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Know Your Correspondent's Correspondent

International financial institutions will have to ask more questions as the Hong Kong Monetary Authority strengthens the regulatory regime.

In the past few years, we've seen intense pressure from regulators to crack down harder on money laundering abuses within the Hong Kong financial system. As one of the leading international financial centers, Hong Kong has long been perceived as a weak link in the global regulatory system. However, that reputation started to improve in 2013-2014 with the efforts of the Hong Kong Monetary Authority to improve the integrity of the financial system. These initiatives appear to be leading to what many say could be a watershed year for Hong Kong in 2016 as the territory moves toward further increasing the enforcement of its renewed regulatory regime. As the chief stepping stone between China and the rest of the world, Hong Kong represents a strategic clearing hub between east and west. Due to this position, there is pressure to ensure that integrity and trust remains in the network – especially with the further liberalisation of the Chinese renminbi in 2016. Thus, the HKMA has put specific emphasis on correspondent banking relationships to ensure that financial institutions are not only properly onboarding and monitoring their correspondent banks from an ownership and news perspective, but that they are also better monitoring transaction flows between the banks. This process is commonly referred to as "Know Your Correspondent's Correspondent" ("KYCC")

KYCC is emerging as an important global consideration for financial institutions – not only with respect to awareness of how their correspondents trade from a geographic and business type perspective, but also with respect to how correspondent's correspondents are trading. This requires an extra level of sophistication and more time dedicated to reviewing KYCC data and how money involved in transactions is flowing. Some of the considerations to be reviewed include whether or not the correspondent bank is receiving and sending the correct mix of international transactions, and are the business areas served continuing to fit the appropriate profiles.

Trade finance transaction issues are closely aligned to correspondent banking issues, as most trade finance transactions require a correspondent banking relationship to complete them. Hong Kong, like Singapore, is a hub for global trade and the regulators are ratcheting up their attention in this area. Singapore has just released AML guidance related specifically to trade transactions and the HKMA is expected to do so as well in early 2016.

Additionally, we have seen a general push specifically related to sanctions screening for entities and vessels. This screening has moved into screening so-called "Dual Use Goods" ("DUGs"). DUGs are products which usually have restrictions attached to them on where and how they may be traded – usually military vs. peaceful uses. Uranium is an example of this type of product. For most countries, Uranium needs to be traded to power nuclear power plants, but for certain countries (such as North Korea) Uranium trade is banned as the Uranium could be used to produce nuclear weapons. Therefore trade financial organizations need to look at both the product and where the product is going to ensure sanctions are not being broken.

Another sophisticated area of trade finance is over and under invoicing. Over invoicing is a basic type of money laundering used to hide proceeds of criminal activities by portraying the transfer of funds as legitimate trades. For example, a criminal in China may want to move US$50mn of illegally gained funds out of the country. This individual would agree to buy US$50mn worth of timber from a friendly timber company in the United States (often this friendly company is owned by the same individual through a series of anonymous holding companies). On paper, the individual would complete the transaction, perhaps for one tonne of timber. The money is transferred, but in fact no timber is ever delivered. So while it appeared to be a legitimate trade, in fact it was just a way to launder money.

Under invoicing is another way to get around import/export duties, VAT and other tax regimes. In this scenario, an importer may be bringing in 10 luxury automobiles valued at US$100,000 each. However, they are declared with a value of US$40,000 on the paperwork associated with the trade. Thus, US$60,000 is undeclared and the tax monies are lost to the government.

While these are easy examples to understand, the detection of these schemes within financial institutions is quite difficult. In the timber example, the financial institution will not only be asked to uncover the beneficial ownership structure of the parties trading, but also to determine if US$50mn is an appropriate price for one tonne of timber. And in the automobile example, they would need to determine if the cars are being declared at their appropriate value. This is what regulators will expect from financial institutions moving forward.

We believe that the regulatory regime in Hong Kong will only get more stringent and sophisticated over the coming years and will be marked with significant enforcement actions against financial institutions that do not adhere to the strengthened HKMA regulations. The time is now for financial institutions to begin to evaluate systems which can uncover complex money laundering operations, ensuring that all appropriate data and information is auditable and is able to demonstrate to the HKMA that the appropriate due diligence and monitoring has been executed.

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