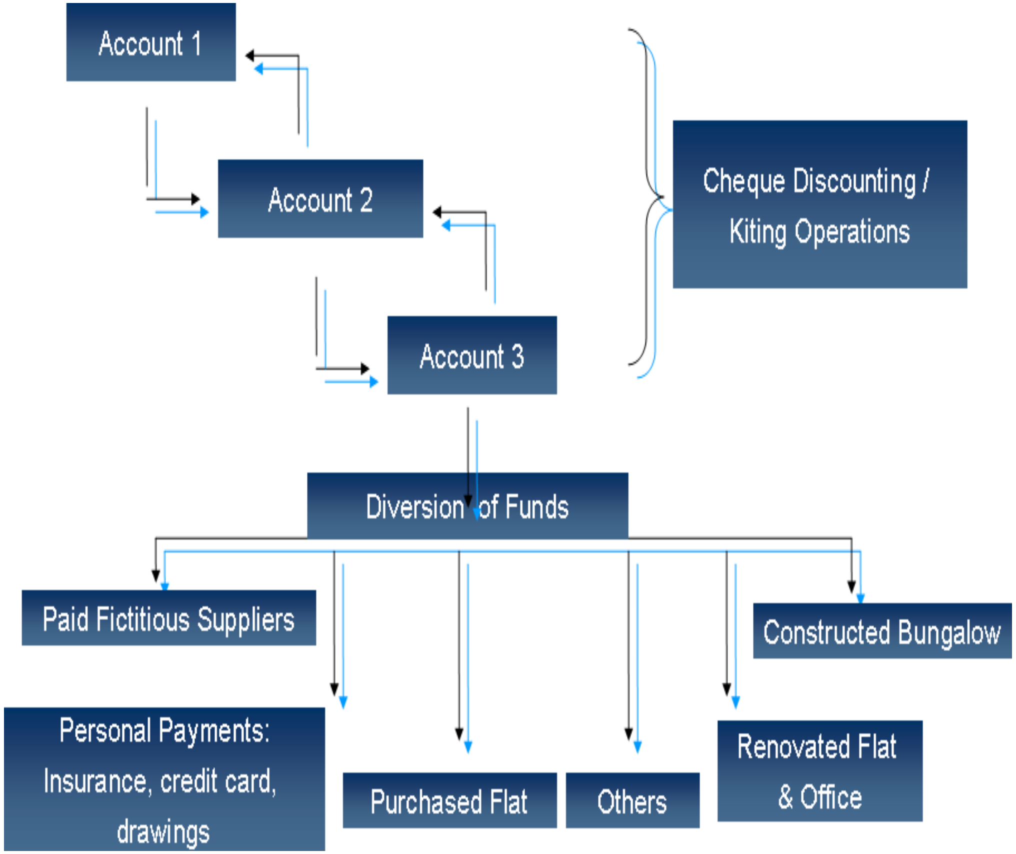
Approach and Methodology

- Interrogation and collection of evidences / written statement primarily of SSR as well as the interviews with key officials.
- Family profiling and assets tracing, including approaching different banks to determine the banking relationships of SSR and SSP.
- Interviews and discussions with Railway Officials, Income Tax Officers , Superintendent of Stamps & Registrar of Assurances , Various suppliers and labor contractor .

Case Study – A Fraud & Money Laundering Case

Modus Operandi – Diversion of Funds

- SSR had sanctioned various credit facilities to MEIL and MFSL. MEIL was sanctioned current account facility at Bandra (West), Jacob Circle Branch and Evershine Nagar Branch. DDP facility was granted to MEIL. The total of unpaid DD's came up to Rs. 1.15 Crores.



Recovery

•The Assets created out of diverted and siphoned money have been identified to the extent of 50-60% of the total moneys diverted.

•The balance was diverted for purchase of business assets such as machinery and inventory.

•Sources of Recovery include the property purchased by the fraudster and retirement funds of the branch manager.

Case Study – III

Background

- RBI directive to conduct special scrutiny of certain accounts and transactions which were classified as quick mortality cases in the RBI inspection.
- The 3 CBC Group of Companies had availed Letter of Credit and Corporate Loan Facilities from the Bank for export and import business of precious metals.
- Under these facilities, they had collectively defaulted on over 50 Crores. Apart from FD's the Bank could recover only 92 lacs.
- The rest of the securities had either no market value; or the charges had not been created at the ROC.
- As security, the company had pledged their Assaying Laboratory worth around 5 Crores. Although the charge was created at the ROC, the machinery was confiscated by the ECGC as they had first right.

Approach and Methodology

Background check:

- Firm and Promoters profiling, Personal interviews, Researching RBI data , Collecting information on default history of promoters and related entities , Purchasing Business Information Reports.

Analysis of:

- Pledged securities and their valuations, history enquiry and third party confirmations, L/C Transactions and underlying documents, determine the financial position of the Group Companies

Verification of:

- Account Statements to determine trail of money, Correspondence and credit proposals, Financial Statements, Site visit reports, Board of Directors relationships and resulting conflict of interest situations at the BOD level.

Case Study – A Quick Mortality Case

Modus Operandi – Diversion of Funds

•G availed a Corporate loan of Rs. 20 Crores for working capital purposes.

Cash Withdrawal
3.25 Crs

Payment of Loan
7.25 Crs

Transferred to various Associate Concerns
8.25 Crs

SN

Purchased goods from Sister Concern SI
2.49 Crs.

