Bysaga K.,
Ivano-Frankivsk National Technical University of Oil and Gas, Ukraine

THE INTERNAL CONTROLS IN THE UK BANKS: THE STRENGTHS SIDES AND THE MAJOR PROBLEMS THAT THEY FACED IN COMPLIANCE WITH ANTI-MONEY LAUNDERING REGIME AND POSSIBLE REFORMS THAT COULD IMPROVE THAT

Abstract. Nowadays, money laundering and avoiding of international sanctions orders are global problems. The zone of an increased risk is banking because of its extensive system. This is because, firstly, it is a unique arena of struggle for the redistribution of property, which involves both 'clean' and 'dirty' money. Secondly, 'laundered' money is usually placed in bank accounts, which are often open to figureheads people, with fictitious names or on behalf of persons acting on behalf of the beneficiaries. A typical tendency is to use the official representative offices of foreign banks for transactions with revenues from the criminal activity. Every country tries to deal with the problem of money laundering by providing anti-money laundering regime and implementation of strict oversight by the supervisory authorities. Beyond the legal norms that exist in the UK, each bank has its own instructions of internal controls and measures with which banks deal every day.
Keywords: internal controls, banks, money laundering, risk, customers, management, information, instruction.

The internal controls and measures that a bank should have in place to avoid money laundering may have a different internal structure, however, basic conditions are that they must comply with two essential requirements. These requirements are: reporting about the suspicious activity and keeping record of all transactions that taking place in the bank. According to the Article 330 Proceeds of Crime Act, the bank is bound to disclose information about the client if there is suspicion that the client could be involved in money laundering; the reasonable information should be disclosed to the responsible person, who should take an appropriate action. If the demands are not fulfilled criminal liability and civil penalties may occur[1].

Besides, according to Articles 20, 21 of the Money Laundering Regulations, a relevant person of the bank must create and retain appropriate and risk-sensitive policies and procedures in order to prevent money laundering[2]. These policies and procedures should include: appointment of the relevant officials; be sure that employees know to whom and how to report any suspicious activity; ensure that managers have enough information about money laundering risks; training of employees regarding the question of anti-money laundering and their obligations; documenting anti-money laundering policies and procedures; take relevant steps and ensure that the risk of money laundering considered in the day-to-day management[3].

As an example, the internal controls and measures of the HSBC bank will be considered below. It can be assumed that such a system of internal control exists in all banks. There may be differences in the internal controls and measures that a bank should have in place to avoid money laundering, but the principles of their activities remain the same. The HSBC is a large bank in the UK (and has branches all over the world), which was involved in several money laundering cases, and it will be interesting to look to its internal control. HSBC's internal control procedures include the following bodies and measures: group standards; delegation of authority within the limits set by the Board; risk identification and monitoring; monitoring the changes in

[1] *Proceeds of Crime Act* (2002) c.29. < http://www.legislation.gov.uk/ukpga/2002/29/contents>
[2] *Money Laundering Regulations* (2007) No.2157. < http://www.legislation.gov.uk/uksi/2007/2157/contents/made>
[3] HM Revenue & Customs, *Anti-money laundering guidance for money servicebusineses* (2010) <http://www.hmrc.gov.uk/mlr/mlr_msb.pdf> (2015, April, 2)

market conditions/practices; strategic plans; disclosure Committee; financial reporting; responsibility for risk management; IT operations; functional management; CEO attestation process; internal audit; internal audit recommendations; reputational risk; operational risk. All these departments and processes have the main goal to protect the bank from money laundering. All these procedures superficially describe what takes place as the internal control in the bank, it is clear that the true effect of these actions and rationality will never be in the public domain.

