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Anti-money laundering (AML) regulation and implementation in Chinese financial sectors: money-laundering vulnerabilities and the 'rule-based but risk-oriented' AML approach

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**ANTI-MONEY LAUNDERING (AML) REGULATION AND
IMPLEMENTATION IN CHINESE FINANCIAL SECTORS:
MONEY-LAUNDERING VULNERABILITIES AND THE ‘RULE-BASED
BUT RISK-ORIENTED’ AML APPROACH**

A thesis submitted in fulfilment of the
requirements for the award of the degree

DOCTOR OF PHILOSOPHY

from

UNIVERSITY OF WOLLONGONG

by

Lishan Ai

Bachelor in Economics (Wuhan Institute of Technology, China)

Master in Transnational Crime Prevention (University of Wollongong, Australia)

FACULTY OF LAW

2012

CERTIFICATION

I, Lishan Ai, declare that this thesis, submitted in fulfilment of the requirements for the award of Doctor of Philosophy, in the Centre for Transnational Crime Prevention, Faculty of Law, University of Wollongong, is wholly my own work unless otherwise referenced or acknowledged. The document has not been submitted for qualifications at any other academic institution.

Lishan Ai

8 March 2012

DEDICATION

This dissertation is dedicated to my parents,

Professor Jun Ai and Associate Professor Peijun Li

ABBREVIATIONS

ABC	Agricultural Bank of China
AI	Artificial Intelligence
AML	Anti-Money Laundering
AMLB	Anti-Money Laundering Bureau
AMLD	Anti-Money Laundering Disclosure
APG	Asia/Pacific Groups on Money Laundering
ATM	Automated Teller Machine
AUSTRAC	Australian Transaction Reports and Analysis Centre
BBC	British Broadcasting Corporation
BCBS	Basel Committee on Banking Supervision
BIM	Bank Insurance Model
BMI	Business Monitor International
BOC	Bank of China
CAMLMAC	China Anti-Money Laundering Monitoring and Analysis Center
CBA	China Banking Association
CBRC	China Banking Regulatory Commission
CCAMLS	China Centre for Anti-Money Laundering Studies
CCB	China Construction Bank
CCTV	China Central Television
CDB	China Development Bank
CDD	Customer Due Diligence

CEO	Chief Executive Officer
CIP	Customer Identification Program
CIRC	China Insurance Regulatory Commission
CIS	Commonwealth of Independent States
CMB	China Merchants Bank
CNY	Chinese Yuan
CPI	Corruption Perception Index
CSR	Corporate Social Responsibility
CSRC	China Securities Regulatory Commission
DNFBP	Designated Non-Financial Business and Professions
DV	Dividing Value
EAG	Eurasian Group on Combating Money Laundering and Financing of Terrorism
EDD	Enhanced Due Diligence
EFTPOS	Electronic Fund Transfer at Point of Sale
EITI	Extractive Industries Transparency Initiative
FATF	Financial Action Task Force
FDI	Foreign Direct Investment
FEP	Financially Exposed Person
FFIEC	Federal Financial Institutions Examination Council
FI	Financial Institution
FIE	Foreign Invested Enterprise

FinCEN	Financial Crimes Enforcement Network
FIU	Financial Intelligence Unit
FPR	False Positive Rate
GDP	Gross Domestic Product
HKD	Hong Kong Dollar
IAC	Insurance Association of China
IAIS	International Association of Insurance Supervisors
ICBC	Industrial and Commercial Bank of China
ID	Identity
IMF	International Monetary Fund
IMoLIN	International Money Laundering Information Network
IOSCO	International Organization of Securities Commissions
IOU	I Owe You
IP	Internet Protocol
IPO	Initial Public Offering
IT	Information Technology
JSCB	Joint Stock Commercial Bank
KPI	Key Performance Indicator
KYC	Know Your Customer
LC	Largely Compliant
LVTR	Large-Value Transaction Reporting
LVTRs	Large-Value Transaction Reports

ML	Money Laundering
MLRO	Money Laundering Report Officer
MPS	Ministry of Public Security
MSB	Money Services Businesses
NC	Non-compliant
NIE	New Institutional Economics
OECD	Organisation for Economic Co-operation and Development
OFCs	Offshore Finance Centres
PBC	People's Bank of China
PC	Partially Compliant
PDS	Property Declaration System
PEP	Politically Exposed Person
PICC	People's Insurance Company of China
PLICC	People's Life Insurance Company of China
PM	Performance Management
PPP	Public-Private Partnership
PRC	People's Republic of China
RBA	Risk-Based Approach
R&D	Research and Development
RMB	Ren Min Bi (also known as Yuan)
RSA	Regulatory and Supervisory Agency
SAC	Securities Association of China

SAFE	State Administration of Foreign Exchange
SAR	Suspicious Activity Reporting
SCNPC	Standing Committee of the National People's Congress
SED	Strategic and Economic Dialogue
SME	Small and Medium Enterprise
SOE	State-Owned Enterprise
StARI	Stolen Asset Recovery Initiative
STR	Suspicious Transaction Reporting
STRs	Suspicious Transaction Reports
TBML	Trade Based Money Laundering
TI	Transparency International
UNODC	United Nations Office on Drugs and Crime
UNTOC	United Nations Convention against Transnational Organized Crime
UK	United Kingdom
US	United States
USD	United States Dollar

ABSTRACT

Since China formally launched its anti-money laundering (AML) campaign in the early 2000s, additional challenges and higher standards are faced by both Chinese AML regulators and regulated entities, and the national scope of combating money laundering (ML) has been expanded. With banks, securities, and insurance industries being the main battlefield, research on AML implementation in Chinese financial sectors is extremely significant since AML experience from the financial sectors will be a useful and important reference for non-financial industries. The first part of this thesis critically examined the soundness and effectiveness of AML regulation and compliance in China, and the factors which have increased AML effectiveness in Chinese financial institutions. The second part explored possible ways to enhance existing AML implementation in Chinese financial sectors.

The thesis examined the most serious issues related to ML with clearly Chinese characteristics, namely, the underground or informal banking system, corruption-related ML, international ‘hot’ money and private loans, and suggests ways to optimise efforts in Chinese financial sectors to address these problems. The thesis indicates that there are significant gaps in the understanding and analysis of the hidden reasons for ineffective compliance with AML program in Chinese financial sectors, including economic, political, legal, and cultural reasons. The thesis also examines the problems that are encountered in existing AML implementation in Chinese financial sectors.

In addition, this thesis analysed the ML risks and vulnerabilities in Chinese banking, securities, and insurance sectors, and emphasises the synergistic relationship between ML risk-rating systems and enterprise-wide AML information programs to help determine and analyse the ML vulnerability of the Chinese financial sectors. The thesis concludes that there are significant gaps in the understanding and analysis of ML risk management in Chinese financial institutions.

The third aim of this thesis was to compare the traditional rule-based AML approach and the latest risk-based AML approach, to determine the most appropriate way to translate the risk-based AML approach into the Chinese reality. Findings indicate that China has yet to reach a stage at which it is able to adopt a full risk-based approach (RBA) to AML compliance. This thesis designed a strategy map of a ‘rule-based but risk-oriented’ AML approach (or partial RBA) applicable to Chinese financial sectors given their current stage of development. It suggests that only the adoption of this approach can provide an effective transition towards future implementation of a full RBA in China.

The author believes that the findings of this thesis present very practical applications that could contribute positively to the development of a more effective AML regime and to the implementation of AML preventive measures in Chinese financial sectors.

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LIST OF PUBLICATIONS

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Refereed Journals

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Ai, Lishan, and Jun Tang, 'Risk-Based Approach for Designing Enterprise-Wide AML Information System Solution' (2011) 18(3) *Journal of Financial Crime* 268–76

Yan, Lixin, Lishan Ai, and Jun Tang, 'Risk-Based AML Regulation on Internet Payment Services in China' (2011) 14(1) *Journal of Money Laundering Control* 93–101

Ai, Lishan, John Broome, and Hao Yan, 'Carrying out a Risk-Based Approach to AML in China: Partial or Full Implementation?' (2010) 13(4) *Journal of Money Laundering Control* 394–404

Tang, Jun, and Lishan Ai, 'Combating Money Laundering in Transition Countries: the Inherent Limitations and Practical Issues' (2010) 13(3) *Journal of Money Laundering Control* 215–25

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Ai, Lishan, 'The Economic, Political, Legal, and Cultural Factors Influencing the Effectiveness of Anti-Money Laundering Measures Taken by Chinese Financial Institutions', *Shadow 2011: The Shadow Economy, Tax Evasion and Money Laundering*, 28-31 July 2011, Münster, Germany.

Chapter 1. INTRODUCTION

1.1 Background of the Study

Money laundering (ML) is the processing of criminal proceeds to disguise their illegal origin in order to legitimise' the ill-gotten gains of crime. This process is of critical importance, as it enables the criminal to enjoy these profits without jeopardising their source. ML can occur practically anywhere in the world, and money launderers tend to seek out areas in which there is a low risk of detection due to weak or ineffective AML program.

The Standing Committee of the National People's Congress (SCNPC) passed China's first general law on AML, the *Chinese Anti-Money Laundering Law (Chinese AML Law)* on 31 October 2006, and became a formal member of Financial Action Task Force (FATF) in 2007. These developments were seen as great successes in combating ML in China. However, the enactment of the *Chinese AML Law* reflects just a fraction of the country's AML architecture. More efforts also need to be taken to further improve the overall system, including revising aspects of the current AML legislation, developing a comprehensive AML program, and ensuring effective compliance with AML regulations. It is common for Chinese financial institutions at the current stage of AML activity to have deficiencies in their AML programs. For example, there is insufficient implementation of such programs, inadequate independent AML compliance testing, inadequate transaction monitoring systems, failures in detecting and reporting suspicious activities, and inadequate controls over informal banking activities. Any of these deficiencies can trigger a gap between the regulations 'on paper' and financial institutions' compliance in practice with the AML program in China, making the AML architecture loosely structured. In this case, all the previous AML successes may prove short lived. China, indeed, still stands within the initial phase of fighting ML, and, as will be shown, while there have been some successes, much more must be done. Thus, before extending the AML regime into other sectors

(such as designated businesses and professions or legal persons and arrangements and non-profit organisations), a thorough assessment should be conducted on the extent to which existing AML regulations are being complied with by Chinese financial institutions. If compliance is weak and ineffective, continuous extension of an AML regime revealed to be inefficient would be meaningless in the long run.

Actually, the AML activities in China cannot be referred to as ‘combating’ ML if there are no ‘fighters’ engaged in combat. Since the early 2000s, China has gained much information from the experience of other countries and international organisations in relation to fighting ML. It may be prudent, however, to pay more attention to examining the local environment instead of purely responding to international requirements. The challenge is to determine what can be done in China to develop a more comprehensive AML program, which can achieve compliance by financial institutions in an effective way, having regard to the local political, economic, legal and cultural environment. If the overall effectiveness of the AML compliance monitoring regime cannot be fairly examined due to the recent implementation of the new requirements contained in the *Chinese AML Law* and associated regulations, maybe it is time to ask how well the current AML system is working. In the years ahead, the focus of central government should be shifted gradually from the expansion of the existing AML regime in China to improving the effectiveness of AML national implementation by considering its adequacy and also AML risks more comprehensively.

An effective AML system requires an adequate legal and institutional framework. China passed its first general law on AML on 31 October 2006 and, two weeks later, the People’s Bank of China (PBC) issued three supporting regulations to implement the *Chinese AML Law*, especially in regard to financial institutions, namely, *the Provisions on Anti-Money Laundering by Financial Institutions*, *the Administrative Rules for the Reporting of Large-Value and Suspicious RMB Payment Transactions*, and *the Administrative Rules for the Reporting of Large-Value and Suspicious*

Foreign Exchange Transactions. In addition, regulatory guidelines are published for various sectors by their respective authority: the China Banking Regulatory Commission (CBRC) for the banking sector, the China Securities Regulatory Commission (CSRC) for the securities sector, and the China Insurance Regulatory Commission (CIRC) for the insurance sector. These bodies not only publish regulatory guidelines to fully support PBC's AML requirement in the relevant financial sectors, they have the responsibility to review AML compliance in their respective sectors. Although the PBC, functioning as the administrative department for AML under the State Council, has made great efforts to regulate financial institutions' AML program, more attention needs to be paid to thoroughly testing Chinese AML implementation and determining money-laundering vulnerabilities in all financial sectors.

Although the AML legislation in China has covered non-banking financial institutions, the quality and effectiveness of AML implementation in such sectors are still weak. AML legislation in the securities and insurance sectors can be very effective, if the financial sector fully understands the ML vulnerabilities and possible risks within the institution, and this is accompanied by the enactment of highly developed and stringent legislation. However, it is here argued that China presently lacks the necessary preconditions for effective AML legislation. Some special risks may be faced by banking, securities, and insurance sectors when establishing business with customers. Examples of situations where it may be essential to more carefully scrutinise the normal conduct of business include non 'face to face' business, securities transactions, and life insurance business. This is at least partly recognised, as financial institutions are already required to have policies and procedures in place to address any 'special risks' regarding non 'face to face' business relationships. The AML-related authorities thus need to keep alert on existing and emerging ML risks in each financial sector, and to ensure that appropriate AML measures adopted for financial institutions and that these are applied in a comprehensive manner by those institutions.

The current AML regime in China encompasses customer due diligence (CDD) procedures, reporting systems for large-value payment and suspicious transactions, recordkeeping systems, and internal control systems. In general, three main shortcomings threaten financial security in China, and disturb the effectiveness of compliance with AML regulations in China. They are: (i) a lack of innovation and precautionary capacity in regard to risk management; (ii) a lack of inter-relational constraints of interests and lack of an incentive mechanism within the governance structure of financial institutions; and (iii) weak internal control in financial institutions owing to the long-term neglect of proper management and limited investment in AML-related human and technical resources. In order to increase the efficiency of CDD compliance, the foremost task is to create customer rating profiles in financial institutions, and to do so accurately. Simplified CDD procedures are undertaken on most customers who have no apparent connections to ML, while enhanced CDD measures are conducted on customers who have complicated transaction records and suspicious activities with features deemed characteristic of or on other occasions associated with ML activities or ML associated persons or entities. Because of the comparatively recent establishment of administrative customer identification measures, most financial institutions have experienced difficulties in complying fully and rapidly with the new CDD regulations. This then creates problems for regulatory departments attempting to conduct compliance audits and for those bodies and others involved in enforcing the law. In China for instance, even though requirements for applying administrative measures on customer identification have been in place for some years, at the time of writing this thesis some banks had still not set up a basic customer's risk-rating system to assist in preventing ML crime and had also not established procedures to conduct a proper investigation to determine the real beneficiary of an account or the person in actual control of the account. This demonstrates the absence of risk considerations within Chinese financial institutions when applying the national AML program, seriously affecting the quality of practical AML operations.

Financial institutions have policies to deal with complex and unusual large transactions that have no reasonable economic or lawful purpose; apparent ‘smurfing’ activities, which intentionally circumvent the reporting threshold, also attract special attention. Chinese AML reporting schemes require financial institutions to report the following four types of large value transactions to the China Anti-Money Laundering Monitoring and Analysis Center (CAMLMAC):

- a) Daily cash payment, receipt, exchange or remittance, either individually or cumulatively, of sums more than CNY 200,000 or USD 10,000 equivalent;
- b) Daily inter-bank transfers between the accounts of legal entities, other organisations or individual commercial/industrial entities, either individually or cumulatively, of sums more than CNY 2 million or USD 200,000;
- c) Daily inter-bank transfers between the accounts of individuals, individual and legal entities, other organisations and individual commercial/industrial entities, either individually or cumulatively, of sums more than CNY 500,000 or USD 100,000;
- d) Daily cross border transactions, either individually or cumulatively, of sums more than USD 10,000 where one of the parties to the transactions is an individual.¹

However, it should be noted that the CNY thresholds are considerably higher than the stipulated USD amounts taking the average exchange rate into consideration. A CNY value threshold of 200,000 for reporting large transactions is more than three times the amount specified by FATF and is therefore a breach of the FATF Recommendations.

Apart from the detailed guidance of large-value transaction reporting (LVTR), the

¹ 中国人民银行 [People’s Bank of China], 《金融机构大额交易和可疑交易报告管理办法》 [*Administrative Rules for the Reporting of Large-Value and Suspicious RMB Payment Transactions*], Notice 2 [2006], 14 November 2006.

authorities have identified a number of different types of suspicious activities subjected to reporting requirements under the Chinese AML architecture: 18 are listed for the banking industry, 16 for the securities industry, and 13 for the insurance industry respectively. However, Chinese financial institutions still focus predominantly on large transactions, rather than enhancing their capability to define suspicious transactions. They simultaneously continue to raise awareness of staff regarding potential ‘red flags’ or suspicious activities for the manual monitoring of transactions. There is a need for greater guidance in identifying ML vulnerabilities in Chinese financial sectors, and for building a money-laundering risk-rating system and AML information solution system to guide the practical detection of suspicious ML activities in the financial sectors. Under the current system of ML reporting in China, vast numbers of reports are made that contain little information. The number of suspicious transaction reports (STRs) and large value transaction reports (LVTRs) does not indicate the quality of reporting.

Indeed, before the enactment and implementation of the *Chinese AML Law*, there are no explicit requirements for Chinese financial institutions to designate an AML compliance officer at management level, nor for such institutions to maintain an adequately resourced and independent audit function to test compliance with internal AML control, or for them to communicate AML policies and procedures to their employees. In response to these loopholes, a PBC notice published at the end of 2008 specifically required financial institutions to improve their internal AML control system. Specific requirements include specifying a person in senior management to be the responsible compliance officer, ensuring relevant AML staff are able to access information in a timely fashion, strengthening the auditing system concerning AML, and enhancing the AML awareness, guidance and training for employees.²

² 中国人民银行 [People’s Bank of China],《关于进一步加强金融机构反洗钱工作的通知》[*Notice for the Purpose of Further Strengthening the Anti-Money Laundering Work in Chinese Financial Institutions*], Notice 391 [2008], 30 December 2008.

Under the current Chinese AML regime the core questions that should be frequently asked include:

- a) Do regulators deal adequately with the full range of potential launderers in their own country?
- b) Do compliance officers within financial institutions communicate effectively with, and affect the behaviour of, staff in their own institutions?
- c) Do the ‘front line’ practitioners in financial institutions take sufficient steps to undertake customer identification in relation to ML, and either prevent ML and/or communicate findings to senior staff?

Regulatory bodies in China should build AML examination criteria in all financial sectors which can be guidelines for reviewing the quality and effectiveness of AML compliance. A comprehensive AML assessment mechanism should determine, in detail, whether a financial institution’s risk management is commensurate with the financial institution’s AML compliance activity. Core examination procedures for regulatory requirements should cover customer identification program (CIP), CDD, suspicious transacting reporting (STR), LVTR, currency transaction reporting exemptions, information sharing, purchase and sale of monetary instruments recordkeeping, funds transfer recordkeeping, foreign correspondent account recordkeeping and due diligence, and so on. Of course, to fully comply with AML regulations at the same level across a country and across sectors is not an easy thing, especially for a country as large and as populous as China. There are practical differences amongst local financial institutions in various aspects, namely the attitude of their respective regulators, their practical capacity, and the external environment for financial markets. For example, even two local banks located in the same street rarely act in the same way regarding AML programs. In short, the AML compliance behaviour of local banks varies considerably. AML law is, of course, only a part of the solution — how the financial institutions perceive the significance of AML programs, and whether and how they actively comply with AML regulations are more vital, for without cooperation legislation will have little or no effect.

With the rapid development of the Chinese financial sector, various products and services based on new or developing technologies are increasingly being introduced on a large scale. This includes many kinds of non ‘face to face’ transactions conducted through telephone, online systems, automated teller machine (ATM), electronic fund Transfer at Point of Sale (EFTPOS) machines and mobile payment systems. Such types of transactions can favour anonymity and obscure the real customer’s identity, making compliance with know your customer (KYC) in financial institutions even harder. Consequently, regulatory measures and technical plans with regard to regulating new technology related transactions should be established and constantly updated. With the development of the Chinese economy, local financial institutions will enjoy more business opportunities but also encounter greater risks of being used as vehicles for ML. Correspondingly ML risk management needs to be strengthened by Chinese AML regulators, especially in a number of economically advanced cities.