SI

Purchased goods from Sister Concern VT
19.99 Crs.

Purchased goods from Sister Concern VT
9.99 Crs.

Exported goods to a Sister Concern SF worth 22.83 and 12.63 Crores respectively

Subsequently defaulted on realization of these export bills

Control Lapses by the Bank

- Confidential reports from existing bankers were not obtained.
- Business information reports of suppliers and customers of entities were not obtained.
- The entities defaulting history with the various banks was not taken seriously
- The necessary charges for the securities pledged was not created at the Registrar of the Company.
- The Bank issued LCs with less than stipulated margin without adequate explanation.
- A holistic view of the group was not taken as an associate company had already defaulted with the Bank and was currently engaged in legal recovery process.

Root Causes – Large Value Frauds

- Inadequate Process Controls
- Physical verification of stock not done on regular period
- Undue dependence on country manager
- Disbursement of money / incentive without verifying the details
- Lack of in-depth scrutiny of books of accounts and ledgers

Reasons Behind Global Financial Crisis

- Collapse of US-sub-prime mortgage market
- Poor judgment by borrowers and/or lenders
- Speculation & overbuilding during the boom period
- Complex financial products & Risky mortgage products
- Inaccurate Credit Rating
- High personal and corporate debt levels
- Central Banks’ restrictive monetary policies in a number of countries
- Governments regulation or the lack of it
- Stock market volatility, downward currency values
- Moral Hazard, abundance of greed, & corruption

Global Crisis & its Impact on AML practices

Impact on AML in light of Current Financial Crisis

- Significant investment in AML systems and controls due to increase in transaction monitoring and staffing
- High Demand for forensic services, fields of fraud & litigation
- More risk-based AML programs
- Restructuring AML regime by centralization or outsourcing functions
- Advanced AML software systems

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Approach to AML and AFC in the current Scenario

Despite squeezed budgets, banks / Financial Institutions and Companies must streamline their prevention technologies, as reduced vigilance could create new openings for money launderers and fraudsters. Major trends noticed on current approach of corporate to manage Fraud and Money Laundering Risks:

- Organizations are combining their compliance, fraud, and security departments into **one single unit** to take care of similar risk areas and synergies benefits.
- The growing adoption of a risk-based approach to counter financial crime issues is driving the **use of technology to implement advanced deviation detection capabilities** and risk measurement techniques thus building more proactive than reactive measures
- Greater reliance on internal capabilities/staff vigilance and front line staff training
- Adopting a pro-active "What can go wrong approach" by the Internal Audit, Risk and compliance teams
- Greater scrutiny on work of Co-sourced work and audit firms
- Intelligent Data Analytics on historical trends, volume of activity and behavioral comparisons for identifying red flags
- Benchmark against global best practices
- Investigating exceptions

Designing & Implementing an AML Structure

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AML - Regulatory Oversight in India

The **Prevention of Money Laundering Act ,2002 (PMLA 2002)** was enacted and the detailed rules were framed there under, subsequently **PMLA rules 2005 came into force on July 01, 2005**.

Under the provisions of the act, **Financial Intelligence Unit (FIU)** was set up for coordinating AML effors in India.

All banks, financial institutions, financial intermediaries have to submit **CTR (Cash Transaction Report) and STR (Suspicious Transactions Report)** to FIU.

Certain **other regulatory bodies** regulating various types of business in the financial sector **have also laid down certain guidelines with regards to AML.**

List of Regulatory Bodies & their Broad Level Guidelines

Regulatory Bodies	Financial Institution	Guidelines
RBI	Banking	Know Your Customer' Standards Customer Acceptance Policy (CAP) Customer Identification Procedure (CIP) Monitoring of Transactions Risk Management Customer Education
SEBI	Stock Markets	Customer Due Diligence Record Keeping Retention of Records Monitoring of Transactions Suspicious Transaction Monitoring and Reporting Designation of an officer for reporting of suspicious transaction
IRDA	Insurance	Internal Policies, controls & procedures for prevention & detection of money laundering Establish procedure for KYC Create a risk matrix for various classes of customers Defining suspicious transactions Reporting the suspicious transactions as per prescribed formats & timelines to FIU Training of employees & intermediaries on AML related matters Internal audit to test AML framework & give suitable recommedations

AML Enterprise wide Implementation Program

Strategize
- Develop a AML strategy and policy in line with the Company's risk profile
- Identifying key stakeholders
- Understanding the reputational, regulatory, operational, technology risk factors through assessments
- Allocating a AML budget in line with the Risk Appetite and a fixed amount
- Recognizing the extended value chain – business partners, regulators, etc

Implement
- Assigning key individuals to manage initiatives
- Training staff to ensure successful delivery of the programs
- Developing a detailed plan of action
- Setting both qualitative and quantitative targets
- Ensuring stakeholder engagement
- Creating awareness on the AML policy

Report and Evaluate
- Ongoing and transparent monitoring of the initiatives
- AML reporting according to standards such as FIU, RBI, etc
- External and Internal evaluations
- Assessing the completion of targets
- Benchmarking initiatives with other industry leaders

AML - Key Indicators

Record Keeping & Alerts monitoring - Transactions & Suspicious Transactions Reports

Electronic Funds Transfer Reports

Terrorist Property Reports

Customer , Vendor, Employee Identification Rules

Employee training

AML Monitoring Structure

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THANK YOU!

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