After analyzing the above internal system it is possible to say that the main role is played in the HSBC by the following functions, which have the direct impact on the situations of how to avoid money laundering. The first is 'risk identification and monitoring', which include control and report on risks and elaboration of an appropriate strategy. The second is 'changes in market conditions/practices'. This internal control function is closely connected with the previously mentioned method, as it is focused on identifying new risks that are arising from the changes in the business world. The third is 'responsibility for risk management', that is focused on the internal control model and its weaknesses. The last is 'reputational risk', which is an integral part of the internal control system. It focuses on curbing money laundering,, counter-terrorist financing, the impact on the environment, the fight against bribery and corruption measures and labour relations. This system of internal controls on prevention of money laundering is based on the principles of checks and balances. The analysis of the internal system of HSBS does not give a detailed description, this is understandable, because the bank will not reveal its inner secrets to the third parties[4].

As any rules, the internal controls and measures have their own strengths and weaknesses that respectively represent a positive or negative attributes. If take into account the activities of banks that are operating in the United Kingdom it is possible to make the following conclusions. The strengths sides of the internal controls and measures manifested in the next examples of good practice. It provides risk assessment on the activities of customers, especially regarding politically exposed persons (PEPs). Carries out detailed examination of suspicious customers. Ensures completion of internal databases with necessary information that allows to avoid problems with money laundering in the future. Provides a detailed analysis of sources of the wealth of the client. Availability of reports on high-risk money laundering, performed the analyses and investigation of credible messages about the criminal activity. Internal control creates a clear judgment about the risk of money laundering that are not compromised by the potential profitability of new and existing relationships. In general the internal controls and measures of the bank are characterized as an effective anti-money laundering process and preservation of customer information.

It is not surprising, that the internal controls and measures are subject to harsh criticism. Since each time it fails somewhere and the bank becomes involved in money laundering. The problems of the internal controls and measures that a bank should have in place to avoid money laundering are different that thereby showing their weakness. The internal control in banks does not pay proper attention to certain political relations of the client. In different bank branches there could exist various internal control systems against money laundering. Inadequate analysis of documents and available information. There is also present banal lack of documentary evidence why the client was within the limits of risk of money laundering. An excessive dependence on undocumented relations, relying only on the fact that the client has long relationships with the bank. Also, in banks there is a present inappropriate use of information that leads to lack of information about the sources of wealth of the client, with little or no evidence to check that the wealth is not related to sphere of crime and corruption. Failure to correctly process the available information and assess the risks. The next issue is the problem that arises from the work on offshore transfers, because usually these payments pose a threat. The disregard to the warnings that the client has a connection with criminals, that is often characterized as negligence on the part of bank employees[5]. One of the problems that banks met is the conflict between their duty of confidentiality and obligation that they must report suspicious transactions.

The weakness of the internal controls and measures that a bank should have in place to avoid money laundering is a serious and persistent problem encompassing banks of all sizes. Sometimes small banks are unable to collect detailed information as it is required by law. In its turn, larger and more successful banks process information adequately, but cannot evaluate it properly[6].

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[4] *HSBC website, Internal control.* <http://www.hsbc.com/investor-relations/governance/internalcontrol> (2015, April, 1).

[5] *Banks' management of high money-laundering risk situations.* (June, 2011). Financial Service Authority Review. <http://www.fsa.gov.uk/pubs/other/aml_final_report.pdf> (2015, March, 31).

[6] *Anti-money laundering annual report 2012/13,* (July, 2013). Financial Conduct Authority. <http://www.fca.org.uk/static/documents/anti-money-laundering-report.pdf> (2015, April, 20).

Over the half of banks, that the Financial Conduct Authority visited, were unable to use significant enhanced due diligence measures in higher risk situations and as a result were unable to determine or record adverse information about the client. The particular concern is the fact that some banks, even when they were aware of the possible damage, still did not take any adequate steps to determine the origin of the funds that would be used for the transaction. Some banks had inadequate security measures regarding the internal management. There are situations where managers are quite aware about the client and render a subjective decision about customer's financial activities. Unfortunately, there are still present facts that these managers receive rewards because of the profit that they brought to the bank, regardless of their performance against money laundering.