ML-related risk management include the risk evaluation of financial products, customers, interface, and also the geographic jurisdiction. To be more specific, various products produce different levels of ML risk. For example, the risk in the traditional business of saving and withdrawal is lower than in the emerging financial services areas, such as stocks and shares. Customers also present distinct and different risk levels. Moreover, financial institutions located in different geographic jurisdictions face dissimilar ML risks. For instance, the financial institutions in Shanghai may face different risks to those facing the institutions in cities in the Western part of China. Therefore, risk evaluation should not be unilaterally considered, but fully evaluated. Each financial institution should establish its own unique risk profile, reflecting differentiation of its customer, product, geographic, transactional, and delivery system composition.

The current Chinese AML system aims to enforce a ‘rule-based’ approach in every regulated entity with insufficient consideration of ML risk management. Indeed, the *FATF Forty Recommendations* as promulgated in 1990 set out the basis of a

rule-based AML system. There are rules that specify that certain kinds of activity are prohibited, rules that require certain types of regulatory arrangements and rules that require action by agencies with regulatory responsibility. However, ML operates through the use of financial activities which are not in themselves illegal. Thus, deciding whether or not something constitutes ML requires an understanding of the processes and participants involved in the financial transaction.

Rule-based regulation is particularly vulnerable as a means of dealing with ML where one of the objectives of the launderer is to identify weak points in the regulatory system and exploit those weaknesses. Policy makers hope that the ‘risk-based’ approach³ will help reduce the number of poor quality reports and improve the quality of intelligence provided to FIUs. Risk-based regulation provides a basis for reducing the flow of reports in a way that factors in those matters that are most likely to generate meaningful intelligence or a productive regulatory or law-enforcement response, and such rules were well regarded as particularly helpful in resolving any ‘conflict’ between differing interests groups when determining appropriate levels of risk management.

This thesis will propose a ‘rule-based but risk-oriented’ approach to be applied in Chinese financial sectors, and insert the ML risk consideration into rule-based compliance, establishing a transitional AML approach from a rule-based approach to an RBA for Chinese financial institutions that better accords with the Chinese reality. Currently, the conditions for applying an RBA are far from mature in China. Thus, in order to solve the contradiction between maintaining an unchanged rule-based approach in Chinese financial institutions and attempting to cope with the whole set of issues raised by the RBA used by developed countries, an appropriate AML approach which includes risk considerations should be developed to respond to the specific Chinese environment. This will combine the merits of both a rule-based

³ The term ‘risk-based regulation’ embraces a very broad range of approaches. The elements of risk-based approaches entail the use of technical risk-based tools, emerging out of economics (cost-benefit approaches) and science (risk assessment techniques).

approach and an RBA. With regard to the AML compliance, different countries have different social, cultural, organisational and technological structures, each delivering different notions of risk, different categories of risk, and different ML threat. ‘ML threat’ refers to the nature and scale of ML and its predicate crimes, and can be thought of as the demand for ML.⁴ The challenge in understanding the ML threat lies with the ability to measure the nature and extent of diverse predicate crimes and their resulting proceeds in order to detect underlying crime trends and patterns. ‘Red flag indicators’ of suspicious activities made by international standard setters may not wholly fit the experience of Chinese financial sectors. Instead of routinely following international standards, regulators and practitioners should thoroughly analyse the *nature* of Chinese financial sectors *per se*, as well as ML predicate offences linked to Chinese financial sectors.

1.2 Literature Review

1.2.1 Global Anti-Money Laundering Regimes in Financial Sectors

International efforts to combat ML have gained momentum in the past decade. Conventions, guidance, reports published by international organisations, together with numerous multilateral governmental initiatives and bilateral agreements, have contributed to the development of a broad set of national and international legal standards. In response to the growing concern about ML activities, the international community has acted on many fronts. The main international standard setters are the United Nations (UN), the Financial Action Task Force on Money Laundering (FATF), the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors (IAIS), as well as regional bodies and other relevant groups, such as the Asia/Pacific Group on Money Laundering (APG) and the Wolfsberg Group

⁴ Bridget M Hutter, *The Attractions of Risk-Based Regulation: Accounting for the Emergence of Risk Ideas in Regulation* Discussion Paper No 33 (Economic & Social Research Council Centre for Analysis of Risk and Regulation, London School of Economics and Political Science, March 2005).

(comprising a number of banks with global reach).⁵ In the absence of effective international cooperation, there will be no realistic chance of defeating or significantly curbing ML. The regulatory regimes operating from country to country are at best piecemeal and often are widely ignored. Lax controls in some countries permit easy access to financial services systems in more regulated jurisdictions, making a global minimum standard necessary for an effective reduction in ML.

The *United Nations Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances (Vienna Convention)* was the first move towards combating ML at the international level. The UN then published *Model Legislation on Laundering, Confiscation and International Cooperation in Relation to the Proceeds of Crime* in 1999, providing comprehensive guidance for countries to structure AML legislation. Other contributions on AML courses made by the UN contain provisions incorporated in the *United Nations Convention against Transnational Organized Crime (UNTOC)* (2000) and the *United Nations Convention against Corruption* (2003).⁶

The *Forty Recommendations of the Financial Action Task Force on Money Laundering* have been established as the international standard for effective AML measures. FATF regularly reviews its members to check their compliance with these *Forty Recommendations* and to suggest areas for improvement. It does this through annual self-assessment exercises and periodic mutual evaluations of its members. FATF also identifies emerging trends in methods used to launder money and suggests measures to combat them. Combating ML is a dynamic process because the criminals who launder money are continuously seeking new ways to achieve their illegal ends. Moreover, it has become evident to FATF through its regular typologies exercises that,

⁵ Paul A Schott, *Reference Guide to Anti-Money Laundering and Combating the Financing of Terrorism* (World Bank Publications, 2nd ed, 2006).

⁶ See, United Nations Office on Drugs and Crime (UNODC), *UN Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances*, 20 December 1988, 1582 UNTS 164 (entered into force 11 November 1990) Article 5; United Nations Office on Drugs and Crime (UNODC), *UN Convention against Organized Crime* (2000) A/RES/55/25, Article 12; and United Nations Office on Drugs and Crime (UNODC), *UN Convention against Corruption* (2005) Article 31.

as its members have strengthened their systems to combat ML, criminals have sought to exploit weaknesses in other jurisdictions to continue their ML activities. In order to reduce the ML vulnerability of the international financial system, governments must intensify their efforts to remove any detrimental rules and practices which obstruct international co-operation against ML. Since the end of 1998, FATF has been engaged in a significant initiative to identify key AML weaknesses in jurisdictions inside and outside its membership. The goal of FATF's work in this area is to secure the adoption by all financial centres of international standards to prevent, detect and punish ML.

The original *FATF Forty Recommendations* were drafted in 1990 with the aim of combating the misuse of financial systems by persons laundering drug money. The recommendations were revised in 1996 for the first time to reflect evolving ML typologies and to develop corresponding counter-measures. The first revision of the Recommendations has been endorsed by more than 130 countries and is the international AML standard. Nine Special Recommendations on Terrorist Financing were adopted in the aftermath of the September 11 terrorist attacks. The Recommendations were revised again in 2003. The 2003 version of the Recommendations reflected their extended scope, encompassing both ML and terrorist financing (TF), and provided an enhanced, comprehensive and consistent framework of measures for combating ML and TF. Indeed, the 2003 FATF Recommendations set minimum standards for countries, which then implement the details according to their particular circumstances and constitutional frameworks. For example, they provide a series of AML preventive measures which can be taken by financial institutions within national systems, including CDD and record-keeping, reporting of suspicious transactions and compliance, other ML deterrent measures, measures to be taken with respect to countries that do not or insufficiently comply with the FATF Recommendations, together with regulation and supervision of reporting entities, and encompassing comprehensive approaches to coping with all manner of new challenges posed to financial institutions by ever-evolving ML

techniques. In 2012, the most recent iteration of the FATF Recommendations placed further attentions on illicit proceeds of corruption, tax crimes, and proliferation financing, providing direction for future global AML activities.⁷

Financial sector soundness and stability has emerged as one of the principal themes of economic policy and international cooperation worldwide. With regard to AML guidance, the BCBS has issued a numbers of key papers, including *Core Principles for Effective Banking Supervision* (1997), the *Prevention of the Criminal Use of the Banking System for the Purpose of Money-Laundering* (1998), *Core Principles Methodology* (1999), and *Customer Due Diligence for Banks* (2001). In these papers, key principles which seek to ensure that banks are not used to hide or launder the profits of crime were highlighted; important guidance was provided for the assessment of the adequacy of KYC requirements, as well as for suspicious transaction reporting, and the sharing of information with other supervisors and law enforcement agencies both domestic and foreign; and the importance of managing operational risk and enhancing internal controls and corporate governance were also encompassed.⁸

Since 2000, the International Monetary Fund (IMF) together with the World Bank started to play their roles in combating ML and financial crime, and protecting the international financial system. The IMF recognised that it has to play its role in protecting the integrity of the international financial system from abuse through its efforts, *inter alia*, to promote sound financial systems and good governance. The World Bank, consistent with its development mandate, plays an important role in assisting countries with legal reform, often in the context of national anti-corruption programs, and in the design and implementation of capacity building programs (for example, in the context of legal and judicial reform, establishing protection of

⁷ Financial Action Task Force on Money Laundering (FATF), *The Forty Recommendations*, 20 June 2003, 2; Financial Action Task Force on Money Laundering (FATF), *International Standards on Combating Money Laundering and the Financing & Proliferation - The FATF Recommendations*, February 2012, 26.

⁸ Basel Committee on Banking Supervision (BCBS), <http://www.bis.org/list/bcbs/index.htm>.

shareholders' rights, and so on) and the promotion of good governance and transparency principles and practices in the financial sector.⁹ The IMF was specifically asked to explore incorporating work on financial system abuse with respect to international efforts to fight ML (where relevant and appropriate) in its various activities. In 2001, the IMF provided its definition on financial system abuse, financial crime, and ML, as well as discussed empirical evidence on its macroeconomic impact.¹⁰ Later, the IMF and the World Bank proposed to strengthen their role in the global fight against financial sector abuse and ML specifically via publicising official statements, cooperating with major international AML groups, and increasing the provision of technical assistance in the area of combating ML.

A policy paper¹¹ in relation to enhancing contributions to combating ML was produced in 2001, discussing measures with respect to helping national authorities improve their systems of financial regulation and supervision so as to create the environment within financial institutions to deter financial crime and ML. This policy paper proposes that the IMF and the World Bank strengthen their role in the global fight against financial sector abuse, and ML specifically, by: (i) publicising, through official statements and other forms of outreach, both the need to put in place the necessary economic, financial, and legal systems designed to protect against ML, and the role that the World Bank and the IMF are playing in helping to meet this need; (ii) recognising the FATF 40 Recommendations as a useful standard for AML related operations; (iii) intensifying the focus on AML elements in the assessment of supervisory standards embodied in the *Basel Committee Principles (BCPs)*, *International Organization of Securities Commissions' Objectives and Principles for Securities Regulation (IOSCO Principles)*, and *the International Association of Insurance Supervisors Insurance Supervisory Principles (IAIS Principles)*, and

⁹ International Monetary Fund (IMF), *Financial System Abuse, Financial Crime and Money Laundering – Background Paper* (2001) < <http://www.imf.org/external/np/ml/2001/eng/021201.htm> >.

¹⁰ Ibid.

¹¹ International Monetary Fund and World Bank (IMF and WB), *Enhancing Contributions to Combating Money Laundering: Policy Paper* (2001) < <http://www.imf.org/external/np/ml/2001/eng/042601.htm> >.

producing a detailed assessment which, with the country's concerned permission, could be published or shared with the FATF and/or the appropriate regional AML task forces; (iv) working more closely with the major international AML groups; (v) increasing the provision of technical assistance from the World Bank and the IMF in this area.

With the aims of preventing the use of securities intermediaries for purposes of financial crime, IOSCO passed the *Resolution on Money Laundering* in October 1992, stated that preventive measures on customer identifying-information, record keeping requirements, suspicious transactions reporting, securities and futures businesses control, monitoring and compliance procedures, and information sharing should be adopted. Later (in September 1998), IOSCO issued its *Objectives and Principles*, which emphasises market integrity as a function of securities sector supervision, and outlines key measures which help counter financial fraud and ML. In June 2003, IOSCO together with BCBS and IAIS conducted the Joint Forum on Combating Money Laundering and issued a document stating their initiatives on the issue.¹² This contains an overview of the common AML standards that apply to all three sectors (namely securities, banking and insurance) and an assessment as to whether there are serious gaps or inconsistencies in approaches and recommendations, covers the relationships between the institutions and their customers, focusing on the products or services that are particularly vulnerable to ML for each sector, and on research on how each Committee has sought to address these vulnerabilities, and describes ongoing and future work in all three sectors. In addition, as the CDD process is one of the long-standing pillars of securities regulation and industry practice, IOSCO further published *Principles on Client Identification and Beneficial Ownership for the Securities Industry* in May 2004, which chiefly aims to prevent securities fraud and market abuse, but also provides general guidance on combating the illegal use of the securities industry such as in ML.

¹² See, Joint Forum, *Initiatives by the BCBS, IAIS and IOSCO to Combat Money Laundering and the Financing of Terrorism*, June 2003; International Organization of Securities Commission (IOSCO), *Principles on Client Identification and Beneficial Ownership for the Securities Industry*, May 2004.

Since the insurance sector was shown to be vulnerable to ML risk, the IAIS (recognised as the leading supervisory institution in insurance sector at the international level) has also made contributions¹³ to combating ML. In 2004, IAIS issued its *Guidance Paper on Anti-Money Laundering and Combating the Financing of Terrorism*, which represents an RBA regarding the combating of ML. The paper explains the risk of ML and how it could be affected through the various types of insurance in detail, provides a set of measures and procedures to control the ML risks in the insurance sector, and addresses the role of supervisors in dealing with their application of the *Insurance Core Principles* and compliance with AML program.

Apart from the international arrangements concerning AML published by the abovementioned international organisations and associations, self-regulatory initiatives in the banking sector also played a significant role in the AML evolution. In October 2000, eleven large international banks, in cooperation with Transparency International (TI), agreed to a set of *Global Anti-Money Laundering Guidelines for Private Banking* (known as the *Wolfsberg Principles*),¹⁴ which focus on KYC requirements, client files, suspicious activities, and monitoring accounts in ways of which are consistent with supervisory principles. The guidelines lay out the ‘Wolfsberg Anti-money Laundering Principles’ that were agreed by 12 major international banks meeting in Wolfsberg, Switzerland, in 2000. These Principles set out to provide important global guidance for sound business conduct in international private banking. A team from TI facilitated the initiative, and the Principles were widely viewed as an important step in the fight against ML, corruption and other related serious crimes. A study undertaken by Hinterseer¹⁵ in 2001 looked at the

¹³ See, International Association of Insurance Supervisors (IAIS), *Guidance Paper on Anti-Money Laundering and Combating the Financing of Terrorism*, October 2004; International Association of Insurance Supervisors (IAIS), *Guidance Paper on Combating the Misuse of Insurers for Illicit Purposes*, October 2005.

¹⁴ Wolfsberg Group, *Global Anti-Money Laundering Guidelines for Private Banking-Wolfsberg AML Principles* (2001) < <http://www.wolfsberg-principles.com/standards.html> >.

¹⁵ Kris Hinterseer, ‘The Wolfsberg Anti-Money Laundering Principles’ (Summer 2001) 5 *Journal of Money Laundering Control* 25.

importance of the *Wolfsberg Principles* from a unique perspective. He noted that of the 11 banks that signed the *Wolfsberg Principles*, most had been associated with an ML scandal in one form or another within the previous decade. As the first Principles focused on financial regulation of private banking activities, the involvement of international private banks, especially ML affected banks, shows that private banks were determined to be seen to be part of the solution, not just part of the problem. The author reviewed each of the *Wolfsberg Principles* in the study, and concluded that the principles constitute a series of measures adopted by certain banks, not at the behest of regulators, but voluntarily, and have the potential to make a meaningful contribution to combating ML.

1.2.2 Anti-Money Laundering Regulation Issues in Financial Institutions

To respond to the evolution of ML regulation approaches and the emerging typologies of laundering money through financial sectors, previous studies concerning AML in the financial sectors mainly focused on the integrity and soundness of AML systems. Reuter and Truman¹⁶ demonstrated macroeconomic estimates and microeconomic estimates when introducing the problem of laundering ‘dirty’ money, detailed ML methods and markets, compared differences between AML regimes in different countries, presented the role of AML in combating predicate crimes involved in ML (both in protecting financial system integrity and in combating global ‘public bads’), and finally addressed practical suggestions for improving the global AML regime. With regard to the global AML regime, the authors argued that the robustness of AML regimes is challenged by differences in institutions, perspectives, and priorities among countries as well as within them, and, consequently, a balance of competing objectives is needed at all levels in all jurisdictions. Reuter and Truman also stated that AML regimes produce financial and non-financial costs in three forms, namely, regulatory costs, compliance costs and costs borne by the general public, which is

¹⁶ Peter Reuter and Edwin M Truman, *Chasing Dirty Money: The Fight against Money Laundering* (Automated Graphic Systems, 2004).

useful for analysing the competing interests among different parts under the AML architecture.

John Broome¹⁷ conducted a comprehensive study on AML issues from various perspectives, including legislation, prevention, investigation, and prosecution, and presented distinct responses to AML practices and policies in different jurisdictions. Broome critically emphasised the importance of AML compliance at every level of an AML system. In the author's view, the highest levels of AML compliance in individual institutions will be achieved when they are driven by a sense of self-interest, and in order to achieve the effective functioning of AML compliance in financial sectors, high professional, legal and ethical standards are needed. Apart from examining traditional banking financial institutions, Broome also extended the research to the insurance and securities sectors, and to other non-financial business industries and professionals. He described ML prevention measures, AML regulatory processes, and especially addressed the important role of culture, compliance and risk in combating ML in all areas. Broome stated that the culture within the regulatory and supervisory agencies is equally significant to the culture within the financial institution, and noted that risk management strategies must be applied by both public and private sector organisations. He also stated that greater attention needs to be given to ensuring AML laws and procedures are effectively implemented by financial institutions. Broome's research covered every aspect of AML programs, analysed different priorities perceived by different AML bodies, and demonstrated conflicts of interest encountered among AML participants, and finally argued that compliance with AML laws should not be seen as a competitive issue between institutions or businesses, and presented practical solutions to balance regulation and compliance. In short, this study provides comprehensive guidance which can be applied to evaluate the effectiveness of an AML program in any jurisdictions.

¹⁷ John Broome, *Anti-Money Laundering: International Practice and Policies* (Thomson/Sweet & Maxwell Asia, 2005).

Past studies¹⁸ on developing a comprehensive AML system also focused on topics such as the prevention of ML, jurisdiction over ML, and the linkages among ML, financial transactions legislation and the banker. In addition, Jackie Johnson¹⁹ identified weaknesses in the global financial system in 2001. Johnson analysed the sources of laundered money from the aspects of bribery and corruption, corruption ‘at the top’, in oil sales, tax evasion, the illegal sale of wildlife, and prostitution. She emphasised the issues of corrupt senior officials and correspondent banking that bring higher risks into international financial systems in regard to combating ML. Johnson claimed that the amount of ML can be reduced only if all the loopholes to the global financial system are closed. As to the spreading influence of ML, Baity²⁰ proposed that banks and non-banks should accept greater responsibility to promote increased transparency, and eliminate practices that encourage crime, undermine financial systems, and damage their own institutions.

