

WHITE PAPER

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PEPs

IDENTIFY, CLASSIFY, RISK RATE & STORE?

Written by Cameron McNeill

London:

6th Floor
125 Old Broad Street
London, EC2N 1AR,
United Kingdom

Tel: +44 845 658 0008

New York:

19 W34th Street,
Suite 1018,
New York, NY 10001,
USA

Tel: +1 646 828 8264

Frankfurt:

1st Floor, An der Welle 4,
Frankfurt am Main
60322,
Germany

Tel: +49 69 75938410

Edinburgh:

9-10 St. Andrew Square,
Edinburgh,
EH2 2AF,
United Kingdom

Tel: +44 131 281 2131

Dublin:

Ground Floor,
One Georges Quay
Plaza,
Dublin 2, Eire

Tel: +353 1 9073297

Paris:

Club Buro Vendome,
5 Rue de Castiglion,
75001,
Paris, France

Tel: +331 5345 1063

For more information please contact us at: info@lysisfinancial.com

The following insight investigates the topic of Politically Exposed Persons (PEPs) and how they are identified, classified, risk rated and electronically stored in both the UK and across Europe.

It is our view, based on our experience in this sector, that many firms are wrongly classifying individuals as PEPs and failing to take the opportunity to rate most UK PEPs as low risk, so saving significant time and money in their screening processes. By acknowledging and utilising some of the following insights, we believe that financial services organisations will also avoid the reputational and other risks of complaints to the Financial Ombudsman Service concerning PEP status.

We believe firms should seize this opportunity to undertake a radical review of policies and procedures regarding the definition of PEPs and the correct classification of risk on a case-by-case basis.

Lysis Financial is a specialist in Client Due Diligence (CDD) and can help firms in several ways including:

- Help to evaluate and amend a firm's approach to PEP classification
- Assistance choosing, testing and validating PEP screening tools
- Revising policies, procedures and risk frameworks with regards to PEPs and;
- Running the client due diligence process as a fully managed service

When is a PEP not a PEP? `

Background

As background, it is worth noting that for years firms have been regarding both UK and non-UK citizens as PEPs, although the formal situation from 2007 until 2017 was that only a non-UK citizen could be correctly classified as a PEP. The fourth money laundering directive changed all that in June 2017 by including UK citizens as PEPs.

The Walker amendment

This change caused widespread outrage in Parliament and a back-bench backlash was led in the House of Commons by Charles Walker MP (a senior back bencher). In a Commons debate he famously said that UK PEPs were being treated like 'African despots'. Many other MPs had anecdotal evidence regarding individuals wrongly classified as PEPs and of firm's insensitive treatment of even long-standing customers. One Government minister gave evidence of the egregious and unlawful behaviour of individual PEPs who were citizens of non-EU third countries which did not have an equivalent AML jurisdiction.

Mr Walker put forward the now significant Walker amendment, which resulted in highly prescriptive changes to the Bank of England and Financial Services Act 2016 and the content of the FCA guidance on the treatment of PEPs. Its purpose was to ensure that UK PEPs were to be regarded as low risk. The amendment was passed in full.

Mandatory Provisions

The Walker amendment ensured that:

- Recognition that classification of an individual as a PEP was preventive not criminal in nature
- The Money Laundering Regulations 2017 recite in detail prescribed provisions in the fourth money laundering directive which embed the risk-based approach
- Clarity would be given to the definition of what constitutes a prominent public function in the UK
- Recognition would be given to the situation where a PEP has ceased to hold a prominent public function but was still subject to EDD for a year
- The FCA had to issue guidance to obliged entities which reflected the detail of the risk-based approach adopted by the directive as set out in detail in the regulations
- An FCA administered complaints and compensation scheme

Following the proposed Walker amendment, as a result the FCA produced new guidance (*The treatment of politically exposed persons for anti-money laundering purposes [FG17/6] July 2017*) which was mandated in highly prescriptive terms both by statute and by the Money Laundering Regulations 2017. The guidance seeks to define and restrict the number of individuals who can correctly be defined as a PEP in the UK ('1.6 ... firms should only treat those in the UK who hold **truly prominent positions** as PEPs ...it is unlikely ... that a large number of UK customers are PEPs').

Status of the FCA guidance

Despite the lack of approval by HM Treasury, the guidance is statutory insofar as its publication was mandated by statute and the regulations.

'2.3 This guidance has **not** been approved by the Treasury ... However, Regulation 35(4)(b) states that firms may **take into account any guidance that has been issued by the FCA.**'

Our estimate of the number of UK PEPs

Based on our own analysis and the revised definitions, our conclusion is that there are now probably about 2,367 genuine PEPs in the UK (unknown marital status) plus 136 accredited diplomatic spouses. Our estimate otherwise excludes family members and close associates. This estimate was conducted as desk research over the course of a day using publicly available on-line sources. It identified 80% of those with prominent public functions in the UK by name with the remaining 20% based on assumptions.