Moreover, a number of major banks in the United Kingdom did not give enough attention to the money laundering red flags in agreements on trade transactions. Some banks still cannot provide adequate controls to detect potentially suspicious transactions. Also, there were situations, when the bank's staff inadequately used the information about the client. The main cause of these problems is often a failure to manage risk of money laundering, which leads to inadequate anti-money laundering internal control.

Furthermore, a number of banks have no opportunities to identify unusual or high risk transactions. Although, banks do not want to reject transactions unreasonably because they will lose their income. However, all these flaws seem not so significant in comparison with the fact that the Financial Conduct Authority identify in their investigation in 2013[7]. It was found out that seven banks did not require staff to consider the risk factor of money laundering when they were dealing with transactions.In addition, the internal controls and measures that a bank should have in place to avoid money laundering faced with the other factors, such as: dealing with not face to face business, corruption, powerful clients, offshore companies[8].

In fact, there are general warning signs on which banks should pay attention when they are dealing with the customer and transaction. The process of money laundering developing every day and try to find new ways to circumvent the control systems from the side of banks. That is why, banks should pay attention to the following situations: client refuses to have face-to-face contact; client tries to give unusual instructions or change them very frequently; the transfer of large amounts of cash; transactions come or will go to or will come from the suspect territory[9].

There are two possible ways in which the internal controls and measures that a bank should have in place to avoid money laundering could be improved and have more effective compliance with the UK anti-money laundering regime. The first way is an internal improvement of the existed controls and measures. The second way is possible reforms that might improve the situation and stop banks from participating in money laundering.

The banking sector is a fast growing market. Despite this, banks must not forget that they should have appropriate anti-money laundering systems and controls, and they should understand the need for compliance with the legislation on anti-money laundering. In general, in recent years, banks have developed effective mechanisms for monitoring to counter with money laundering. However, some mechanisms and procedures are rather weak and inadequate.

In order to improve the performance of banks to identify suspicious transactions that may relate to the 'dirty money' banks should take the following steps. Create (if it still does not exist) or improve the response of the crisis management teams. It should consist of a good anti-crisis team. This team should be able to analyze the existing problems, carry out the analysis of the main causes and make recommendations to other departments of internal control. The reputation risk management committee also should be present, because the reputation of the bank plays one of the main role in anti-money laundering sphere. This committee ensures the connection full cooperation between interested parties and regulatory authorities[10].

Also, banks should improve their customer due diligence process. The information about the client must be recorded correctly. Any new information regarding the client must be preserved and remain within the bank. Besides, banks should remember about the efficiency improvement, in particular, a system of notification of

[7] *Bank's control of financial crime risks in trade finance.* (TR13/3, July 2013). Financial Conduct Authority. <http://www.fca.org.uk/static/documents/thematic-reviews/tr-13-03.pdf> (2015, April 4).

[8] *Anti-Money Laundering and Anti-Bribery and Corruption Systems and Controls: Asset Management and Platform Firms,* (TR13/9, October 2013). Financial Conduct Authority. <http://www.fca.org.uk/yourfca/documents/thematic-reviews/tr13-9> (2015, April, 14).

[9] The Law Society. *Anti-money laundering. Practice note.* (October 2013), 137.

[10] Venkatesan Govindaraja and Amit Das. *10 steps banks should follow to ensure a robust anti-money laundering process.* (2 July 2013). <http://www.informationweek.in/informationweek/news-analysis/178980/steps-banks-follow-ensure-robust-anti-money-laundering-process> (2015, April 20).

suspicious transactions. Usually, this system is quite stable, but sometimes it fails when under suspicious activity falls quite a lot of customers and the bank is not able to handle it properly. Each bank knows its own violations of anti-money laundering regime in the sphere of notification. Thus, reduction of inaccurate suspicion signals could improve processing of existing threats. Furthermore, banks should improve their data review. The database which the bank uses should be the only one. The gap between enterprise systems leads to failure in detection against money laundering.

Most banks need to conduct considerable work of their internal control in order to take into account all the financial risks. Stuff that are responsible for risks that are connected with money laundering should have better training in order to easily identify potentially suspicious transactions. All banks need to improve the management sphere, thus that senior management knew the risks of financial crimes.