In late 1990s, the attention of both international organisations and national authorities was drawn to the operations, financial impact and prudential issues of offshore financial centres, including their role in the growing problem of tax evasion and ML. Regarding the impact of offshore financial centres (OFCs) on international ML, Blum and Levi²¹ examined OFCs and jurisdictions where bank secrecy prevailed as vehicles for ML and other financial crimes. They outlined the various stages of ML, identified various kinds of secrecy that facilitate ML, and explored the way in which OFCs and bank secrecy jurisdictions are used by criminals with the aim of laundering illicit funds. Hampton and Levi also examined the growth of ML in conjunction with

¹⁸ See, Guy Stessens, *Money Laundering: A New International Law Enforcement Model* (Cambridge University Press, 2000); John Handoll, *Capital, Payments and Money Laundering in the European Union* (Richmond Law & Tax, 2006); W S Weerasooria, *Banking Law and the Financial System in Australia* (Butterworths, 5th ed, 2000); James R Richards, *Transnational Criminal Organizations, Cybercrime, and Money Laundering* (CRC Press, 1999); Donato Masciandaro, *Global Financial Crime: Terrorism, Money Laundering and Offshore Centres* (Ashgate Publishing, 2004).

¹⁹ Jackie Johnson, ‘In Pursuit of Dirty Money: Identifying Weaknesses in the Global Financial System’ (Autumn 2001) 5 *Journal of Money Laundering Control* 122.

²⁰ William Baity, ‘Banking on Secrecy – The Price for Unfettered Secrecy and Confidentiality in the Face of International Organised Crime and Economic Crime’ (2000) 8 *Journal of Financial Crime* 83.

²¹ Jack A Blum, Michael Levi, Thomas Naylor and Phil Williams, *Financial Havens, Banking Secrecy and Money Laundering* (1998) < <http://www.cardiff.ac.uk/socsi/resources/levi-laundering.pdf> >.

the associated development of OFCs from three perspectives, namely, the secrecy perspective (confidentiality), the regulatory perspective, and political perspective; and framed an analysis of the growth of offshore finance and the emergence of a suitable environment for international money-laundering. The issue has been recently addressed by Peter Reuter who demonstrates that hundreds of billions of dollars are illicitly flowing out of developing countries to tax havens and other financial centres in the developed world. In their study,²² the authors considered political, social and economic aspects in the regulation of ML in OFCs, and found it difficult to ascertain whether the restrictive measures can be achieved in practice under the economic environment of OFCs. The conflicting issues of confidentiality and disclosure confronted by OFCs have also been examined by Antoine.²³ In her study, Antoine stated that the need to balance competing interests is particularly important to the competitiveness of the offshore sector in the world of international finance.

Greater concerns regarding the linkage between the informal financial systems (such as ‘underground banking’ systems) and ML activities have also caught researchers’ attention. Trehan²⁴ explained the difference between operating business services through underground banking and conventional banking, presented the modus operandi being followed by underground bankers, demonstrated the linkage between the underground banking system and conventional ML, and provided meaningful solutions to tackle underground or parallel banking. Nawaz²⁵ stated emerging evidence indicated that informal financial services networks have played an instrumental role in the international movement of finance for terrorism and in ML; and ‘clean’ funds may be channelled out of the regulated institutions easily by using

²² Mark P Hampton and Michael Levi, ‘Fast Spinning into Oblivion? Recent Developments in Money-Laundering Policies and Offshore Finance Centres’ (June 1999) *Third World Quarterly* 645; Peter Reuter, *Draining Development?: Controlling Flows of Illicit Funds from Developing Countries* (World Bank Press, 2012).

²³ Rose-Marie B Antoine, ‘Analysis: The Protection of Offshore Confidentiality: Policy Implication and Legal Trends’ (1999) 17 *Journal of Financial Crime* 9.

²⁴ Jyoti Trehan, ‘Underground and Parallel Banking Systems’ (July 2002) 10 *Journal of Financial Crime* 76.

²⁵ Shahid Nawaz, Roddy McKinnon and Robert Webb, ‘Informal and Formal Money Transfer Networks: Financial Service or Financial Crime?’ (Spring 2002) 5 *Journal of Money Laundering Control* 330.

the informal money transfer networks. The reasons for the growth of informal money transfer networks were also detailed.

1.2.3 Issues regarding the Effectiveness of AML Compliance

Studies on AML regulation and compliance in banking institutions and other non-bank financial sectors have been conducted by various scholars who paid attention to solving the practical deficiencies in implementing AML programs, and analysed these issues from different and unique perspectives. One of the leading scholars is Donato Masciandaro, who started to look at the economic analysis of ML in the early 1990s, and conducted a series of studies on the analysis of interactions between the criminal economy and financial markets. In his early research,²⁶ Masciandaro applied the tools of economic analysis to the topic of ML by connecting macroeconomic theory, the economic theory of crime and the theory of banking regulation. He noted the relationship between the presence of asymmetric and incomplete information and ML in the banking industry, and highlighted the role of intermediaries and of the central bank in combating ML. Masciandaro's later study²⁷ helped legislators know how to face the need to limit damage caused by ML on one hand, and to take into account the results of AML regulations in terms of burdens and costs imposed on the banking and financial systems on the other hand. The author stated that effective and efficient regulation can be established on the basis of a well-designed system of incentives and costs for financial institutions, and noted that the legislator's tolerance of both the damage caused by ML and the cost of regulation determine the strictness of an AML policy.

Antoinette Verhage undertook interesting research in her PhD study, exploring the

²⁶ Donato Masciandaro, 'Money Laundering, Banks and Regulators: An Economic Analysis' Working Paper, Innocenzo Gasparini Institute for Economic Research (May 1995).

²⁷ Donato Masciandaro, 'Money Laundering: the Economics of Regulation' (1999) 7 *European Journal of Law and Economics* 225.

AML complex and its interactions with the compliance industry.²⁸ Verhage examined AML regulation and compliance from a unique perspective, one which adds the compliance industry to the traditional two-part AML architecture of the AML complex and the financial institutions. She also strongly emphasised the important role of the compliance officer in AML systems. Introduced as the ‘second force’ behind the AML evolution in the study, the compliance industry plays a critical role in increasing AML effectiveness, and includes software providers, professional advisors, and so on. Verhage also stated that the compliance officer, as a partner in between both worlds (that of the AML complex and financial industry), should in practice continuously balance commercial interests and law-abiding goals among the three types of institutions involved in the battle against ML so as to achieve better AML results.

With the growth in activity has come a growth in cost. While there are no definitive figures on how great a financial burden the fight has imposed upon firms and ultimately their consumers, even rough estimates are frightening. Yet it remains unclear whether this cost has resulted in a system that is truly effective against ML. What is clear, however, is that a number of efforts have created a burdensome bureaucracy for the innocent, whilst providing scant deterrence for the launderer. The resultant systems and checklists made for cumbersome account opening processes, and an endless number of requests for documentation to be provided, irrespective of the potential risk that the customer posed. Managing the huge volumes of reporting files continues to be a major problem in the effective management of AML.

Form filling and the requirement for documentation, however superfluous, does provide comfort to firms and individuals. The mountains of paper produced demonstrate that they are ‘doing their job’ or more accurately ‘doing what is asked of

²⁸ See, Antoinette Verhage, ‘Between the Hammer and the Anvil? The Anti-Money Laundering-Complex and Its Interactions with the Compliance Industry’ (November 2008) 26 *Crime, Law & Social Change* 9; Antoinette Verhage, ‘Supply and Demand: Anti-Money Laundering by the Compliance Industry’ (2009) 12 *Journal of Money Laundering Control* 371.

them'. For example, it is likely to lead to knee-jerk acceptance among compliance officers that all large cash payments are suspicious, and thus an increase in the reporting of false positives. In other words, suspicious reporting becomes a bureaucratic decision in many jurisdictions, and the code for the AML system is not built on the basis of risk consideration, and focuses on legalism rather than regulatory effectiveness, making self-defensive actions by the reporters the norm while failing to really focus on truly suspicious activity. This approach becomes a universal phenomenon in many financial sectors.

The existing AML control procedures are designed in a way that inevitably provokes fear of penalties and reputational damage. However, this fear does not automatically mean that reporting institutions will provide higher quality intelligence to the authorities in a consistent and methodical manner, because the system is largely based on vague concepts and subjective assessments. Under the fear of regulatory enforcement, institutions excessively report, as a self-defensive act by the reporters. Higher effectiveness could be attained if financial institutions proactively share the burden of examining suspicious ML activities, resulting in reduced false positive reporting and fewer defensive reporting, and build screening layers among financial networks with the aim of sending useful information to financial intelligence units (FIUs). Therefore, more focus should be placed on how institutions can utilise internal intelligence and other resources for the generation of STRs, and how feedback mechanisms amongst various stakeholders can clarify the suspicious/non-suspicious distinction and thereby improve the quality of reporting.

The link between the effectiveness of the AML regulations and the characteristics of the compliance costs involved for banks was further researched by Masciandaro and Fillotto²⁹ in 2001. Based on economic analysis and a principal-agent model, the authors found that collective gains can be produced in the war against ML only if the

²⁹ Donato Masciandaro and Umberto Filotto, 'Money Laundering Regulation and Bank Compliance Costs: What Do Your Customers Know? Economics and the Italian Experience' (Autumn 2001) 5 *Journal of Money Laundering Control* 133.

regulations take due consideration of the problem of compliance costs. The effectiveness of AML regulation as well as the greater imperviousness of the banking and financial system to ML depend on increasing information and incentives. Masciandaro and Fillotto finally encouraged regulation makers to forge AML regulations that can produce not only costs but also benefits for the regulated banks. Economic analysis of the conflicting interests of AML regulation and compliance has also been well developed. In 2007, Geiger and Wuensch³⁰ outlined the impact of AML measures on banks and the financial services industry, and also discussed possible reasons for the failure of AML to defeat the predicate crimes. The authors stated that the implementation costs associated with AML place a significant burden on the financial entities, especially on smaller market participants, while the AML regime's effectiveness and efficiency in fighting predicate crime is doubtful. In order to combat ML, financial institutions are faced with developing their own capacity to apply an RBA, in order to avoid the risk of wrong decisions, and also to qualify their AML arrangements as regime compliant. The different roles of banks and the financial services industry and regulators and policy setters, however, may hamper the achievement of AML goals. In this case, cost-benefit analyses should be performed, and instead of broadening the current AML framework, a thorough review of the current approach should take place. Indeed, it is worth noting that in developing measures, regulators must balance compliance costs with risks, because there is a point at which the costs incurred in controlling the risk will outweigh the benefits.

1.2.4 Anti-Money Laundering Preventive Measures in Financial Institutions

In response to the demands to strengthen the capacity to prevent financial sectors being abused as channels for ML, serial AML policies have been developed — such as KYC rules and CDD measures. From the very beginning of AML research, policy reform around the topic of such fundamental AML instruments has never stopped. As

³⁰ Hans Geiger and Oliver Wuensch, 'The Fight against Money Laundering: An Economic Analysis of A Cost-Benefit Paradoxon' (2007) 10 *Journal of Money Laundering Control* 91.

the entire AML regime and its associated programs are never static systems but rather constantly in flux, supervisors, regulators, actual practitioners in related sectors, as well as other stakeholders, are forced to observe every trend concerning ML, and constantly make what they believe are the most appropriate decisions and implement countermeasures. In early 1990s, for example, Zagaris and MacDonald³¹ drew great attention to ML conducted via new forms and technologies (such as credit cards and ATMs, commodity transactions, and electronic wire transfers) and suggested long-term measures to combat new forms of ML. These measures included strengthening the audit trail, increasing regulation of non-bank business sectors, strengthening the KYC requirement, increasing attention on complex, unusual and large transactions, enhancing monitoring of cash at the border, improving supervision of banks and other financial institutions, and constructing an effective international financial sub-regime.

Moving into early 2000s, several studies³² argued that full implementation of all aspects of KYC programs is difficult because it is hard to establish when a financial institution was in compliance. KYC was seen as difficult to implement, because there was no obvious end-point to the information that would be useful to a bank manager in seeking to prevent ML. It has been noted that it is hard to deal with third-party introducers where the main beneficiaries wish to remain anonymous, and it can be hard to balance KYC with a customer's right to privacy. Current KYC proposals require financial institutions to determine the identity of customers, determine the customer's sources of funds, determine normal and expected transactions, monitor transactions, identify transactions that are not normal, and determine whether transactions are usual or suspicious. However, sometimes reaching the prescribed level of KYC is not enough to combat ML in the context of global businesses and

³¹ Bruce Zagaris and Scott B MacDonald, 'Money Laundering, Financial Fraud, and Technology: The Perils of an Instantaneous Economy' (1992–1993) 26 *George Washington Journal of International Law & Economy* 61.

³² See, John J Byrne, 'Know Your Customer: What Happened and What Happens Next?' (2000) 3 *Journal of Money Laundering Control* 345; Andrew Jackson, 'Recognizing and Reporting Money Laundering: How Well Should You Know Your Customer?' (2000) 3 *Journal of Money Laundering Control* 317.

transactions. To meet different objectives, AML practitioners should conduct distinct countermeasures, that is, at no time and under no circumstances should the ‘one-size-fits-all’ principle be applied to fighting against ML.

In 2006, FATF released a specific document³³ focused on trade-based money laundering (TBML), demonstrated the risks and vulnerabilities that can be exploited by criminals, officially defined TBML for the first time, and provided a number of ML cases that involved the international trade system and illustrated how the system had been exploited. FATF further highlighted the risk of the trade system being misused for ML,³⁴ set up the directions for capacity building and awareness-raising in relation to TBML, and provided practical plans for identifying typologies and supplied red flag indicators of TBML. FATF also encouraged countries to develop domestic mechanisms to link the work of relevant authorities and international cooperation. With regard to issues concerning TBML, Delston and Walls³⁵ focused on preventive measures required beyond financial institutions (normally banks). It is true that more should be done for identifying ML activities outside the financial sectors, however, the loose watch kept by bankers in relation to the TBML problem will lead to serious consequences. Scott³⁶ analysed the link between TBML and banking sector, and stated that ML through trade financing is an issue that needs to be monitored by banks that finance international trade transactions. She also suggested that banking sectors should extend the KYC policy to a ‘know your business’ policy, and recommended that international banks should protect themselves so that they do not finance illegal customers and businesses.

³³ Financial Action Task Force on Money Laundering (FATF), *Trade Based Money Laundering*, 23 June 2006.

³⁴ See, Financial Action Task Force on Money Laundering (FATF), *Best Practices Paper on Trade Based Money Laundering*, 20 June 2008.

³⁵ See, Ross S Delston, ‘The 41st FATF Recommendation: Why Preventive Measures Targeting Trade-Based Money Laundering Should Reach Beyond Banks’ (March 2008) Money Laundering Bulletin; Ross S Delston and Stephen C Walls, ‘Reaching Beyond Banks: How to Target Trade-Based Money Laundering and Terrorist Financing Outside the Financial Sector’ (2009) 41 *Case Western Reserve Journal of International Law* 85.

³⁶ Kathleen A Scott, ‘Trade-Based Money Laundering’ (2008) 240 *New York Law Journal*, 17 September 2008.

1.2.5 Anti-Money Laundering Risk Management in Financial Sectors

The movement for the adoption of practical AML policies in financial sectors in addition to existing AML-related literature and policies was influenced by a growing awareness of ML vulnerabilities that had previously lain hidden in every possible aspect of financial transactions, from the customer, transaction interface, payment instruments, financial services and products, and so on. These emerging challenges and potential ML risks placed financial sectors in a difficult position, and forced them to keep reviewing previous AML arrangements, trying to recognise and offset the weaknesses and eliminate loopholes, and proposing revised approaches. Following this trend, the latest AML countermeasures are presented as risk-reducing plans, involving the establishment of the customer risk-rating, ML risk management, and the application of RBA.

Some studies³⁷ have described the laundering of criminal proceeds through the abuse of internet banking, and the potential for abuse presented by the development of smart cards and cyber-wallets in the new century. In addition, e-banking, new payment technologies and digital currencies have been identified as possessing risk characteristics which pose a threat to traditional due diligence systems in the international campaign against ML, and limit the effectiveness of implementing internal controls in numerous areas. Joyce and Moulette³⁸ argued compliance with full due diligence requirements through electronic operating procedures is challenging, and suggested solutions regarding this issue, such as applying the international initiatives pertaining to electronically focused risk management principles, establishing partnership with international litigation and business advisory services

³⁷ See, Brian P Joyce, 'E-diligence: Money Laundering Risks in the Electronic Arena' (Autumn 2001) 5 *Journal of Money Laundering Control* 146; William C Gilmore, *Dirty Money: The Evolution of Money Laundering Counter-Measures* (Council of Europe Publishing, 2nd ed, 1999); Patrick Moulette, 'Money Laundering: Staying ahead of the Latest Trends' (April 2000) *The OECD Observer* 28. In this study, Moulette focused on the increasingly sophisticated methods of laundering money, including the derivatives and securities markets, insurance services, and electronic payment technologies, all of which brought greater difficulty for the prevention and detection of ML offences. On the other hand, Moulette also pointed out that the preventive measures in place should make it possible to detect any suspect transactions.

³⁸ See, Joyce, above n 35; Moulette, above n 35.

engaged in AML programs, and implementing tailored best practices and standards to reduce the vulnerabilities from advanced technology and minimise electronic breaches of security.

Jackie Johnson³⁹ drew upon the responses of the financial services sector to the upgraded CDD procedures in FATF's new CDD procedures, represented the increasing concerns on high-risk areas of politically exposed persons (PEPs), correspondent banking relationships, and non-face-to-face transactions in relation to ML prevention, and assessed the likely reactions of the financial services sector to the FATF's expanded CDD recommendations. Johnson concluded that simplified CDD procedures based on the perceived risk will inevitably lead to different standards of application even within jurisdictions, and that leaving a heavy burden of implementing upgraded CDD procedures on individual financial institutions is unrealistic, costly, inefficient and time-consuming without resulting in effective prevention of ML offences. The latest trend of exploring the high-risk posed by the PEPs and examining the PEPs-related CDD measures has resulted in calls for extending enhanced CDD policies that exist in relation to foreign PEPs to domestic PEPs. Johnson⁴⁰ argued that PEPs should be dealt with at a local/domestic level before countries are able to deal with CDD for foreign PEPs, and stated that this will become a prerequisite for effective global regulation. Kim-Kwang Choo⁴¹ holds a similar viewpoint regarding extending PEP monitoring to individuals holding prominent public positions in their own jurisdictions, or individuals exercising functions not normally considered prominent but who have political exposure comparable to those of similar positions at a prominent level, and individuals holding important positions in private sectors, such as the Chief Executive Officers (CEOs) of listed companies.

³⁹ Jackie Johnson, 'How Will the Financial Services Sector Respond to the Financial Action Task Force's Increased Customer Due Diligence Requirements?' (December 2003) 5 *Journal of International Banking Regulation* 127.

⁴⁰ Jackie Johnson, 'Little Enthusiasm for Enhanced CDD of the Politically Connected' (2008) 11 *Journal of Money Laundering Control* 291.

⁴¹ Kim-Kwang R Choo, 'Politically Exposed Persons (PEPs): Risks and Mitigation' (2008) 11 *Journal of Money Laundering Control* 371.

Previous studies also raised awareness of ML risk management in financial sectors. Alexander⁴² said that national regulatory authorities need to promote safe and sound banking systems through the effective management of systemic risk in national markets. Alexander also stated that the lack of a coherent international regime providing standards for the risk-taking activities of financial institutions has exposed financial systems to an increased risk of systemic failure, and banks should recognise that traditional methods of risk management have to assess the risk of new financial instruments. Finally, Alexander called upon authorities to establish minimum standards of prudential practice, monitor national compliance with such standards and coordinate enforcement with national authorities. A project conducted by Savona and Martocchia⁴³ suggested that a crime risk assessment mechanism should be applied to examine the effectiveness of risk prevention in financial sectors. In this study, notions of crime risk index, crime threat index and harm index have been introduced as well as assessment standards for market/sector vulnerability to ML.