To calculate these numbers, a starting point is that PEPs in the UK and equivalent jurisdictions are low risk, based on the following items within the FCA guidance:

1. Use of a risk-based approach:

'2.5 Firms should **only** take measures beyond this guidance where:

- this is justified on the basis of their risk assessment
- risk factors are associated with that customer **unrelated** to their position or connection to a PEP'

'2.10 [For PEPs] ... a case by case assessment and **not** an automatic assessment that [there is] ... a **high risk** of money laundering.'

2. *Minimum approval level for senior management approval:*

The FCA define the required senior management approval as being **at least** at the CF11/SMF11 MLRO role. In our view, this level of approval is appropriate for all UK (and equivalent jurisdiction) PEPs except where a higher degree of risk is identified '**unrelated** to their position or connection to a PEP'.

3. *UK definition of prominent public function:*

At 2.16 of the guidance, the FCA sets out a prescriptive list of which prominent public functions in the UK qualify as PEPs mapping onto the list at regulation 35(14). This list is set out in full at the end of this paper(*) along with our estimate of how many individuals are covered by each category (not including family members or close associates).

EU definition of prominent public function

It is notable that this exercise is to be mirrored at the EU level with lists which define prominent public function for each Member State.

4. *Specific disapproval of 'Once a PEP always a PEP' policies:*

The guidance makes it clear that a PEP who no longer holds prominent public function should only be considered a PEP for **a further 12 months (and no longer) except** where there is an assessment '*that PEP as posing a higher risk.*'

5. *Treatment of family members and close associates:*

However, the guidance states '*This does **not** apply to family members, who should be treated as ordinary customers ...*'. There is to be no 12-month extension for family members. Nothing is said about a PEP's close associates but our view is that it is safe to assume that they should be treated on the same footing as family members.

In our view, firms that don't immediately treat relatives and close associates as ordinary customers, the moment the PEP is no longer a PEP, will face complaints to the Ombudsman. This would not be the case when there are other risk factors not related to the former status of the PEP.

*'2.29 ... A PEP ... in the UK should be treated as low risk, unless a firm has assessed that other risk factors **not linked to their position as a PEP** mean they pose a higher risk. ...'*

6. The guidance is for a 'light touch' approach:

'2.35 ... in lower risk situations a firm may ...

- *... make **no** enquiries of a PEP's family or ... close associates **except** those necessary to establish whether such a relationship does exist.*
- *Take **less intrusive and less extensive steps** to establish the source of wealth and source of funds ...*
- *... less frequent formal review ...'*

7. *FCA definition of family member:*

Family member is defined at regulation 35(2) as including:

- Spouse or civil partner of the PEP
- Children of the PEP and their spouses or civil partner

- Parents of the PEP

This list is not exhaustive and surprisingly the FCA extend it to include the brothers and sisters of a PEP.

8. *Complaints and compensation*

Individuals who have been either:

- A **Incorrectly** classified as a PEP, a family member of a PEP or close associate of a PEP
- or
- B **Correctly** classified as a PEP, family member or close associate and who wish to complain about an act or omission by a firm as a result may now apply to the Financial Ombudsman Service (a subsidiary of FCA) for compensation.

Our recommendations

It is our strong view that firms are neglecting the opportunity to reduce the costs of client due diligence by ignoring the clear signals given by FCA in its guidance that:

- mandate the adoption of a restrictive approach to the definition of who holds a prominent public function in the UK
- encourage a reduction in the risk ratings given to PEPs in the UK and equivalent jurisdictions

Firms should seize this opportunity to undertake a radical review of policies and procedures regarding the definition of a PEPs and the correct classification of risk on a case-by-case basis. PEPs can be low risk.

It is our view, based on our experience in this sector, that many firms are wrongly classifying individuals as PEPs and failing to take the opportunity to rate most UK PEPs as low risk so saving time and money.

Firms will also avoid the reputational and other risks of complaints to the Financial Ombudsman Service concerning PEP status

The regulatory risk is low if the review of risk policies and procedures is adequately documented with reference to the appropriate guidelines

() FCA guidance on who holds a prominent public function in the UK*

Emphasis added in bold to highlight the FCA guidance – our estimates of numbers is in square brackets

'Who should be treated as a PEP?'