In addition, all banks should publicly declare that they will work to prevent money laundering. For instance, as a Mizuho Bank Ltd did it. The bank announced its anti-money laundering policy on the official website. Mizuho Bank has declared that it will provide customer due diligence, provides measures for freezing assets, provides reports of suspicious transactions, will train employees in matters related to the prevention of money laundering and will check the adequacy of the Anti–Money Laundering Policy and compliance with the Policy, and frequently improve internal controls based on the outcomes of these checks. It will not stop the money laundering through banks immediately, however, it could be a psychological factor that would indicate that the bank is open in its policy and indicates that it is fighting against money laundering[11].

Concerning improvements in legislation, it is hard to not agree with the words of John Mann MP. He mentioned: 'The British Parliament should instigate an unbiased and far reaching investigation into money laundering in Britain, involving British banks and the endangering the well being of British interests and the British people'[12]. Only a strict control from the government could help to minimize the participation of banks in money laundering in the future. Perhaps, it would not solve the problem, but could help to understand the major gaps in the internal controls and measures of the banks.

Nowadays, banks are trying to keep up with current regulations for anti-money laundering. However, banks need to develop their resource plan for the years ahead, and, usually, because of this, they cannot predict some risks related to money laundering. What was effective ten years ago, now is useless. To ensure that banks work within the legal framework there should be the appropriate control of the government. As Malcolm Taylor (London-based director at software provider BankersAccuity) mentioned, that regulators should be involved in greater scrutiny of banks' anti-money laundering systems and continue to punish violators with large penalties. Such inspections should also be focused on the board members of banks in order to verify that they are using all necessary precautions regarding the proper functioning of the bank[13].

All further reforms in the UK legislation should be based on a fair assessment of the current problems of money laundering through the banks. Thus, it is necessary clearly identifying whether there is possible a particular revision of existing standards or adoption of the new norms is required. Besides, should not forget that the penalties and public exposure that the bank was involved in money laundering, do their work and causing significant blow to the bank's reputation[14].

The process of money laundering is a threat to the overall economic development of the territories and countries that refuse to have strict control on this type of international criminal activity. Uncontrolled inflow and outflow of large amounts of 'dirty' money has the potential to destroy the national economy of the country. The excess of cash flows that fall in circulation, distort the demand for currency, interest rates and, thus, lead to inflation. The outflow of billions of pounds per year from the economic system threatens not only the stability and development of the national economies, but also to the financial system in general.

Banks should consider that the risk of money laundering exists during the whole period of the transaction. A good practice for banks will be the possibility to assess each money transfer promptly and monitor subsequent transactions. In the case of any suspicions about possible involvement of a given transfer to the field of money laundering, as soon as possible need to report such incident to officials in order to be able to stop payment.

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[11] *Anti-money laundering policy.* Mizuho Bank website. <http://www.mizuhobank.com/uk/laundering/index.html> (2015, April, 20).

[12] Mann, J. *Money Laundering: Time for a UK Inquiry.* <http://www.johnmannmp.com/money-laundering-time-for-a-uk-inquiry> (2015, March, 20).

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In most banks during the process of staff training not enough attention is given to the factors and risks that are associated with money laundering, that is why, there are low levels of prevention of money laundering.

It is important that all banks kept appropriate records in order to show that internal controls and measures were conducted effectively. If banks do not keep such records, it will be difficult to demonstrate that there is compliance with internal standards and to prove the fact that during the entire activities of the bank there was an effective management against money laundering.

It was found out that the internal control of anti-money laundering is varied and depends on different aspects, for example, bank's size. On the one hand, some banks know their obligations and try to meet them; on the other hand, some banks need to improve their internal controls and measure. Nevertheless, there is still a lot of work for most of the banks.

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12. *Proceeds of Crime Act* (2002). s.29. <http://www.legislation.gov.uk/ukpga/2002/29/contents>

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