Mentioned earlier, ML risk management in banking institutions has been illustrated in several studies. In 2002, the Wolfsberg Group agreed on Principles that constitute global guidance on the establishment and maintenance of correspondent banking relationships. The Wolfsberg Group believes that (as stated in the Preamble to those Principles):

[A]dherence to these Principles will further effective risk management and enable institutions to exercise sound business judgment with respect to their clients. Furthermore, adherence to these Principles will support the aim of Wolfsberg Group members to prevent the use of their worldwide operations for criminal purposes.⁴⁴

⁴² Kern Alexander, 'The Need for Efficient International Financial Regulation and the Role of a Global Supervisor' (Summer 2001) 5 *Journal of Money Laundering Control* 52.

⁴³ Ernesto U Savona, and Sara Martocchia, 'Developing the Crime Risk Assessment Mechanism' (2006) 12 *European Journal of Criminal Policy and Research* 325.

⁴⁴ Wolfsberg Group, *The Wolfsberg Anti-Money Laundering Principles for Correspondent Banking* (November 2002) <<http://www.wolfsberg-principles.com/corresp-banking.html>>.

A group of researchers undertook a study on crime risk assessment mechanisms, and focused on the effectiveness of financial entity regulation, ML regulation and offshore banking services regulation. The authors defined the market/sector vulnerability to ML risk as the combination of two main components — market/sector attractiveness and market accessibility to criminals. By examining the market/sector vulnerability indicators to ML, financial sectors and financial services market can effectively reduce illicit conduct via the financial entities in practice.⁴⁵

In relation to ML prevention, the securities sector and insurance industry are new areas compared to banking in international AML battlefield. In any event, as banking institutions increase their defences against ML, it is important to ensure that securities, the futures markets and insurance industry do not become a comparatively more attractive alternative for money launderers. As previously mentioned, IOSCO and IAIS have identified central issues that should be considered in developing tools for combating the use of the non-banking institutions for ML, including customer identification, record keeping and the ability to reconstruct transactions, detecting and reporting suspicious transactions, developing programs for intermediaries to guard against ML, and ensuring cooperation and coordination among domestic and international authorities.

In fact, FATF published separate guidance for combating ML in the securities sector and life insurance sector in late 2009.⁴⁶ New products and services in the securities sector and insurance industry, combined with the speed in executing transactions and the global reach of these sectors, made the industries attractive to those who would abuse them for ML. FATF also released a typology report in 2009 relating to combating ML in the securities sector, presenting detailed case studies to illustrate the ML risks and vulnerabilities involved in the securities industry, identified typical ML

⁴⁵ Federica Curtol, Andrea Di Nicola, Sara Martocchia and Ernesto U Savona, 'Regulation of Offshore Banking Services and Financial Entities' (2006) 12 *European Journal of Criminal Policy and Res* 279.

⁴⁶ See, Financial Action Task Force on Money Laundering (FATF), *Risk-Based Approach Guidance for the Life Insurance Sector*, October 2009; Financial Action Task Force on Money Laundering (FATF), *Money Laundering and Terrorist Financing in the Securities Sector*, October 2009.

predicate offences linked to securities, and called for further improvement in identifying suspicious activities and filing STRs in the industry. In a similar fashion, the FATF 2009 guidance for the life insurance sector outlined the high-level principles for the creation and implementation of an RBA, listed the characteristics of risk indicators for life insurance companies and intermediaries as vehicles for ML, provided suggestions for applying an RBA to the life insurance sector, and illustrated a number of factors for creating an effective internal control structure in the life insurance sector.

As the RBA was first introduced by FATF in 2007,⁴⁷ various scholars voiced their criticism on the issues of effective RBA implementation. Killick and Parody,⁴⁸ for example, highlighted the need for regulators to fall in line with the RBA and to pass to senior management the responsibility for the implementation of systems of control which are appropriate and proportionate; however, most of the current AML systems of control are driven by regulatory requirements and not an understanding of the risk facing the financial entities. Jos de Wit⁴⁹ focused attention on the issues in relation to implementation of RBA to AML by reviewing CDD procedures, customer acceptance program, and the importance of risk management and risk qualification. He also outlined the controversy between financial institutions and regulators in the approach to AML, and found that regulators and financial institutions need to co-operate so that AML standards can be set within an RBA and be implemented in the most effective way possible in order to prevent ML.

Issues in relation to practising risk-based AML strategies which involve significant elements of uncertainty were addressed by Ross and Hannan as well.⁵⁰ The authors

⁴⁷ Financial Action Task Force on Money Laundering (FATF), *Guidance on the Risk-Based Approach to Combating Money Laundering and Terrorist Financing-High Level Principles and Procedures*, June 2007.

⁴⁸ Marcus Killick and David Parody, 'Implementing AML/CFT Measures that Address the Risks and Not Tick Boxes' (2007) 15 *Journal of Financial Regulation and Compliance* 210.

⁴⁹ Jos de Wit, 'A Risk-Based Approach to AML: A Controversy between Financial Institutions and Regulators' (2007) 15 *Journal of Financial Regulation and Compliance* 156.

⁵⁰ Stuart Ross and Michelle Hannan, 'Money Laundering Regulation and Risk-Based Decision-Making'

argued that the move to RBA represents a fundamental conceptual shift from the previous rule-based and case-based approaches, and that there are a number of theoretical and practical issues that must be resolved if risk-based strategies are to work effectively. The study analysed the rationale for risk-based AML regulation, made comparisons among rule-based, case-based and risk-based approaches when they are applied in practice, defined risks in ML as probabilistic risk, consequence risk and regulatory risk, and presented the elements of a risk assessment system. The study concluded that risk assessment systems move towards a regulatory approach that is based on risks rather than compliance with rules, and that there is also a need for fundamental changes in the relationship between the regulators and the regulated. The authors pointed out that those responsible for developing and refining risk-based decision models must have access to knowledge about the outcomes of assessments.

1.2.6 Anti-Money Laundering in Chinese Financial Sectors

With regard to the ML issues in China, there is little literature in English to be found. Since China is a relatively special country with its unique characteristics as regards culture, economy, and politics, not many foreign scholars have examined the working mechanism of combating ML in China. However, international researchers are still concerned with the soundness of Chinese financial institutions as well as the Chinese AML system. McCusker noted Chinese financial institutions should improve their integrity, compliance, discipline and transparency, and the external discipline provided by the financial system has been a major weakness.⁵¹ The author maintained that previous high profile cases of governance failure, corporate misconduct and significant fraud scandals that have occurred show the poor oversight and lax internal controls within Chinese financial sectors; and argued that the e-trading and globalisation will keep challenging the comprehensiveness and soundness of Chinese

(2007) 10 *Journal of Money Laundering Control* 106.

⁵¹ Rob McCusker, 'China, Globalisation and Crime: A Potential Victim of Its Own Prospective Success?' (August 2004) 12 *Journal of Financial Crime* 44.

financial institutions. Lewis⁵² conducted a review study concerning China's compliance with UNTOC's requirements. As an important part of UNTOC, the criminalisation of the laundering of proceeds of crime was carefully looked at. The author described revisions to Chinese legislation in relation to AML since signing UNTOC, detailed the evolution of the battle against ML, including the establishment of the Chinese FIU, the enactment of the *Chinese AML Law*, the expansion of AML regulated entities, and the increasing participation in international AML cooperation. Although China has significantly strengthened its AML efforts in a short period of time, financial risk management in the financial sectors is still weak. Apart from these two scholars (McCusker (2004) and Lewis (2007)), the most comprehensive document concerning Chinese AML working system is the First Mutual Evaluation Report in relation to China, which was published by FATF on 29 June 2007.⁵³ This report provided a summary of the AML measures in place in China before November 2006, and set out China's levels of compliance with the FATF 40 Recommendations, and suggested how certain aspects of the system could be strengthened. However, this examination was conducted before the enactment and implementation of the *Chinese AML Law*, and a numbers of loopholes mentioned in the report have since been gradually addressed; nevertheless some shortcomings still exist in the current AML system in China.

In fact, a limited number of research papers written in English by Chinese scholars concerning ML issues in China have been published internationally during the past decade. The very first academic literature in English was by Song Yang in 2002.⁵⁴ The author illustrated three main ML methods in China, discussed major problems encountered by Chinese law enforcement authorities in cracking down on ML, and

⁵² Margaret K Lewis, 'China's Implementation of the United Nations Convention against Transnational Organized Crime' (2007) 2 *Asian Journal of Criminology* 179.

⁵³ Financial Action Task Force on Money Laundering (FATF), *First Mutual Evaluation Report on Anti-Money Laundering and Combating the Financing of Terrorism — People's Republic of China*, 29 June 2007.

⁵⁴ Song Yang, 'Money Laundering in China: A Policy Analysis' (November 2002) 18 *Journal of Contemporary Criminal Justice* 370.

made recommendations on AML improvement in China. Ping He⁵⁵ analysed the legislative loopholes in Chinese AML system in early 2000s. By reviewing the evolution of the *Chinese Criminal Law* relating to ML, Ping He explained the definition of ML crime in relevant Articles in the *Chinese Criminal Law* (2001) (the Code), demonstrated the scope of the predicate offences for ML defined in the Code, described the behaviour patterns of ML crime under the Code, and comprehensively presented the system of sanctions applicable for ML crime in China. The study shows that although the *Chinese Criminal Law* (2001) has loopholes in many aspects, including a relatively short list of predicate offences for the ML offence, as well as a number of ambiguous definitions for some of the terms used in the legislation, the legislation on confiscation in *Chinese Criminal Law* is an efficient tool in the fight against ML and related crimes. In her later study,⁵⁶ Ping He described the issues in China that are closely related to the predicate offences and other relevant factors, such as corruption, underground banking system, and shell companies. The author presented evidence and cases showing the relationship between predicate offences and ML in China, and indicated various loopholes that exist in Chinese AML legislation, as well as the difficulties involved in conducting an AML investigation in China. She stated that to investigate ML, AML authorities should recognise the weakest link in the process, that is the placement stage of the ML process. She noted that financial institutions should truly implement relevant obligations, and the FIU should really plays its role by improving the ability to analyse suspicious transaction activities, and enhance the feedback system in relation to guiding the regulated entities in combating ML. She concluded that China should make greater efforts to investigate ML activities efficiently and successfully.

Dongrong Li⁵⁷ detailed the legislative improvements of AML in China, especially in

⁵⁵ See, Ping He, 'Chinese Criminal Law Concerning Money Laundering' (Spring 2003) 6 *Journal of Money Laundering Control* 337; Lifang Zhu and Ping He, 'The Chinese Financial Institution Campaign against Money Laundering' (Autumn 2003) 7 *Journal of Money Laundering Control* 145.

⁵⁶ Ping He, 'Is Money Laundering a True Problem in China?' (February 2006) 50 *International Journal of Offender Therapy and Comparative Criminology* 101.

⁵⁷ Dongrong, Li, 'China: Anti-Money Laundering in a Foreign Exchange Area' (August 2005) 8

the foreign exchange area. As the deputy administrator of the State Administration of Foreign Exchange (SAFE), the author maintained that since 2003, SAFE has taken effective measures to strengthen legal, institutional and electronic systems to create the foundations of an AML system for foreign exchange transactions, and reviewed the achievements made by SAFE at the primary stage in relation to combating ML. Li also stated that, under the supervision of PBC, as well as working more closely with Chinese FIU, the judicial authorities and other law-enforcement agencies and financial regulatory departments, SAFE will continue to upgrade the level of screening and analysing reports on large-value and suspicious foreign exchange transactions, and further advance its AML work in the foreign exchange field.

After the enactment of the *Chinese AML Law* in 2007, various Chinese scholars described the progress of the AML legislation in China, starting from the revision of criminal law, the three rules published by PBC, and the greatest success, the enactment of *Chinese AML Law*, have been successively appraised. These studies⁵⁸ generally examined merits and shortcomings of the three PBC rules promulgated in 2003, as well as the newly enacted *Chinese AML Law*. It is evident that the AML legislation is improving, from the revision of criminalisation of ML, greater supervision of AML, and broader AML obligations of financial institutions, to the strengthened customer identity recognition system, retention of customer identity documents and transaction records system, and the adoption of large-sum transactions and suspicious transactions reporting systems, as well as the growth of AML investigations, international AML cooperation, and the imposition of legal liabilities for violating the *Chinese AML Law*. The authors noted that the 2007 law has made significant progress compared to previously adopted AML legislation and regulations in China. It expanded the PBC 2003 rules from applying only to banking institutions

Journal of Money Laundering Control 335.

⁵⁸ See, Tiecheng Yang, and Nan Zhang, 'China's New Rules on Anti-Money Laundering' (2007) 8 *Journal of Investment Compliance* 58; Ping He, 'Comments on the Law of the People's Republic of China on Anti-Money Laundering' (2007) 10 *Journal of Money Laundering Control* 438; Ping He, 'The Measures on Combating Money Laundering and Terrorism Financing in the PRC — From the Perspective of the Financial Action Task Force' (2008) 11 *Journal of Money Laundering Control* 320.

to applying to other non-bank financial institutions, thus involving more financial sectors in combating ML in China. However, its shortcomings are also evident, and the authors pointed out that the *Chinese AML Law* fails to cover criminal matters and confiscated assets and sharing systems, so as to clearly provide the scope and the obligations of non-financial institutions, nor does it pay enough attention to identifying PEPs as well as to conducting CDD on the basis of risk sensitive assessment.

However, all the above-mentioned studies are taken on the basis of the law ‘on paper’, that is they are mainly focused on discerning the gap between Chinese AML legislation and the international standards and best practice, rather than addressing the real problems experienced in the practical implementation of such laws and their provisions. Tang and Ai⁵⁹ addressed the practical issues in relation to Chinese AML implementation in 2009. The authors not only revealed the gap between the international CDD requirements of FATF and the Chinese CDD provisions, but also critically examined the practical shortcomings in implementing CDD measures in China, and provided recommendations on future practice. The authors stated that Chinese practice in CDD-related areas should require the establishment of executive guidelines and examination procedures in a timely fashion, enhance supported social resources of customer identification, improve regulation on new technology-related transactions, integrate customer information in AML and other financial business, and apply CDD measures to AML risk management.

Numerous articles written in Chinese showed the enthusiasm for discussing ML issues in Chinese academic circles; however, most of them are repetitive explanations which lacked innovative thinking and in-depth analysis. For this reason, only studies with relatively high quality concerning ML issues in Chinese will be reviewed below.

⁵⁹ Jun Tang and Lishan Ai, ‘The International Standards of Customer Due Diligence and Chinese Practice’ (2009) 12(4) *Journal of Money Laundering Control* 406, 406–16.

Concerns related to ML by Chinese scholars started from the end of 1990s. At the primary stage of research into ML,⁶⁰ the main results were the definition of ML offences, the introduction of foreign AML experiences, providing explanations of ML steps, and so on. The productive stage⁶¹ focused on learning from others, and basic thoughts on the rationales of applying foreign AML systems to the Chinese environment were based on a basic knowledge of ML and AML programs. Coupled with the evolutionary courses of standardising the Chinese AML system, the needs for more practical countermeasures with Chinese characteristics were recognised. Since 2003, several researchers considered the Chinese AML legislation using comparative study of legislation.⁶² By reviewing the international standards on AML, loopholes in the then existing Chinese legal system in this field were found, and significant

⁶⁰ See, 邵沙平 [Shao Shaping], 《跨国洗钱的法律控制》[Legal Control on Transnational Money Laundering] (武汉大学出版社[Wuhan University Press], 1998); 阮方明 [Ruan Fangmin], 《洗钱罪的惩治与预防》[Penalties for and Prevention of Money Laundering Offences] (中国检察出版社 [China Prosecute Press], 1998); 甄进兴 [Zhen Jinxing], 《洗钱犯罪与对策》[Money Laundering and the Countermeasures] (东方出版社 [Oriental Press], 2000); 宋炎禄 [Song Yanlu], 《洗钱与反洗钱的较量》[The Competition between Laundering Money and Anti-Money Laundering] (西南财经大学出版社 [Southwestern University of Finance and Economics Press], 2001); 阮方明 [Ruan Fangmin], 《洗钱罪比较研究》[Comparative Study of Money Laundering Crimes] (中国人民公安大学出版社 [Chinese People's Public Security University Press], 2002).

⁶¹ See, 赵金成 [Zhao Jincheng], 《洗钱犯罪研究》[Research on Money Laundering Offences] (中国人民公安大学出版社 [Chinese People's Public Security University Press], 2006); 俞光远 (编) [Yu Guangyuan (ed)], 《反洗钱的理论与实践》[The Theory and Practice of Money Laundering] (中国金融出版社 [China Financial Publishing House], 2006); 詹昭, 柳军, 柳杰 [Zhan Zhao, Liu Jun and Liu Jie] 《反洗钱解读与操作实务》[Interpretation and Applicable Operation of Anti-Money Laundering] (中国人民公安大学出版社 [Chinese People's Public Security University Press], 2008; 严立新, 张震 [Yan Lixin and Zhang Zhen] 《反洗钱基础教程》[Basic Course of Anti-Money Laundering] (复旦大学出版社 [Fudan University Press], 2008); 李竞雄 [Li Jingxiong], 《反洗钱典型案例评析》[Analysis on Typical Cases of Anti-Money Laundering] (中国金融出版社[China Financial Publishing House], 2008).

⁶² See, 邵沙平 [Shao Shaping], 《控制洗钱及相关法律问题研究》[Legal Issues regarding the Control of Money Laundering and Related Crimes] (人民法院出版社 [Court Press], 2003); 郭建安, 王立宪, 严军兴 (编) [Guo Jianan, Wang Lixian and Yan Junxing (eds)], 《国外反洗钱法律规范汇编》[Legislative Standards for Anti-Money Laundering in Foreign Countries] (法律出版社 [Law Press], 2004); 张阳 [Zhang Yang], 《国际反洗钱规范透视》[Perspective on International AML Standards] (中国财政经济出版社 [China Financial & Economic Publishing House], 2004); 何萍 [He Ping], 《中国洗钱犯罪立法与司法》[Legislation for Money Laundering Offences and Criminal Justice in China] (上海人民出版社 [Shanghai People's Publishing House], 2005); 徐汉民, 贾济东, 赵慧 [Xu Hanmin, Jia Jidong and Zhao Hui], 《中国反洗钱立法研究》[Research on Chinese Anti-Money Laundering Legislation] (法律出版社 [Law Press], 2005); 安建, 冯淑萍, 项俊波 [An Jian, Feng Shuping and Xiang Junbo], 《〈中华人民共和国反洗钱法〉释义》[Interpretative Notes on the Anti-Money Laundering Law of The People's Republic of China] (人民出版社 [People Press], 2006); 徐汉民, 赵慧 [Xu Hanmin and Zhao Hui], 《中国反洗钱法研究》[Research on Chinese Anti-Money Laundering Law] (法律出版社 [Law Press], 2008).

progress was made during the past decade, and the possibilities for future improvement was also addressed. Falling within the area of combating ML in Chinese financial sectors, the most favourite topic in past studies⁶³ was the discussion of the AML mechanism operating in Chinese financial institutions, followed by the application of international standards for preventive measures to Chinese financial institutions, and the explanation of AML operating procedures in Chinese financial institutions. Although researchers began to analyse financial sector-related ML issues within a more specific purview, the aforementioned studies were overwhelmingly focused on operational problems faced by banking institutions, while the conditions of implementation of an AML program in the securities sector and insurance industry were rarely observed. Previous studies demonstrated the importance of undertaking a comprehensive AML program in the Chinese financial sectors, supported by sound AML legislation in the meantime. However, the ‘skin-deep’ studies did not provide valuable contributions towards the goal of really enhancing the AML effectiveness in the Chinese financial sectors.