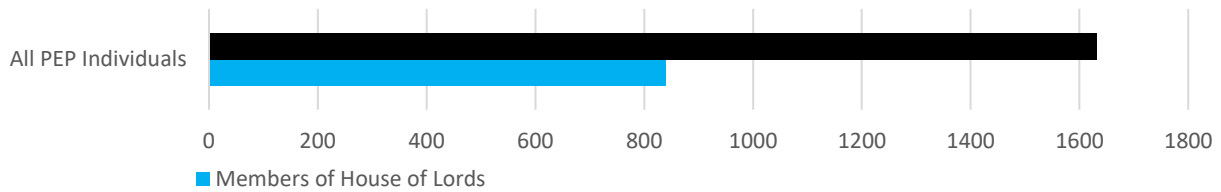
2.16 PEPs are defined as individuals entrusted with prominent public functions, including:

- heads of state, heads of government, ministers and deputy or assistant ministers

[In the UK all these individuals are also 'members of parliament or of similar legislative bodies']

- members of parliament or of similar legislative bodies – ***similar legislative bodies include regional governments in federalised systems and devolved administrations, including the Scottish Executive and Welsh Assembly, where such bodies have some form of executive decision-making powers. It does not include local government in the UK but it may, where higher risks are assessed, be appropriate to do so in other countries.***

In the UK there are 1631 individuals meeting this definition plus 839 members of the House of Lords. Ministers are always MPs or members of the House of Lords. The convention is that non-Parliamentarians who are appointed as ministers become members of the House of Lords.



- members of the governing bodies of political parties – ***the FCA considers that this only applies to political parties who have some representation in a national or supranational Parliament or similar legislative body as defined above. The extent of who should be considered a member of a governing body of a political party will vary according to the constitution of the parties, but will generally only apply to the national governing bodies where a member has significant executive power (eg over the selection of candidates or distribution of significant party funds).***

[In the UK this is about 20 political parties so our estimate is between 40-60 individuals]

- members of supreme courts, of constitutional courts or of any judicial body the decisions of which are not subject to further appeal except in exceptional circumstances – ***in the UK this means only judges of the Supreme Court; firms should not treat any other member of the judiciary as a PEP and only apply EDD measures where they have assessed additional risks.***

[There are 12 members of the UK Supreme Court]

- members of courts of auditors or of the boards of central banks

[The Bank of England has 12 directors]

- ambassadors, charges d'affaires and high-ranking officers in the armed forces – ***the FCA considers this is only necessary where those holding these offices on behalf of the UK government are at Permanent Secretary/Deputy Permanent Secretary level, or hold the equivalent military rank (eg Vice Admiral, Lieutenant General, Air Marshal or senior)***

[In the UK there are about 190 diplomats accredited at this level with 136 spouses - there are 43 senior civil servants and 13 high-ranking officers in the UK armed forces]

- members of the administrative, management or supervisory bodies of State-owned enterprises – ***the FCA considers that this only applies to for profit enterprises where the state has ownership of greater than 50% or where information reasonably available points to the state having control over the activities of such enterprises***

[Our estimate is that there are no more than 30 state-owned enterprises in the UK (broadly defined)]

- directors, deputy directors and members of the board or equivalent function of an international organisation – ***the FCA considers that international organisations only includes international public organisations such as the UN and NATO. The Government made clear in their consultation of 15 March 2017 that they do not intend this definition to extend to international sporting federations.'***

[Our estimate is that there are no more than **35** international organisations in the UK (defined as those accredited by the Foreign and Commonwealth Office) – the number will reduce after the UK leaves the EU]

There are about 30 state-owned enterprises (SOEs) in the UK some of which will be excluded under the ‘for profit’ proviso in the guidance. The formal definition includes ‘members of the administrative, management or supervisory bodies’ of SOEs and we have not researched this.

[Our estimate that no more than 20 will be ‘for profit’ with an average board of ten individuals so **200** PEPs.]

As far as international organisations are concerned the guidance states that ‘only ... [organisations]... such as the UN and NATO’ qualify.

[Our approach is to assume that only 15 of the 35 international organisations accredited by the Foreign and Commonwealth Office would meet that requirement with an average board of 15 individuals so **225** PEPs.]

FCA Finalised Guidance on PEPs [FG17/6] can be found at:

<https://www.fca.org.uk/publications/finalised-guidance/fg17-6-treatment-politically-exposed-persons-peps-money-laundering>

References

Fourth Money Laundering Directive [(EU) 2015/849]

Financial Services and Markets Act 2000 Part 20C and s333U

Bank of England and Financial Services Act 2016 s30

Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 [SI 2017/692]

The treatment of politically exposed persons for anti-money laundering purposes [FCA FG 17/6] 11 July 2017

Fifth Money Laundering Directive [(EU) 2018/843]