Apart from these academic contributions, there are so far several doctoral dissertations⁶⁴ in Chinese, which have analysed ML issues. However, neither any

⁶³ See, 王进诚 [Wang Jincheng], 《中国金融业反洗钱机制选择》[The Choice of AML Mechanism in Chinese Financial Sectors] (当代中国出版社 [Contemporary China Publishing House], 2002); 梁英武 [Liang Yingwu], 《支付交易与反洗钱》[Payment Transaction and Anti-Money Laundering] (中国金融出版社 [China Financial Publishing House], 2003); 李德, 张红地 [Li De and Zhang Hongdi], 《金融运行中的洗钱与反洗钱》[Money Laundering and Anti-Money Laundering in Financial Operations] (中国人民公安大学出版社 [Chinese People's Public Security University Press], 2003); 欧阳卫民 [Ouyang Weimin], 《反腐败、反洗钱与金融情报机构建设》[Anti-Corruption, Anti-Money Laundering and Development of Financial Intelligence Units] (法律出版社 [Law Press], 2006); 孟建华[Meng Jianhua], 《洗钱与银行业机构反洗钱》[Money Laundering and AML in Banking Institutions] (福建人民出版社 [Fujian People's Publishing House], 2006); 熊海帆 [Xiong Haifan], 《中国保险业反洗钱制度研究》[Research on the Anti-Money Laundering Institution of the Insurance Industry in China] (经济科学出版社 [Economic Science Press], 2008).

⁶⁴ See, 朱宝明 [Zhu Baoming], 反洗钱若干问题的经济理论分析 [Economic Research on Several Questions of Anti-Money Laundering] (PhD Thesis, 暨南大学 [Jinan University], 2005); 叶涛 [Ye Tao], 全球金融机构反洗钱制度比较研究[A Comparative Study of Anti-Money Laundering of Global Financial Institutions] (PhD Thesis, 厦门大学 [Xiamen University], 2006); 严立新 [Yan Lixin], 银行反洗钱机制 [Anti-Money Laundering Mechanism in Banking Sector] (PhD Thesis, 复旦大学 [Fudan University], 2006); 高增安 [Gao Zengan], 基于交易的可疑洗钱行为模式与反洗钱对策研究 [Research on Transaction-Based Suspicious Money Laundering Behavioural Patterns and Anti-Money Laundering Countermeasures] (PhD Thesis, 西南交通大学 [Southwest Jiaotong

single previous scholar of these studies posited the ML vulnerabilities faced by Chinese financial sectors as the research topic, nor has their research concerned the best approach for AML compliance in the Chinese financial sectors.

1.3 Significance and Contributions

The success of the global AML regime heavily depends on effective national implementation by individual countries. International standards are maintained by related countries in accordance with their legislation and institutional capabilities, which differ considerably from country to country due to varying economic, social, and cultural circumstances. The new round of evaluation of compliance with the FATF standards will include a particular focus on the effectiveness of AML systems, earlier detection of threats or vulnerabilities within jurisdictions and other measures to strengthen the system. Since risk first appeared as an explicit AML regulatory consideration in the FATF revised *Forty Recommendations* issued in June 2003, the idea of risk-based regulatory efforts has been developed as a central element in contemporary AML strategies at the international level.

By reviewing existing related literature, it can be seen that this research is addressing a significant need. This study will contribute to interpreting and applying international AML standards to create a Chinese relevant version, coupled with a critical evaluation on the effectiveness of the current AML system in Chinese financial sectors, primary explorations of vulnerability determination in Chinese banking, securities and insurance sectors, and practical proposals on the most applicable AML approach for strengthening the AML system in Chinese financial sectors.

University], 2007); 林安民 [Lin Anmin], 我国反洗钱立法演变研究 [Research on the Evolution of Chinese Anti-Money Laundering Legislation] (PhD Thesis, 华东政法大学[East China University of Political Science and Law], 2008; 杨冬梅[Yang Dongmei], 金融网络中洗钱行为分析、识别与监管研究 [A Study on the Analysis, Identification and Supervision of Money Laundering Behaviours in a Financial Network:] (PhD Thesis, 上海交通大学[Shanghai Jiao Tong University], 2008.

This research will provide innovative analysis of current Chinese AML regulation and compliance in financial sectors by linking the most contested issues and most topical concerns in China in regard to effectiveness evaluation, containing corruption, ‘hot money’ (that is, speculative short-term inter-country capital flows), capital flight, the grey (underground) economy, and so on. The most recent concerns include international TBML, risk management of ML threat, domestic PEPs, independent AML audits and the Chinese AML compliance industry, all of which are very new research topics in China. This research will also provide the first extensive study summary which summarises the non-financial and financial factors determining AML effectiveness in Chinese financial institutions. It will also provide innovative perspectives on the role that coordination and cooperation among financial institutions, competent authorities, and the AML compliance industry can play. For example, the financial institutions, law enforcement agencies, and the People’s Procuratorate can together combat corruption-related ML. Similarly, financial institutions, the SAFE, CBRC, CSRC, and CIRC can work out the problem of ‘hot money’ and capital flight-related ML, while the financial institutions, custom authority, tax authority, import and export authority can prevent international trade from being abused for ML.

In addition, since a comprehensive study on ML vulnerabilities faced by financial sectors in China has not yet been carried out, this research will provide the first examination of early threats and vulnerabilities in Chinese financial sectors in relation to ML activities. It will be the first proposal of key indicators of ML for a national risk-rating system in the Chinese financial sectors, and the first appraisal of applying a rule-based AML approach and a risk-based AML approach in the context of Chinese reality. It will also explore a completely new concept of Chinese ‘rule-based but risk-oriented’ AML approach.

Based on the above explanation, this research is designed to fill theoretical gaps in the literature and practical loopholes in the current Chinese AML program in the financial sectors. It is hoped that the research will make a significant and innovative

contribution to the national implementation of international AML standards in China, and will provide important and supportive input to the risk assessment concerning ML in China, as well as the future regulatory reform of the Chinese AML regime.

1.4 Research Design

1.4.1 Methodology

1.4.1.1 Theory of the Research

Combating ML in the Chinese financial sectors is basically a study on crime prevention. According to the definition of the National Crime Prevention Institute of the United States (US), crime prevention is an ‘elegantly simple and direct approach that protects the potential victim from criminal attack by anticipating the possibility of attack and eliminating or reducing the opportunity for it to occur’.⁶⁵ Crime prevention can also be operationally explained as the practice of crime risk management, which involves the development of systematic approaches to crime risk reduction that are cost effective and that promote both the security and the socio-economic well being of the potential victim. Its focus is the potential victim and the environment, and it works by analysing the vulnerabilities of potential victims and taking countermeasures through which victim behaviour and the immediate social and physical environment are altered as so to reduce those vulnerabilities.

As ML offences are in themselves or ostensibly ‘victimless crimes’, however, crime risks have been transplanted onto the possible channels which could be abused by criminals with the aim of laundering ‘dirty’ money, that is the proceeds of other criminal activity. In this case, financial sectors become potential ‘victims’ if ML cases occurs through any financial institution. Public authorities place the burden of being ‘in the front line’ on financial institutions whose services may be exploited by

⁶⁵ National Crime Prevention Institute (NPCI), *Understanding Crime Prevention* (Butterworth-Heinemann, 2nd ed, 2001) 1.

criminals. They are thus expected to lead the battle against ML by undertaking a range of AML activities and fulfilling specific reporting responsibilities. Financial institutions should, therefore, undertake risk management to analyse the risk of their services being abused by criminals as well as the risk of their being fined as the result of reporting failures. With regards to the ML risks faced by the Chinese financial sectors, it is known that what will work for one crime in one sector may not work for the same crime in another. ML vulnerabilities should be analysed in each of the banking, securities, and insurance sectors respectively. Thus, the principal approach of the research is to conduct hybrid research, which contains both evaluation research and policy study. On the one hand, this research will evaluate the comprehensiveness of the current AML program in Chinese financial institutions, and on the other, this research will make practical suggestions for future improvement in practice.

In general, evaluation research may be the single most important task faced by the crime prevention program.⁶⁶ Without knowledge as to results, it is impossible to accurately plan for subsequent activities. Another part of this research is policy study, which involves systematically examining the nature, causes, and effects of alternative public policies with particular emphasis on determining the policies that will achieve given goals. Policy studies also examine the conflicts and conflict resolution that arise from the making of policies in civil society, the private sector, or more commonly, in the public sector. For the common goal of combating ML in Chinese financial sectors more effectively, financial institutions should fully understand the policy requirements imposed by public authorities, and the public authorities, on the other hand, should hold adequate knowledge of the structure, features and vulnerabilities in each financial sector to make right decisions.

These are examples of ‘if... then...’ statements addressed by policy analysis. In this study, the statement can be ‘If China implements a new “rule-based but risk-oriented”

⁶⁶ Michael G Maxfield and Earl Babble, *Research Methods for Criminal Justice and Criminology* (Wadsworth, 2nd ed, 1998).

approach with its national risk rating system to combat ML, then the effectiveness of AML in Chinese financial institutions will be increased.’ Answering such questions provides a counterpart to evaluation research.

1.4.1.2 Choice of Research Method

When undertaking this hybrid research, the document and content analysis, and existing data method were used to evaluate the existing regulatory comprehensiveness concerning AML in the Chinese financial sectors. The author examined secondary resources include books, theses, conference papers, electronic or manual academic journals, newspapers, and magazines.

With regards to practical issues, a survey method was adopted. Open-ended interviews were undertaken by the author and AML-related professionals and exporters. Apart from surveys conducted, agency records were collected primarily by the author, and included published statistics and non-public agency records which are available to researchers.

Together with content analysis, the data analysis method was used in interpreting the statistical information to find out the ML vulnerabilities in Chinese financial sectors. Governmental annual reports and national conference publications were examined as well.

The comparison method also played a significant role in this research when comparing the ‘rule-based’ approach and ‘risk-based’ approach. International standards were reviewed, and key requirements were interpreted and assessed under Chinese conditions.

The model sample method was used in this research when providing workflow data for an enterprise-wide AML information solution system in Chinese financial institutions, and provided a map of strategy for a ‘rule-based but risk-oriented’ AML

approach in Chinese financial sectors.

1.4.2 Data and Sources

This research was conducted on the basis of various primary and secondary data.

Primary data refers to official data in relation to combating ML that has been issued by international standard setters and Chinese governmental authorities, including international AML standards, Chinese AML legislation and provisions, court convictions in the case of ML in China, government official reports, documents, or other official data. Data collected from interviews also contributed to the study.

Secondary data and materials represent data collected earlier by another researcher for some purpose other than the topic of the current study, including theses, papers, articles, research reports, and conference reports. This data was collected by using the university library, public and private libraries, manual and electronic journals, newspapers, magazines, official sites, and so on.

Data and records produced by formal organisations are the most common source of data in this research. This kind of agency data was extracted from official websites of organisations, agencies and forums, such as FATF, the Bank for International Settlements (BIS), the International Association of Insurance Supervisors (IAIS), the International Organization of Securities Commissions (IOSCO), Transparency International (TI), the Asia-Pacific Group on Money Laundering (APG), the Wolfsberg Group, the World Bank Institute (WBI), and the International Money Laundering Information Network (IMoLIN).

At the domestic level, data from the websites of the following organisations contributed greatly to the research: the People's Bank of China (PBC), the State Administration of Foreign Exchange (SAFE), the China Banking Regulatory

Commission (CBRC), the China Securities Regulatory Commission (CSRC), the China Insurance Regulatory Commission (CIRC), the China Anti-Money Laundering Monitoring and Analysis Center (CAMLMAC), and the China Centre for Anti-Money Laundering Studies (CCAMLS).

Data collection was also conducted through interviews with compliance officers from the Chinese financial sectors, senior officers in Chinese law enforcement agencies, AML experts and specialists, and practitioners in AML-related areas in China and globally.

1.5 Thesis Structure

Chapter 2 examines the definition of ML in Chinese legislation, the main features of ML activities in China, issues that are closely related to ML in China, and current arrangements in Chinese financial institutions.

Chapter 3 analyses economic, political, legal, and cultural factors which limit the effectiveness of AML activities in Chinese financial institutions, such as the unsound economic environment in the financial industry, inherent limitations and practical issues faced by transition countries, delayed and powerless criminal justice operations against financial crimes, negative effects of aspects of traditional Chinese culture, and the deficient informal system for AML in China.

Chapter 4 focuses on the implementing factors within financial institutions which may have an adverse impact on AML effectiveness, including the degree of enforceability of AML programs, AML internal control systems, and competing interests in regard to AML practice by the regulators and the financial institutions.

Chapter 5 analyses ML risks linked to financial institutions, comments on ML vulnerabilities in Chinese banking, securities, and insurance markets, and reveals ML

risks associated with mixed-businesses in Chinese financial sectors.

Chapter 6 explains the importance of developing combined functions of an ML risk-rating system and an enterprise-wide AML information solution system. In order to enhance risk management capacity and efficiency in regard to combating ML activities, financial institutions should carefully determine, analyse, and grade risks associated with customers and business operations, while taking national reality into consideration, and develop an enterprise-wide AML information system based on subjective assessment to produce a valuable monitoring result for further use by law enforcement agencies.

Chapter 7 examines both the rule-based and risk-based AML approaches, analyses the rationales of approach transition, examines the difficulties of adopting a full-blown RBA to AML compliance in Chinese financial sectors, and finally concludes that the ‘rule-based but risk-oriented’ AML approach or partial RBA framework is the correct choice given China’s AML realities.

Chapter 8 is the concluding chapter.

Notes:

1) Renminbi (RMB) or Chinese Yuan is represented throughout by its standard international abbreviation of CNY (unless in a quote).

2) This thesis was written from 2009 to 2012, and the average level of currency exchange rate between USD and CNY during this time period is ‘1 USD = 6.30 CNY’.

3) Given the ethical consideration, the identities of some interviewees are not be revealed for use in future publications.

Chapter 2. THE CRIMINAL OFFENCE OF MONEY LAUNDERING AND ANTI-MONEY LAUNDERING LEGISLATION AND REGULATION IN CHINA

Great progress has been made in defining and broadening the scope of predicate crimes for ML in Chinese legislation since ML became an important issue to the Chinese government in the early 2000s, in particular, the *Chinese Criminal Law* and the *Chinese AML Law*. Apart from these laws, a series of administrative rules and guidelines has allowed the Chinese AML system to develop comprehensive AML programs in the financial sector. These include CDD measures, a reporting system for large-value payments and suspicious transactions, a record keeping system, internal control systems, and AML awareness and training. The central bank (the People's Bank of China), in conjunction with other AML authorities, has fully implemented its powers to improve all aspects of the Chinese AML regulation system through such measures as the *Chinese AML Law*, the establishment of a Chinese FIU and the development and coordination of AML mechanisms.

This chapter introduces the definition of ML in Chinese legislation, discusses the main features of ML activities in China, describes issues that are closely related to ML in China, and briefly lists current arrangements in Chinese financial institutions.

2.1 The Criminal Offence of Money Laundering in China

Historically, ML has been seen as an economic activity. Currently, ML is regarded as a criminal activity, as ML has caused huge harm to national security, economic development, financial security, and social order. A few decades have passed since ML first became such a serious issue that it cannot be ignored, and the definition of ML has been changed gradually, with ML methods also evolving and prompting further refinement of the definition.

2.1.1 Definition of the Offence of Money Laundering in China

Before the policy of economic reform and openness, China experienced a highly-centralised planned economy. All financial activities were under national regulation, and the scope of business in the financial industry relied on manual operations. There were few interactions between the Chinese financial system and the global financial network, and economic crimes were rarely encountered at that time. Thus, the first version of *Chinese Criminal Law* in 1979 did not include a definition of ML as a crime. The implementation of a policy of openness and economic transition brought the opportunity for development to the country. However, due to unmatched reform measures, a lag in putting in place an effective legislative structure, and the increasing temptations generated by a consumer society, serious crimes such as smuggling, drug-trafficking, tax evasion, financial fraud, and crimes committed by criminal syndicates have gradually emerged in China. International criminal organisations also started to infiltrate into Chinese society. In order to conceal, and legitimate massive amounts of illicit funds, ML finally made an appearance in China.

In the 1990s, with the economic take-off, corruption and bribery of public officers rapidly spread. Most organised crime and in particular smuggling is connected to and assisted by corrupt officials, some even acting as the chief conspirator. When the demand for ML grew, large amounts of national capital flowed out of China. It is reported that the annual amount of ‘black’ money (that is, undeclared income from illegal activities) laundered abroad through underground banks reaches CNY 200 billion, including approximately CNY 30 billion estimated to stem from corruption and bribery.⁶⁷ However, in the 1990s, the criminal offences defined as predicate crimes to ML in the *Chinese Criminal Law* only included drug-related crime, crimes committed by organisations in the form of syndicates, and smuggling. With later developments, the range of ML predicate crimes has kept expanding. The 2001 revision extended the predicate offences for ML to include terrorist crime. Later, in 2006, the ML predicate offences were further enlarged by adding the crime of

⁶⁷ 马经 [Ma Jing] 《金融机构反洗钱实用手册》 [Practical Manual for Anti-Money Laundering in Financial Institutions] (中国金融出版社[China Financial Publishing House], 2008) 7.

corruption or bribery, the crime of disrupting financial management order, and the crime of financial fraud. This has made a significant contribution to combating ML in China.

Since laundering drug-related proceeds was stipulated in the *Decision on Banning Drugs* (1990), the *Chinese Criminal Law* (2006) has been amended a number of times to further define ML predicate crimes. The criminal law currently categorises the predicate offences for ML as drug-related crime, crimes committed by organisations in the form of a syndicate, terrorist crimes, the crime of smuggling, the crime of corruption or bribery, the crime of disrupting the financial management order, and the crime of financial fraud.

The sixth amendment to the *Criminal Law* was adopted at the 22nd meeting of the Standing Committee of the Tenth National People's Congress on 29 June 2006.

Paragraph I of Article 191 of the *Criminal Law* was amended as follows:

Where anyone who obviously knows that any income is obtained from any drug-related crime, crimes committed by organisations in the form of a syndicate, terrorist crime, crime of smuggling, crime of corruption or bribery, crime of disrupting the financial management order, crime of financial fraud, etc. as well as the proceeds generated therefrom, yet commits any of the following acts for the purpose of disguising or concealing the origin or nature thereof, the income obtained from the commission of the aforementioned crimes as well as the proceeds generated therefrom shall be confiscated, and the offender shall be sentenced to fixed term of imprisonment of not more than five years or detention, and/or a fine of 5% up to 20% of the amount of the money laundered shall be imposed. If the circumstances are serious, he/she shall be sentenced to a fixed term of imprisonment of not less than five years but not more than ten years, and a fine of 5% up 20% of the amount of money laundered shall be imposed:

- (1) Providing any capital account;
- (2) Assisting the transfer of property into cash, financial instruments, or negotiable securities;
- (3) Assisting the transfer of capital by means of transfer accounts or any other means of settlement;
- (4) Assisting the remit of funds to overseas;
- (5) Disguising or concealing the origin or nature of any crime-related income or

the proceeds generated therefrom by any other means.⁶⁸

Each change in legislation more closely approaches international standards in combating ML, however, it is still not entirely consistent with the FATF standard which specifies designated categories of predicate offences. For Chinese legislation to be entirely FATF compliant, ‘knowing acquisition’ and ‘use of proceeds’ should be included in the list of ML offences and self-laundering (where the perpetrator offence also launders the resultant proceeds) should also be criminalised.

2.1.2 Main Forms and Features of Money Laundering in China

Although the methods of ML have varied with the development of the economy and technology, ML methods have some recognised common factors. One method is converting proceeds to cash, and using financial institutions to enable the converted capital to move into countries with fewer restrictions on payment systems.

In detail, frequently-used methods for ML in China are as follows:

- (1) Through financial institutions, including the use of counterfeited commercial drafts; ML through the securities and insurance industries; through accounts opened by cheque; exploiting the cross-border movements of bank deposits; using credit loans;⁶⁹ and using futures and options for ML.⁷⁰

⁶⁸ 《中华人民共和国刑法修正案（六）》 [Criminal Law of the People’s Republic of China (VI)] (People’s Republic of China) National People’s Congress Standing Committee, 29 June 2006. According to FATF, ‘designated categories of offences’ include participation in an organised criminal group and racketeering; terrorism; trafficking in human beings and migrant smuggling; sexual exploitation; illicit trafficking in narcotic drugs and psychotropic substances; illicit arms trafficking; illicit trafficking in stolen and other goods; corruption and bribery; fraud; counterfeiting currency; counterfeiting and privacy of products; environmental crime; murder, grievous bodily injury; kidnapping, illegal restraint and hostage-taking; robbery or theft; smuggling; tax crimes; extortion; forgery; piracy; and insider trading and market manipulation.

⁶⁹ ‘Using credit loans’ refers to money-launderers use of illicit fund (eg, bank certificates of deposit or securities, etc) to get legitimate bank loans, and then using these loans to purchase real estate, companies or other kinds of property.

⁷⁰ Using financial derivatives available in the global financial system to conduct complicated financial transactions for transferring money is the primary method of cross-border laundering. Futures and options are effective tools for criminals with regard to conducting complex transaction. Criminal gains can be invested and laundered in the global futures market by futures brokers, and this is attractive for criminal organisations. In the global futures market, transactions are performed under the broker’s name. Futures exchanges do not request brokers to clarify details of customers and the origin of their funds. For this reason, criminals can achieve the goal of hiding the nature and origin of illicit funds.

- (2) Taking advantage of local policies in some countries and regions where there is strict privacy protection for banks or personal property, for example OFCs.
- (3) Investing the illicit funds to start legitimate businesses, for example, by establishing a shell company, investing in cash-intensive industries, and getting assistance from window finance corporations or law firms to launder money.
- (4) Transferring dirty money via the commodity market. Due to the strict regulation of currency transaction reporting, money launderers find that it is difficult to convert cash to bank certificates of deposit in the short term, but the risk of holding large volumes of cash is too high. Consequently, in order to change the form of wealth from cash to assets, feasible choices for money launderers include buying expensive metals, antiques and precious art productions. The reasons for choosing these means are based on following factors: the relatively high fluidity; the ease of re-conversion to cash when necessary; the fact that it is customary to deal with large amounts of cash in these transaction without arousing any special attention and suspicion; and smuggling expensive metals, antiques, and precious art productions is safer than cash-smuggling.⁷¹
- (5) Moving money through underground banking system or private loans. In recent years, the Chinese AML system has gradually built up its legislation, and strengthened the means of combating illegal foreign exchange transactions. Consequently, the risk of ML through the formal banking system is increasing, and the underground banking system has become a popular channel to shift money. In the coastal areas of China, some underground banks are established specifically for ML, providing special services for transferring ‘black’ money between the mainland and Hong Kong.

2.2 Issues Related to Money Laundering Offences in China

Anonymity of futures transactions obscures possible money-laundering activities. Funds involved and associated companies are from all over the world, making the concealed illicit funds hard to detect. In addition, unpredictable futures prices and the complex transaction skills involved can dazzle the supervisory systems.

⁷¹ 严立新, 张震 [Yan Lixin and Zhang Zhen] 《反洗钱基础教程》 [Basic Course of Anti-Money Laundering] (复旦大学出版社 [Fudan University Press], 2008) 11.

An important objective of the global AML regime has been to protect the integrity of the core financial system. Banks in particular are quasi-public utilities, and the public does not want them to be involved with ‘dirty’ money. This objective appears to have been largely achieved by means of setting rules and obligations in the formal financial sectors. However, it is also worth noting that one consequence of the substantial successes in reducing the direct involvement of large banks and the major financial centres in ML activities has been to divert laundering to other, less-regulated channels and institutions.⁷² Underground banks and private lending/credit businesses in particular have become optimal ML substitutes for formal financial institutions. Apart from these underground banks and private loans, corruption and international ‘hot’ money are also critically related to ML in China, and to a degree, all of these four modes show a strong correlation.

2.2.1 The Underground Banking System

The transfer process can be conducted through formal remittance processes via banks or other financial institutions, but it can also be implemented via illegal organisations. Based on the currency type and business classification, underground banks in China are divided into three main types: local currency based, foreign currency based, and hybrid underground banks.⁷³

- (1) In particular, local currency based underground banks predominantly conduct business in RMB, such as through deposits and loans, loan sharks, pawn shops and fund-raising. This type of underground bank survives in most provinces in China, especially in provinces where the numbers of private businesses are rapidly growing, namely, Zhejiang Province and Jiangsu Province, and so on.

⁷² Peter Reuter and Edwin M Truman, ‘Anti-Money Laundering Overkill?’ (2005) 27 (Winter) *The International Economy* 60, 56–60.

⁷³ 时延安[Shi Yanan] 《地下钱庄在资金非法跨境转移中的作用及刑事法制的对策》[*The Role of Underground Bank in Illegal Cross-Border Fund Transactions and the Measurement from Perspective of Legal Justice*] in 刘明祥, 冯军 (编) [Liu Mingxiang and Feng Jun (eds)] 《金融犯罪的全球考察》[*Global Examination on Financial Crimes*] (中国人民大学出版社[People’s University of China Press], 2008) 424.

- (2) Foreign currency based underground banks are mainly engaged in illegal financial services, including foreign exchange trading, cross-border transfers, and ML activities. These illegal financial services operate in foreign currencies, and any RMB involved in the business is normally for exchange. Foreign currency based underground banks are mainly located in the export-oriented economic regions, in places with many foreign-funded enterprises, coastal and border areas, that is, in provinces such as Guangdong, Fujian, Shandong and Heilongjiang.
- (3) The hybrid underground banks are concurrently engaged in the businesses of the abovementioned two types of underground banks.

Underground banks in China feature prominently in ML. It was reported by China Central Television in late 2004 that the commission fee for providing ML services is around 0.3 per cent, and this percentage ranges from 0.4 to 3.5 in 2011.⁷⁴ As the amount of funds for laundering is normally huge, ML services are very profitable. According to Chinese government data, unlicensed banks are believed to have lent more than CNY 630 million nationwide in 2005.⁷⁵ It is reported that 47 underground banks were shut down in 2005, resulting in CNY 1.7 million worth of funds being frozen, and in December 2006, 7 additional underground banks were uncovered with assets of more than CNY 14 billion.⁷⁶

The huge number of underground banks in China has had a critical impact on Chinese AML operations. The following three factors can explain the long-term survival of underground banks.

⁷⁴ See, 胡长春, 周人杰 [Hu Changchun and Zhou Renjie] 海南地下钱庄案 [Hainan Underground Bank Case] (18 October 2004) <<http://topic.news.hexun.com/detail.aspx?classid=1&id=870768>>; 新华社 [Xinhua News Agency] 海南地下钱庄 2 年洗钱 727 亿 [*Underground Bank in Hainan Laundered CNY 72.7 Billion within 2 Years*] (26 February 2012) <<http://finance.sina.com.cn/china/dfjj/20120226/084711455028.shtml>>.

⁷⁵ George W Russell, 'Dirty Money: Cleaning up China's Securities and Insurance Markets' (May 2006) 1 *Asia Law* 4.

⁷⁶ FATF, *First Mutual Evaluation Report on AML/ CTF — People's Republic of China*, above n 53.

* *The needs of the private economy and individuals* — Chinese financial institutions were set up in the age of the planned economy. Their organisational structure and functional objectives were mainly designed for providing services for large and medium sized state-owned enterprises. For the private economy and individuals it was difficult to get financial support from the traditional banking system. On the other hand, the simple process of obtaining finance from underground banks is welcomed by the individuals and the privatised economy, even if the loan interest is higher than that charged by the formally established banks.⁷⁷

* *Severe restrictions on foreign exchange* — current foreign exchange regulation means that companies and individuals cannot satisfy their demand for foreign exchange.⁷⁸ The deficiencies in the official foreign exchange system and related policies have bolstered the underground banking network to a certain extent. Although there has been a gradual and constant evolution of the foreign exchange system in China during the past 20 years, it remains tightly controlled, especially as regards control of foreign exchange in capital accounts. Only under special circumstances and subject to specific conditions can companies use foreign exchange. Companies do not have the sole right to determine foreign currency strategies, and the exchange risk is rising. Although foreign exchange regulations in China are not as tight as previously, the large demand for foreign exchange still cannot be met. As a result, individuals or corporations seek foreign exchange from underground banks.

* *The existence of illicit activities, such as money laundering or tax evasion*⁷⁹

⁷⁷ As is known to all parties and observers locally, the great development of small-sized enterprises in Wenzhou is closely connected with and supported by local ‘underground’ banks. See, 时延安[Shi Yanan], above n 73.

⁷⁸ Public security agencies found that the demand for foreign exchange for individuals and businesses has kept growing due to China’s opening-up reform, growth of foreign trade, and the more liberal policy in regard to Chinese citizens’ individual travel abroad. Because of the severe foreign exchange controls, there are strict requirements on the qualifications of foreign currency purchasers, with the result that demand for foreign exchange cannot be met through the regular channels. Also, according to China’s current foreign exchange system, free conversion and direct remittances of a lot of currencies (such as the Chinese Taipei dollar) are not allowed, resulting in difficulties in fund-raising and the availability of foreign exchange for private enterprises.

⁷⁹ 严立新, 张震 [Yan Lixin and Zhang Zhen], above n 71, 26.

— After making a profit from an initial investment, some corporations transfer the illicit gains overseas via underground banks in order to evade national tax obligations. In addition, smugglers and corrupt officers move their illicit funds out of China through underground banks, and convert the laundered money into various units of foreign exchange, to be used after fleeing China.

For a better understanding, three detailed cases are provided below to show ML through underground banks in China.

*Case One:*⁸⁰

In the Xiamen Yuanhua Inc smuggling case, Lai Changxing's proceeds were transferred overseas through an underground bank (Dong Shi Li) and involved CNY 12 billion of illicit proceeds. Lai's organisation also exploited shell companies and engaged in depositing and withdrawing cash through financial institutions. Although the underground bank was not the only vehicle to launder money in the Yuanhua Smuggling Scandal, the underground bank was the key element in the case.

*Case Two:*⁸¹

From the beginning of 1999 to August 2004, Huang Xitian, Zheng Jiming, Fang Liangbo, Lu Jiabin, and others smuggled huge amounts of diesel fuel and well-known cigarette brands from Vietnam to Beihai City in Guangxi Province. They then distributed most of the goods to Guangzhou, Zhongshan, and other places. Fully knowing the money was gained by smuggling and taking advantage of their experience as bankers, Huang Guangrui and Huang Xitian deposited CNY 170 million of that money into dozens of bank accounts opened in other people's names or with fake ID cards, withdrew the money and then gave it to a middleman who transferred the money to the Hong Kong accounts of two international trade companies, Xinxing and Yongxing, via underground banks. The 15 accomplices, including Huang Xitian, were sentenced to death with a two-year reprieve or different terms of imprisonment. Huang Guangrui was found guilty of ML and sentenced to five years of imprisonment, a fine of CNY 6 million with the illegal proceeds of CNY 1 million

⁸⁰ Ping He, 'A Typological Study on Money Laundering' (2010) 13(1) *Journal of Money Laundering Control* 21, 15-32.

⁸¹ Ibid.

confiscated.

*Case Three:*⁸²

In order to move criminal proceeds from smuggling, tax evasion and tax fraud to overseas, Xu Pengyan, the criminal head of a smuggling organisation in Shantou, Guangdong Province, established an underground bank with other two shareholders. Xu's younger brother, Xu Pengzhan, was in charge of the underground bank's daily operation. Xu Pengzhan and his criminal team opened many business accounts under more than 20 names of 'agricultural by-product' trading companies between September 1999 and September 2001. These trading companies were in fact shell companies. Since it is not obligatory under the large-value cash-withdrawal reporting system to report the purchasing of agricultural by-product companies, Xu's team withdrew huge amount of RMB in cash or accepted cash directly from clients, and transferred these monies through another underground bank in Shenzhen. Just in the period from March – August 2001, Xu Pengzhan assisted 15 clients to transfer money to the specific overseas accounts, with funds involving HKD 537 million (almost equals to CNY 530 million) in total. This was done through domestic settlement of RMB currency and overseas settlement of foreign exchange funds, and it was determined that most of this money was generated from smuggling, tax evasion and tax fraud.

Chinese authorities have closed a significant number of underground financial institutions over the past few years, and the PBC sees the fight against underground banks as an important measure to combat ML. Unlike traditional models of *hawala*-styled remittance system, Chinese underground banks are illegally established organisations that by their nature provide a range of business and financial services.⁸³ Article 174 of the *Criminal Law* stipulates that a person who sets up a commercial bank or other financial institution without authorisation from the PBC, shall be sentenced to a fixed term of imprisonment of not more than 3 years of criminal detention and/or a fine of not less than CNY 20,000 and not more than CNY 200,000;

⁸² 欧阳卫民 [Ouyang Weimin]《中外洗钱案例评析》[Analysis of Money-Laundering Cases in China and Foreign Countries] (法律出版社 [Law Press], 2005) 81.

⁸³ Legislation against the use of underground banks as a channel for money laundering and capital flight is found in the following articles of PRC Criminal Law: Article 174 outlines the crime of establishing commercial banks or other financial institutions without due approval; Article 176 describes the crime of illegal pooling of public deposits; Article 225 deals with the crime of illegal operation; Article 191 deals with the crime of money laundering.

and if the circumstances deemed to be ‘serious’, to a fixed term of imprisonment of not less than 3 years and not more than 10 years *and* a fine of not less than CNY 50,000 and not more than CNY 500,000.⁸⁴

Underground banks normally settle transactions in RMB in China, and in foreign currency abroad; however, these overall settlements by underground banks have to be operated through formal banks. Thus, there is an inevitable link between underground banks and formal banks, which is significant for combating ML. Attention should be paid to frequent transactions between a local company and an associated foreign company, and the large-value remittance of local and foreign currency transacted by individuals.⁸⁵ It is also necessary to manage the risk-control of enterprises involved in foreign exchange. For some foreign owned enterprises, the use of underground banking means they avoid going through all the tedious transaction process, and even assists them in obtaining profit from exchange rate transactions, in evading tax, and avoiding national regulations concerning foreign exchange. The eagerness of some domestic enterprises for illegal foreign exchange activities (such as fake investment, tax evasion, smuggling, and tax fraud) stimulates the growth of the underground banking industry in China.

Thus, in order to control some aspects of the booming business of underground banks in China, the financial market should be subjected to fewer restrictions. Some commercial banks should be permitted to operate the business of depositing and cross-border settlements of certain kinds of foreign currency as well as the business of exchange between foreign currency and RMB. In this way some of the business needs serviced by underground banks can be satisfied by legal banks. In addition, the current foreign currency administrative regulations should be modified to meet the normal demand for foreign currency by Chinese individuals and institutional residents

⁸⁴ 《中华人民共和国刑法修正案（六）》[Criminal Law of the People’s Republic of China (VI)]. The determination of the existence of serious circumstances depends on the degree of social impact of each individual crime.

⁸⁵ Tiecheng Yang and Nan Zhang, ‘China’s New Rules on Anti-Money Laundering’ (2007) 8 (2) *Journal of Investment Compliance* 58, 58-62.

and the approval procedures for this purpose should be simplified. Given the size and nature of the underground banking system, the government needs to respond and the way it can do this is by subsidising certain financial transactions or by permitting banks to offer a premium rate to allow the formal banks to compete with underground banks, and to attract more people to deposit their foreign currency reserves in legal bank accounts issued by formal banks.

2.2.2 Corruption Related Money Laundering

A unique group of money launderers in China are corrupt public officials. China, as an emerging transition country, and due to this as well as many complicated reasons arising from China's history, corruption is an extremely critical problem for the central government and the broader community. In 2006, a senior officer from Ministry of Public Security stated that:

[T]he most frequently occurring money laundering activities in China are corruption, embezzling state-owned property, fraud assisted by inside officers, and stealing financial institution's capital and then transferring the illicit gains to overseas jurisdictions.⁸⁶

The annual amount of money laundered in these four abovementioned ways has been estimated to be as high as hundreds of billions of RMB, reaching over 60 per cent of all the ML activities'.⁸⁷ Unfortunately, only the crimes of corruption and bribery are listed as ML predicate crimes in the current *Chinese Criminal Law*, that is to say, other means of transferring state-owned capital are not contained in current AML legislation. This is obviously a serious blind spot in combating ML in China. Although SCNPC passed the 7th Amendment of Criminal Law in August 2008, which has widened the scope of the crimes of corruption and bribery to include immediate relatives of public servants and dismissed public servants,⁸⁸ the expanded list is still

⁸⁶ 熊海帆 [Xiong Haifan], 《中国保险业反洗钱制度研究》[Research on the Anti-Money Laundering Institution of Insurance Industry in China] (经济科学出版社 [Economic Science Press], 2008) 40.

⁸⁷ Ibid.

⁸⁸ This may have some connection with the big move to crack down from 10 July 2008 on syndicate type organisations launched in Chongqing City, Sichuan Province.

way short of the international standards.

ML is a leading cause of capital flight, and a large part of illicit funds generated from corruption has flowed abroad. A statistical survey by SAFE revealed that China has more than 4,000 suspected cases in relation to the stealing public funds till 2008, and it is estimated corrupt public officials who have fled abroad have taken out of China more than CNY 50 billion (thousands of millions, the US definition) derived from bribery. During the period 1997–1999, capital flight amounted to USD 8.4 billion, which was more than the total annual income from foreign investment in China.⁸⁹ Hence, corruption related ML activities in China represent a very serious problem.

Due to the nature of transnational crime and the inherent limitations of cross-jurisdictional regulation, the international financial system used by corrupt officials to transfer their proceeds out of China makes the regulation and investigation of these transfers difficult. Furthermore, the prosecution of cross-border ML conducted by corrupt officials may result in relevant issues becoming intertwined because of the inclusion of a number of special factors. Corruption-related ML is not only closely linked to the destruction of economic order but also of the political and social order because criminals in such cases have special capacities due to their political, financial and personal power. Consequently, corrupt officials usually flee to foreign countries and apply for political asylum so as to politicise their economic crimes, generating great difficulties for the extradition and prosecution with regard to such offences.⁹⁰

In general, the current new ML methods related to corruption are as follows:

- a) ‘Profiteer First, Laundering Second’⁹¹ — public employees build up an

⁸⁹ 王明高，罗凤梅 [Wang Minggao and Luo Fengmei], 《洗钱犯罪及其防范》 [Money Laundering and Its Prevention] (2005) 2 湖湘论坛 *Huxiang Forum* 29, 29–32.

⁹⁰ 张长龙 [Zhang Changlong], 《腐败分子跨国洗钱及其对策》 [Transnational Money Laundering in Corruption and Its Counterstrategies] (2006) 3 商场现代化 *Market Modernization* 228, 228–9.

⁹¹ 王明高，罗凤梅 [Wang Minggao and Luo Fengmei], above n 89.

illegitimate fortune during their tenure of office, and then quit their jobs to establish their own corporations. They then legally invest their money in business or the stock exchange, hiding the criminal proceeds behind these new transactions;

b) ‘Profiteer While Laundering’⁹² refers to public employees who arrange for their family members and relatives to set up their own companies, restaurants, or other commercial businesses with the money collected by using their official powers. They then hide the ‘black’ money in the various firms’ bank accounts;

c) ‘Profiteer, Laundering at the Same Time’⁹³ means public employees and general managers in state-owned enterprises (SOEs) establish private enterprises under their own names so that ‘black’ money can be transferred to the accounts of these private enterprises, and moved abroad; and

d) ‘Transnational Laundering of Money’ that is, after collecting illegal gains from corruption, embezzlement, or through accepting bribes, then the public employees launder the illicit money outside of China.⁹⁴

Apart from ways of money-laundering that have been mentioned above, there are other means applied by the corrupt to whiten (‘launder’) illegal income. Firstly, corrupt officials can ‘wash’ illicit money through their children’s educational expenses in foreign countries, and bribes can be a direct deposit into the accounts of the corrupt official’s children opened from foreign country.⁹⁵ It is worth noting that cross-border ML activities in relation to corruption have shown new features recently, namely, ‘en-cashing after off-position’.⁹⁶ To be specific, this new type of corruption

⁹² Ibid.

⁹³ Ibid.

⁹⁴ 李春 [Li Chun], 《我国当前洗钱犯罪的新形式及其防范对策：兼对洗钱犯罪刑法意义的商榷》 [New Types and Preventive Countermeasures of Money Laundering Crime in China: Discussion about the Criminal Significance of Money Laundering Crime] (2003) 3 云南警官学院学报 *Journal of Yunnan Institute of Police Officer* 54.

⁹⁵ 张长龙 [Zhang Changlong], above n 90.

⁹⁶ Ibid 229.

related ML refers to the corrupted officials not accepting illicit incomes from bribes straight after completing a transaction, but receiving these economic benefits after their resignation or retirement via various methods. These include getting a post-retirement job from the company supplying the bribe, exchanging their power inherent in their tenure of office into economic benefits after resigning from their position. Moreover, China suffers heavily from new forms of capital outflow, that is, there have been more and more so-called ‘Chinese business migrants’ to foreign countries who are virtually corrupt officials and unscrupulous merchants, laundering their black money derived from corruption under the mask of investments.⁹⁷

The increasingly restrictive regulations on government officials, the growing anti-corruption campaign, as well as ‘the crime of huge unidentified property’ possession identified by the *Chinese Criminal Law*, forces those who have gained from corruption to clean illicit incomes in any way possible.⁹⁸ In many cases, illicit funds gained from corruption are laundered through family-owned private companies, which do not have a standard business structure, with incomplete financial records, and large numbers of cash transactions and invisible transactions, and these become a Gordian knot for those involved in investigation and collection of evidence.

When a large part of illicit funds derived from corruption have been successfully laundered, the criminal will not be punished fully. The investigative agency will then seek out large value cash deposits, bank certificates of deposit, and precious goods from the suspect’s house, where these are clearly not compatible with the legal earnings of the suspect. These at least can constitute ‘the crime of huge unidentified property’. However, with the evolution of ML methods, corrupt officers can provide various kinds of documents to validate the ownership of massive ‘unidentified property’, making the charge of the crime of possession of ‘huge unidentified property’ even harder to prove. The Chinese procuratorial authority has put increasing

⁹⁷ 李春 [Li Chun], above n 94.

⁹⁸ Ibid.

efforts into fighting against corruption in recent years, but the number of corruption crimes has not declined at all. In order to solve this problem, a property declaration system has been conducted by the government since 2000 to monitor the financial situation of public servants. In addition, recent changes to the Chinese Criminal Law now enable some application of unexplained wealth laws to be implemented.

2.2.3 International Hot Money and Money Laundering

Profit seeking activity from international floating capital is sometimes accompanied by ML activities. With increasingly freer exchange policies regarding international capital, huge amounts of short-term foreign capital are used for speculation in countries which do not have a sound domestic economic structure. Such funds are referred to as 'hot money'. Foreign capital specialises in seeking profit from the money market and the securities market, and little of this hot money functions as a transnational corporation's foreign direct investment (FDI). It is clear that the absence of regulations for international hot money facilitates ML activities.

Before 1979, China's economy was relatively closed to the outside world, and had virtually no capital inflows and outflows — the international capital flow was almost zero. After 20 years of development, and particularly since it joined the World Trade Organization in 2001, China has increasingly participated in the process of world economic integration. The liberalisation of capital and financial accounts has steadily progressed, and international capital flows have been further strengthened.⁹⁹ Globalisation and China's integration with the world economy, the diversification of business transactions, the increase in FDI and the rapid development of more sophisticated forms of communication technologies have inevitably contributed to intensifying the scale and complexity of the ML processes in China.

⁹⁹ China and the US (in the China-US Strategic Economic Dialogue in 2005 and 2006) made a series of agreements or commitments to improve capital flow, including China's loosening of exchange controls, acceleration of capital account, and especially China's application for the membership of FATF, which was agreed by FATF in 2007.

International hot money activities are normally attached to international trade, and with the development of international business between China and foreign countries, the varied export and import prices are increasingly used by criminals to launder money. In the process of importing goods, domestic importers usually put criminal proceeds into trading funds at an irregularly high import price. Exporters then layer illicit money from integrated payments, and transfer these back to importers in their nominated transaction account. Importers can also make an initial payment at an irregularly low price, and then make up the balance using criminal proceeds.¹⁰⁰ Similarly, in the case of export goods, some covert business operations can be used for achieving the goal of laundering money. It has been reported that during the months between March 2003 and September 2004, SAFE received up to 5.7 million reports of large-value and suspicious foreign exchange transactions from banks.¹⁰¹ Furthermore, tax fraud is also a common outcome of ML in relation to international trade. Tax avoiders or fraudsters may set up a fake business entity, falsify exporting transactions, manipulate export customs declarations, forge special invoices of value-added tax, and defraud departments of export tax refunds, and this black money will be finally distributed and transferred.¹⁰²

From 2006, ML via international trade has explored new methods as some criminal organisations began to enter the Chinese stock market under the names of either institutions or individuals. In particular criminals choose to buy blue-chip shares which attract profitable dividends and appreciation, making AML works in this area more difficult.¹⁰³ In fact, China currently implements relatively strict capital controls, thus the capital flow in the stock market is still within a range of control. The inflow of foreign capital is an impetus for the internationalisation of China's stock market, and it also helps listed companies and domestic regulators to further adapt to

¹⁰⁰ 马新燕 [Ma Xinyan], 《我国洗钱与金融安全问题探讨》 [Discussion on Money Laundering and Financial Security in China] (2003) 1 海南广播电视大学学报 *Journal of Hainan Radio & TV University* 23, 23–4.

¹⁰¹ Li, above n 57, 336.

¹⁰² 刘慧明 [Liu Huiming], 《我国洗钱形态探析》 [On Forms of Money Laundering in Our Country] (October 2005) 24 兰州交通大学学报 *Journal of Lanzhou Jiaotong University* 34, 34–6.

¹⁰³ 严立新, 张震 [Yan Lixin and Zhang Zhen], above n 71, 82.

international rules. However, opening the stock market too quickly would bring significant financial risks when the market *per se* is not perfect yet. Particularly in the context of a weak risk control capacity, massive inflows of short-term speculative capital (hot money) would seriously endanger the security of the securities market as well as the entire financial system.

2.2.4 Private Loans and Money Laundering

At present, China has not yet established a sound credit authentication system. As commercial banks usually require the borrower to provide appropriate guarantees in order to lessen financial risk, many small and medium enterprises (SMEs) find it difficult to obtain loans from formal big banks. Private lending activity correspondingly becomes a favoured financing phenomenon for SMEs. Most of private lending activities are voluntarily conducted among relatives or friends in private agreements. The entire process of borrowing and lending is very simple, and, if it is a small loan, the deal can often be made on basis of only an oral agreement. In a slightly more formal situation, there is an 'I owe you' (IOU) between the two parties, often without any clear statement of the terms involved. These characteristics mean private loans become an ideal ML channel.

The *modus operandi* of private loans is similar to loans by underground banks. Criminals place their ill-gotten gains with the private financial service providers, and the illegal funds are given to rural SMEs as loans. Private lending funds will be re-circulated into bank accounts designated by criminals. The illegal funds can also be used to establish urban and rural SMEs for re-laundering the dirty money. It is reported that about 13 per cent of private lending activities have the obvious purpose of ML.¹⁰⁴ In particular, underground economic organisations and illegal financial activities permeate the private lending market, and corrupt officials and mafia-style organisations also transfer illegal funds to private loan service providers for ML.

¹⁰⁴ 詹昭, 柳军, 柳杰 [Zhan Zhao, Liu Jun and Liu Jie]《反洗钱解读与操作实务》[Interpretation and Applicable Operation of Anti-Money Laundering] (中国人民公安大学出版社[Chinese People's Public Security University Press], 2008) 114.

Some private-loan service providers even developed these private lending organisations into ‘underground banks’ specialising in ML services.

These private lending activities mainly occur between individuals, between an individual and an enterprise, and between an enterprise and another enterprise. It has developed an increasingly complex nature as it has become larger in scale. The *China Private Economy Development Report* published in September 2006, stated that the total amount of private lending in recent years remains at the level of 6–7 per cent of GDP, which is equivalent to 4–5 per cent of the year-end balance of foreign currency loans of financial institutions.¹⁰⁵ According to the monitoring and investigative results from PBC, private lending activities have expanded from less developed areas to economically developed regions; private capital has spread from consumption areas towards production areas; borrowing and lending between private enterprises is quite significant; and the interest rates of private lending has become increasingly diverse.

The reasons why private lending is favoured include (a) the growth in supply of private funds and increasing needs for private financing — in some economically developed regions, financial revenue grows rapidly, and the income of urban and rural residents accordingly experiences a substantial increase; and (b) financial institutions find it difficult to meet the various needs of SMEs.¹⁰⁶ To be specific, the standards for obtaining credit loans from financial institutions are relatively high so that they are difficult to meet, and also the credit line set by financial institutions (including rural credit unions) is too low to satisfy the actual needs of the clients. In addition, there are stringent requirements for applying for guaranteed loans from financial institutions, and the loan servicing processes that are set by financial institutions are too

¹⁰⁵ Ibid 54. In fact, the current level of real interest rates of private lending is relatively complex. Low interest between 6% and 10% per annum is used for loans between relatives and friends. From 10% to 20% per annum is a medium rate adopted in private loans between enterprises, or between business and an individual. A loan interest rate of between 20% and 35% per annum is relatively high, mainly sought by enterprises with poor business conditions and by some small real estate companies. Annual interest rates between 50% and 150% are regarded as usury, and are imposed in loans by guarantee companies to individuals.

¹⁰⁶ Ibid 55.

complicated. Even when applying for a small loan, completing the verification and approval procedures will take many days. The long business cycle is unable to meet the production and operating needs of SMEs. The above-mentioned shortcomings of loan services provided by formal financial institutions confer an advantage on private lending, resulting in private loans becoming increasingly attractive.

Indeed, SMEs contribute 51 per cent of the entire GDP in China, but only receive weak support from banks.¹⁰⁷ To some extent, this has restricted the country's economic development. More seriously, financing difficulties faced by SMEs are so prevalent that many of these enterprises turn their eyes to the illegal private finance sector. Although private finance has made great contributions to local economic development, it creates serious liquidity risks on raised funds, and becomes a fuse for financial insecurity.

2.3 Anti-Money Laundering Regulation and Supervision in China

Chinese AML legislation began in 1990 when the SCNPC enacted the *Decision on Banning Drugs*. Some twenty years later, Chinese AML legislation is composed of a combination of criminal law, administrative measures, departmental rules at all levels and the framing of a sound and standard legislative system in relation to AML.

In regard to AML preventive measures, China had made great improvements. In 2003, three AML rules¹⁰⁸ on the responsibility of financial institutions in the prevention of ML were published by the PBC. These old rules did not require non-financial institutions to undertake AML obligations, and were considered as inadequate because of their narrow coverage and low level of governance. To remedy this, the SCNPC

¹⁰⁷ 叶莉, 陈立文 [Ye Li and Chen Liwen] 《中国金融安全运行机制与预警管理研究》 [Research on Operation Mechanism and Early Warning Management of Chinese Financial Security] (经济科学出版社 [Economic Science Press] 2009) 117.

¹⁰⁸ The former AML rules (published in 2003) are: the *Provisions on Anti-Money Laundering by Financial Institutions*, the *Administrative Rules for the Reporting of Large-Value and Suspicious RMB Payment Transactions*, and the *Administrative Rules for the Reporting of Large-Value and Suspicious Foreign Exchange Transactions*.

passed the *Chinese Anti-Money Laundering Law* in October 2006. After the enactment of the *Chinese AML Law*, the PBC has successively published *Provisions on Anti-Money Laundering by Financial Institutions* and *Administrative Rules for the Reporting of Large-Value and Suspicious Transactions by Financial Institutions* in 2006. These replace the three original AML rules and provide the norms for AML regulatory management and associated AML guidance for both financial and non-financial institutions.

As the first Chinese legislation in AML, the *Chinese AML Law* combines with the revised *Criminal Law*, reflecting the national will to combat ML and to begin standardising the Chinese AML system. In particular, the three landmarks of Chinese AML regulation and supervision are the enactment of the *Chinese AML Law*, the establishment of the Chinese FIU, and the launch of the Ministerial Joint Anti-Money Laundering System.

2.3.1 Legislation of the *Chinese AML Law*

The *Chinese AML Law*, passed by the National People's Congress on 31 October 2006, entered into effect on 1 January 2007. It provides specific AML obligations from a series of perspectives, including supervision and administration, the AML obligations of financial institutions, AML investigations, and cooperation to prevent international ML. According to the *Chinese AML Law*, the term 'anti-money laundering' as defined in Article 2 of the present law refers to

an act of adopting the relevant measures according to the provisions of the law, and the sources and nature of criminal proceeds by all means generated from any drug related crime, crimes committed by organisations in the nature of a syndicate, terrorist crime, the crime of smuggling, crimes of corruption or bribery, the crime of disrupting the financial management order, and crimes of financial fraud, etc.

Article 3 of the *Chinese AML Law* requires a financial institution as established within

the territory of the People's Republic of China or a special non-financial institution to adhere to all the obligations of AML legislation, including that they adopt relevant measures for ML prevention and conduct AML supervision in accordance with the law, establish and improve client proof of identity systems, maintain a recording and preservation system for client identification materials as well as maintaining transactional records and a reporting system for large sum and doubtful transactions.¹⁰⁹ The *Chinese AML Law* consists of 37 articles, and some of them will be discussed in detail below.

In general, the *Chinese AML Law* has many merits. Firstly it establishes the AML supervision and management system in China, and clearly defines the AML responsibilities and functions of the competent authority of the State Council. It imposes AML obligations on designated non-financial institutions in order to accord with trends in AML practices in the international community. It pays close attention to protecting individual and legal entity rights while stressing the fight against ML.¹¹⁰ However, its shortcomings are obvious as well. There is no mention of 'negligent money laundering' or provision for 'value or substitute confiscation', nor is there a 'confiscated assets sharing system' in the law. It also does not define the scope and the obligations of non-financial institutions. Conducting CDD on a risk sensitive basis and the prevention of ML in the use of new technologies are also not required in the current legislation. It has been five years since the enactment of the *Chinese AML Law*, and great effort has been put into strengthening all aspects of the law. Thus, revisions in line with the latest AML trends should be made accordingly.

2.3.2 Obligations of the Chinese AML Competent Authorities

¹⁰⁹ 《中华人民共和国反洗钱法》[Anti-Money Laundering Law of the People's Republic of China] (People's Republic of China) National People's Congress Standing Committee, Order No 56, 31 October 2006.

¹¹⁰ Ibid. For example, Article 5 states that any client's identification material or transactional information as acquired in the performance of AML duties and functions shall be kept confidential. Article 7 states that where any entity or individual finds any money laundering activity, s/he has the right to inform the AML administrative department or the public security entities. The entities that receive these tip-offs shall keep the identity of their informants as well as all content of the communication confidential.

The Chinese AML system is constituted of a set of functional units. These include the AML legislative system, the AML specialised agency, reporting institutions, the AML investigation agency, and the AML judicial agency. ML needs professional techniques, and normally involves more than one industry. In this regard, an AML specialised agency is required to implement uniform AML actions across the entire country. The *Law of the People's Republic of China on the People's Bank of China (revised)* determines the position of the PBC as the administrative department of AML.¹¹¹ Apart from the PBC, the Ministerial Joint Anti-Money Laundering System, consisting of more than 20 competent AML authorities in China, has played a significant role in Chinese AML efforts since August 2004.

2.3.2.1 AML Role of the People's Bank of China

The PBC is established as a leading entity for the supervision of the financial institutions' AML operations. Its specific duties regarding AML are as follows.

- (a) Supervising and coordinating AML procedures in financial institutions;
- (b) Conducting research and formulating strategies, working out plans and policies on AML for financial institutions, establishing mechanisms for AML operations and setting up reporting systems for large-value and/or suspicious RMB fund transactions;¹¹²
- (c) Establishing a monitoring system for scrutinising payment transactions;
- (d) Working out efficient solutions to major difficulties encountered by financial institutions in combating ML;
- (e) Cooperating in international AML operations and providing guidance for international exchange in the areas of AML by financial institutions; and
- (f) Other AML functions of the PBC.

¹¹¹ 《中华人民共和国中国人民银行法》 [Law of the People's Republic of China on the People's Bank of China] (People's Republic of China) National People's Congress Standing Committee, Order No 12, 27 December 2003. Article 46 clearly gives the PBC the right to impose administrative penalties on obliged entities that violate AML regulations.

¹¹² The State Administration of Foreign Exchange (SAFE) is responsible for supervising reporting of large-value and/or suspicious foreign exchange transactions and will establish a reporting arrangement to monitor such transactions.

The *Chinese AML Law* gives the PBC power to investigate suspicious transactions.¹¹³ When the PBC detects an unusual transaction, it can review, copy, and seal all documents relevant to the case. It can also freeze accounts for up to 48 hours, depending on the investigation. If there is still a suspicion of illegal activity after a thorough investigation, the PBC will forward the case to the Ministry of Public Security, China's primary policing and investigative authority. The PBC and its branches at provincial level are authorised to make a decision according to the details of the situation of individual cases as to whether the suspicious transactions should be subject to actual investigation and verification. If the suspicious transactions are obviously unrelated to any ML activities, and do not constitute a crime, or the suspicion was the result of an operational error made by staff of the financial institution, the investigation and verification process may not be launched.

To deter money launderers, the law allows the PBC to impose the following liabilities on financial institutions that impede its efforts or fail to fulfil its requirements: i. a fine of up to CNY 5 million and/or a revocation of the institution's financial operation permits; and ii. imposition of fines of up to CNY 500,000 on the directors, senior management, and other personnel with direct responsibility in an institution; and/or their removal from the financial sector, or prohibition on their practising therein.¹¹⁴

2.3.2.2 Anti-Money Laundering Disclosure Index

As the State Council AML Administrative Department and the central bank of China, the PBC holds the responsibility for guiding and implementing AML regulations in China, and overwhelmingly in financial institutions.¹¹⁵ Without a doubt, how the

¹¹³ Generally speaking, AML investigation refers to an administrative act conducted by the PBC with the specific purpose of collecting and verifying information.

¹¹⁴ 马经 [Ma Jing], above n 67, 16.

¹¹⁵ Only in 2007 did the PBC publish more than 30 guidance documents relating AML one after the other, including the *Operating Manual for AML Investigation by PBC (try out or Draft)*, the *Administrative Measures for AML On-Site Examination (try out)*, the *Administrative Measures for Off-Site Supervision (try out)*, and the *Feedback for AML Supervisory Domain in Securities Sector and Insurance Sector by PBC*. 'Try out' is transliterated from 试行 in Chinese. It means that the

central government perceives the importance of AML largely governs the effectiveness of AML implementation in the regulated entities. In order to evaluate the will to expose ML issues from the perspective of the central bank of a country, it is worth introducing the concept of ‘anti-money laundering disclosures’ (AMLD) into the discussion.

The AMLD Index consists of a checklist from FATF (2003) involving 35 specific categories (see Table 2.1) providing recommendations to combat ML. The AMLD Index ‘helps in explaining the central bank’s practices which are carried out on a voluntarily disclosure basis and the work of regulatory boards with seemingly public interest duties’.¹¹⁶ By using the AMLD Index, the following issues can be examined: to what extent does the PBC provide AML information in its annual report, and what is the overall attitude conveyed in annual report by the PBC in regard to AML information. Utilising the AMLD Index can reveal the level of information disclosure by the central bank in regard to ML issues and its quality.

Table 2.1: Anti-Money Laundering Disclosure Index¹¹⁷

Customer due diligence and Record keeping (Index I)	<ol style="list-style-type: none"> 1. Identifying the customer 2. Verifying the customer’s identity using reliable independent source document 3. Identifying the beneficial owner 4. Verifying the identity of the beneficial owner 5. Obtaining information on the purpose and intended nature of business relationship 6. Conducting continued due diligence on the business relationship 7. Appropriate measures to determine politically exposed persons 8. Senior management approval for establishing business relationships
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administrative measures are a ‘first attempt’ or initial draft, and still need time to see whether they are enforceable.

¹¹⁶ Mitch Van der Zahn, Mikhail I Makarenko, Greg Tower, Alexander N Kostyuk, Dulacha Barako, Yulia Chervoniaschaya, Alistair M Brown and Helen Kostyuk, ‘The Anti-Money Laundering Activities of the Central Banks of Australia and Ukraine’ (2007) 10(1) *Journal of Money Laundering Control* 118.

¹¹⁷ Ibid 125.

	<p>9. For politically exposed persons, take measures to establish source of wealth and source of funds</p> <p>10. Gather sufficient information about a respondent institution</p> <p>11. Assess respondent institution's anti-money laundering controls</p> <p>12. Document respective responsibilities of each institution</p> <p>13. Attention to money laundering threats arising from new or developing technologies</p> <p>14. Maintain for at least five years all records on transactions, domestic and international</p> <p>15. Special attention to all complex, unusual large transactions</p>
Reporting suspicious transactions (Index II)	<p>16. Financial institutions to promptly report suspicious transactions to the financial intelligence unit</p> <p>17. Protection for the directors, officers and employees of financial institutions for reporting suspicious transactions</p> <p>18. Financial institutions to develop internal policies, procedures and controls against money laundering</p> <p>19. Financial institutions to initiate ongoing employee training programs</p> <p>20. Establish an audit function to test the system</p>
Other measures (Index III)	<p>21. Countries to ensure effective, proportionate and dissuasive sanctions</p> <p>22. Countries to disapprove continued operation of shell banks</p> <p>23. Adoption of FATF recommendations</p> <p>24. Special attention to business relationship with companies from countries that do not apply FATF recommendations</p>
Regulation and supervision (Index IV)	<p>25. Ensure financial institutions are subject to adequate regulation and supervision to effectively implement FATF recommendations</p> <p>26. Supervision and regulation of other non-financial businesses, e.g. casinos</p> <p>27. Competent authorities should establish guidelines and provide feedback to combat money laundering</p>
Competent authorities, their powers	<p>28. Countries should establish a FIU that serves as a</p>

and resources (Index V)	<p>national centre for receiving, analysing and dissemination of information on suspicious transactions</p> <p>29. Ensure designated law enforcement authority have responsibilities for money laundering investigations</p> <p>30. Supervisors should have adequate powers to monitor and ensure compliance by financial institutions</p> <p>31. Providing regulatory authority with adequate financing, human and technical resources</p>
International co-operation (Index VI)	<p>32. Take immediate steps to become party to and implement the Vienna and Palermo Conventions</p> <p>33. Provision of mutual legal assistance with respect to money laundering investigations</p> <p>34. Recognition of money laundering as an extraditable offence</p> <p>35. Provide widest range of international cooperation to their foreign counterparts</p>

By using the AMLD Index, the extent of AMLD by the PBC (see Table 2.2) can be calculated in the light of information in the AML annual reports published by the PBC from 2005 to 2010 as the report of 2011 is still unavailable.¹¹⁸ These figures demonstrate that the PBC has reported in accordance with the six above main categories in its annual reports; however, not all details have been disclosed. In the first two years of China's AML reports the following issues were not covered: issues concerning verifying information on the nature of business relationships, the determination of PEPs, the gathering of information about respondent institutions, and the regulation of shell bank operations. Only in the 2007 report was the establishment of audit systems to assess the AML system mentioned, making the scores higher than the previous two years. Moving into 2008 and 2009, even more information was

¹¹⁸ See, 中国人民银行 [People's Bank of China],《2005 年中国反洗钱报告》[*Anti-Money Laundering Annual Report* (2005)], 24 August 2006; 中国人民银行 [People's Bank of China],《2006 年中国反洗钱报告》[*Anti-Money Laundering Annual Report* (2006)], 5 November 2007; 中国人民银行 [People's Bank of China],《2007 年中国反洗钱报告》[*Anti-Money Laundering Annual Report* (2007)], 4 September 2008; 中国人民银行 [People's Bank of China],《2008 年中国反洗钱报告》[*Anti-Money Laundering Annual Report* (2008)], September 2009; 中国人民银行 [People's Bank of China],《2009 年中国反洗钱报告》[*Anti-Money Laundering Annual Report* (2009)], June 2010; 中国人民银行 [People's Bank of China],《2010 年中国反洗钱报告》[*Anti-Money Laundering Annual Report* (2010)], May 2012.

revealed in the annual reports, including attention to the ML threats that have arisen from new or developing technologies and the supervision and regulation of other non-financial businesses. However, reporting concerning beneficial owners and PEPs were still lacking. In addition, although the PBC annual reports now disclose most of the 35 categories, many of these are mentioned generally rather than in depth.

Table 2.2: Extent of AMLD by PBC (expressed as a percentage)

		2005	2006	2007	2008	2009/ 2010
AML broad disclosure categories	AML individualised disclosure components	PBC	PBC	PBC	PBC	PBC
Value (35 Categories)	Value (35 Categories) aggregated- percentage	65.7	65.7	68.6	80.0	80.0
AML Value (6 Categories)	Value (6 Categories) aggregated- percentage	100.0	100.00	100.0	100.0	100.0

The AMLD Index, to a certain extent, is helpful in illustrating that the PBC has the desire to effectively regulate ML over its full range. However, a number of loopholes have not been addressed until recently. More importantly, whether action on the disclosed information is effectively and fully implemented should be subject to qualitative research rather than quantitative research. That is, although the annual report mentioned that relevant actions have been taken, this is not equal to saying that those actions achieved successful results.

2.3.2.3 The Chinese Financial Intelligence Unit (FIU)

Compared with other crimes, ML possesses a relatively high social dependence. Before the money can be successfully laundered, illicit funds have to be handled by corporations and/or individuals, and go through many procedures and phases in the domestic and/or international financial system. As any financial products, financial service providers and any institutions or individuals of entities obliged to submit reports are vulnerable to criminal abuse, financial institutions, including banks, securities companies, and insurance company, should provide advice and basic

information concerning AML in a timely manner.¹¹⁹

According to the FATF's requirement, the FIU functions as a central and national agency responsible for receiving, analysing and disseminating financial information to the competent authorities in order to combat ML. The FIU is the centralised point of information on ML, and processes and evaluates the information it receives, and serves as a conduit for information exchange on suspicious financial transactions.¹²⁰

When financial institutions suspect or have reasonable grounds to suspect that funds are the proceeds of a criminal activity, STRs are sent to the FIU regardless of the amounts involved in the transaction. In return, the FIU and other competent authorities in relation to AML, should provide appropriate feedback to financial institutions, encompassing statistics on the number of disclosures and on the results of these disclosures. Information on current detection techniques, methods, and typologies concerning AML, together with sanitised case studies of examples of ML, and case by case feedback should also be supplied.¹²¹

In 2004, China's Anti-Money Laundering Monitoring and Analysis Center (CAMLMAC) was set up under the PBC.¹²² As a centralised, independent, administrative authority with no enforcement powers, CAMLMAC receives and processes information from the financial sector and transmits disclosures to judicial or law enforcement authorities for prosecution. It functions as a buffer between the financial and the law enforcement communities. The Center is not a regulatory agency, but an agency for the collection, analysis and dissemination of information concerning ML. Its main duties include:

¹¹⁹ Donato Masciandaro, 'Financial Supervisory Unification and Financial Intelligence Units' (2005) 8(4) *Journal of Money Laundering Control* 357.

¹²⁰ Guy Stessens, *Money Laundering: A New International Law Enforcement Model* (Cambridge University Press, 2000) 184.

¹²¹ Financial Action Task Force on Money Laundering (FATF), *Methodology for Assessing Compliance with the FATF 40 Recommendations and the FATF 9 Special Recommendations*, 27 February 2004, 40.

¹²² The Center is equipped with an administrative office, a research department, an intelligence gathering department, five transaction analysis departments, an investigation department, a technical support department, an international communication department, a finance department, and a human resources department.

- 1) meeting with related departments to research and formulate the reporting standards in relation to large-value and suspicious activity reports;
- 2) collecting, arranging and keeping the reporting records;
- 3) researching, analysing and identifying large-value and suspicious activity reports, and coordinating with related administrative law-enforcement agencies to conduct further investigation;
- 4) disseminating and providing the analysis and conclusions, in accordance with regulatory policy, of ML suspicious activity reports to the relevant department;
- 5) submitting large-value payment information, in accordance with regulatory policy, to the relevant department;
- 6) researching and analysing methods, means and describing trends in ML offences, and providing theoretical grounds for formulating AML policies;
- 7) researching the information management project of large-value and suspicious transactions and taking part in project development, operation and maintenance;
- 8) undertaking the work of communicating and cooperating with foreign FIUs, as authorised by the AML administrative department, and assisting the PBC to carry on diplomatic affairs in the field of AML; and
- 9) undertaking other proceedings authorised or assigned by the PBC.

A key element to improve the quality of the FIU's work is to enhance the information sharing and cooperation between the Chinese FIU and related domestic departments. The characteristics of ML activities determine that AML work is a cross-sector, and cross-jurisdictional phenomenon, and one that requires cross-industry systems implementation. With regard to AML intelligence, the filtering of reports deemed suspicious relies on detailed information resources from other industries apart from the financial sector. The more detailed the information that has been collected, the higher the accuracy of the intelligence analysis produced. Undeveloped credit systems result in the financial institution having limited knowledge of its customers,

particularly about their personal credit standing and ‘respectability’. It has a direct impact on the identification, investigation and tracing of suspicious transactions, and accordingly, the need for collecting detailed supplementary information is of significant importance.

Indeed, CAMLMAC recognises the importance of information sharing among competent AML authorities. The Center has a database for large-value transactions, suspicious transactions and other supporting databases, that include those for the monitoring of the Center’s own data (focusing on the suspicious transactions reports, cash transactions reports and cross-border transfer reports previously archived by the Center), information from public access sources (such as the information on a company register, their business viability, and credibility report from information released by private companies, auditing firms and accounting firms) and information from the governmental database (tax records, the company establishment records, records of violations of the law, immigration and customs records, vehicle registration records, and regulatory records, and so on.).¹²³ By using the suspicious transaction database as the trigger point, in combination with the large-value transaction database and any other supporting information, AML authorities seek to determine cases of ML. In a sense, the role of information on large transactions is indirectly used in the AML investigations, while the role of suspicious transaction information is directly linked to investigations into ML activities. The Center determines suspicious activities via data analysis, and then the reports are transferred to the AML Bureau (AMLB) of the PBC for further forensic work. If an investigation still cannot discount the possibilities of a ML crime, the case will be handed over to judicial authorities for in-depth investigations.

2.3.2.4 The Chinese AML Coordination Mechanism

The Ministerial Joint Anti-Money Laundering System, as the AML coordinating

¹²³ 詹昭, 柳军, 柳杰 [Zhan Zhao, Liu Jun and Liu Jie], above n 104, 52.

mechanism among Chinese governmental departments, deals with the relationship between prudential regulations by all the governmental departments and AML regulation by the PBC. This avoids unnecessary repetitive activities and resource waste, achieving better administrative information sharing, and providing organisational and systemic guarantees for inter-departmental AML coordination in China. The Ministerial Joint Anti-Money Laundering System stipulates the specific responsibilities of each of its members.¹²⁴

- 1) The People's Bank of China (PBC) — see 2.3.2.1
- 2) The Supreme People's Court — Supervising and guiding trials of criminal cases involving ML, and drawing up judicial interpretation, in a timely manner, regarding the application of legal issues. While the Supreme People's Court has a supervisory role, jurisdiction to try ML cases is also exercised by the Higher People's Courts and the Intermediate People's Courts.

It does not mean that only the Supreme People's Court has the jurisdiction to try ML cases, but also the Higher People's Courts and the Intermediate People's Courts.

- 3) The Supreme People's Procuratorate — Supervising and guiding the arrest, prosecution, and recording of ML cases. In carrying this out, particular attention is focused on discovering and dealing with crimes committed by national public servants involved in ML cases, who have taken advantage of their powers.
- 4) Ministry of Foreign Affairs — Researching policy related to international AML cooperation, assisting in China's accession to international or regional agreements and membership of associated AML organisations, developing AML cooperation between the Chinese government and other countries'

¹²⁴ 严立新, 张震 [Yan Lixin and Zhang Zhen], above n 71. The 'Ministerial Joint Anti-Money Laundering System' is transliterated from 反洗钱工作部际联席会议制度.

governments, and ensuring China's implementation of relevant international AML conventions.

- 5) Ministry of Public Security — As the highest agency with policing functions in China, the MPS organises, coordinates, and commands the local policing agencies in their full implementation of AML procedures, as well as investigating information on suspicious financial transactions and the detection of suspected ML crimes.
- 6) Ministry of State Security — As it functions as the highest intelligence agency, the MSS assists in ML intelligence collection and processing, and facilitates appropriate information sharing and cooperation in AML investigation programs. In regard to suspected ML cases in foreign jurisdiction, the Ministry will provide assistance in case investigation and verification.
- 7) Ministry of Supervision — the MS is involved in ML investigations, including the handling of any issues regarding illegal and undisciplined behaviour by any public servant or staff appointed by the state administrative agencies, strengthening the establishment and operation of AML investigative mechanisms and support systems, focusing on curbing ML activities at the placement stage, and the setting up information sharing systems and cooperative investigation systems to combat corruption and bribery-based ML cases.
- 8) Ministry of Justice — The Ministry's role is strengthening AML system structures in the legal services area, researching relevant AML treaties and conventions, and providing AML legal assistance, especially in coordinating the recovery of outflow capital.
- 9) Ministry of Finance — Ensuring government financial support for the use of

AML activities, further strengthening the management of financial funds and accounts, researching the financial and administrative supervision of state-owned assets, preparing the establishment of a storage system for the recovered criminal proceeds, encouraging intermediary agencies and certified public accountants, appraisers and other practitioners to assist in AML works, and using international bilateral and multilateral cooperation and the relevant international forums to carry out AML work.

- 10) Ministry of Construction — Developing AML works in the real estate industry, and studying practical AML measures that can be used in that estate industry.
- 11) Ministry of Commerce — Enhancing management in the areas in which ML frequently occurs, studying AML regulatory issues for China's foreign joint ventures, Sino-foreign cooperative enterprises, and wholly foreign owned enterprises, and providing corresponding suggestions to improve AML activities in these areas, as well as upgrading the supervision of the import and export trade to prevent international TBML via collusion between domestic and foreign criminals.
- 12) General Administration of Customs — Studying the establishment of onsite monitoring and detection systems to combat cross-border ML, and enhance the supervision of currencies, deposit books, negotiable securities and gold and silver products involved in international trade, as well as closely cooperating with related departments to draw up AML information sharing programs.
- 13) State Administration of Taxation — Studying policy and countermeasures to prevent ML involving tax offences, undertaking research to combat and prevent ML, through tax evasion, tax fraud, and tax violations, and working together with relevant departments to establish appropriate mechanisms of information transmission and ways of providing law enforcement cooperation.

- 14) Industry and Commerce Bureau — Implementing strict policies on market access, establishing AML information sharing and AML reporting systems with other competent departments, and assisting AML authorities in combating ML in the non-financial business sector.
- 15) The State Administration of Radio Film and Television — Involved in AML awareness and education work to improve citizens' awareness of the importance of AML policies and legislation.
- 16) Legislative Affairs Office of the State Council — Involved in drafting the *Chinese Anti-Money Laundering Law* and other AML administrative regulations, this Office specialises in research on the development of Chinese AML legislation.
- 17) China Banking Regulatory Commission (CBRC) — Assisting the PBC to develop AML policies on suspicious transactions monitoring and reporting systems in China's banking sector, assisting the PBC to develop AML supervisory guidelines in the banking sector, and facilitating the PBC's implementation of the AML regulatory requirements imposed on the banking industry.
- 18) China Securities Regulatory Commission (CSRC) — Assisting the PBC to develop AML policies and reporting systems as well as the monitoring of suspicious transactions in China's securities and futures sector, assisting the PBC to develop AML supervisory guidelines in the securities and futures industry, supervising the implementation of AML provisions in the securities and futures industry, and developing policy recommendations based on the research on the major issues in China's domestic securities and futures industry.

- 19) China Insurance Regulatory Commission (CIRC) — Assisting the PBC to develop AML policies and develop suspicious transactions monitoring and reporting systems in China's insurance sector, assisting the PBC to develop AML supervisory guidelines in the insurance sector, supervising the implementation of AML provisions in the insurance sector, conducting on-site and off-site AML investigations in the insurance sector, and developing policy recommendations based on research on the major issues in China's domestic insurance sector.
- 20) Ministry of Civil Affairs — The MCA replaced the State Post Bureau on the Ministerial Joint Anti-Money Laundering System Committee after the establishment of the Postal Savings Bank of China in 2007. Its role is to assist relevant departments to undertake AML works.
- 21) State Administration of Foreign Exchange (SAFE) — Led by the national universal AML guidance from the PBC, SAFE is responsible for the monitoring of large-value and suspicious foreign exchange transactions reports and devising associated reporting rules, analysing, filtering, and monitoring atypical cross-border capital flows, pursuing investigations into undisciplined foreign exchange businesses, transferring related information on suspected criminal activities involving foreign exchange to law enforcement and judicial agencies, cooperating with relevant departments to combat 'underground banks', managing AML works involved in the foreign exchange business, and participating in the study of unified reporting standard for reporting suspicious transactions in domestic and foreign currencies.

As an AML coordination mechanism, participating members have to meet and these coordinating mechanisms should have actual function, and, in the mean time, there has to be action taken under these coordination mechanisms. Indeed, the Ministerial

Joint Anti-Money Laundering System has satisfied all the requirements mentioned above since its establishment in 2004, and the joint system covers major financial industries, as well as the real estate industry, foreign joint ventures, sino-foreign cooperative enterprises, and wholly foreign owned enterprises.

There were five meetings held between 2004 and 2009. The first meeting, on 27 August 2004, emphasised the launching of formal AML efforts in China. The second meeting on 2 September 2005 was held after China had attained observer status at FATF, and this meeting focused on arranging the detailed work for FATF's first mutual evaluation of AML in China, and preparing the application for formal membership of FATF. The third meeting was conducted to coincide with the enactment of *Chinese AML Law* on 25 December 2006, and, a few weeks later, the members gathered again to propose suggestions for the nation-wide implementation of the *Chinese AML Law*. The most recent meeting was held on 26 December 2008, and at this meeting China's 2008–2012 Anti-Money Laundering National Strategy was approved, promoting Chinese AML work to a higher level. It can be seen that the Ministerial Joint Anti-Money Laundering System provides regular venues at an extremely high level; however, the AML coordination mechanism also requires daily cooperation at an operational level.

2.3.3 AML On-site Examination and Off-site Supervision

*The Administrative Measures for AML On-Site Examination (try out)*¹²⁵ clarifies the following: the establishment and performance of AML internal control, AML organisational structures, CDD, customer information-keeping and transaction record-keeping, large-value and suspicious transactions reporting, AML information and training, coordination with law enforcement agencies to conduct AML investigations and the investigation and prosecution of suspect ML crimes, and other items that should be examined by the PBC.

¹²⁵ 'Try out' is a transliteration of 试行 in Chinese (see footnote 115). It means that the administrative measures are first attempt or initial draft, and still need time to see whether they are enforceable.

The *Administrative Measures for AML Off-Site Supervision (try out)* was enacted on 27 July 2007. The measures clarifies the PBC's duty regarding the collection of AML information reported by financial institutions, analysis and assessment of the regulated institutions' compliance with AML legislation, and guidance for the regulated institutions to take appropriate actions on risk warnings and AML rectification measures within designated time-periods according to the aforementioned assessment reports. More specifically, AML off-site supervision comprises the following duties to be performed and reported on by the regulated institutions: AML internal control systems, establishment of AML working institutions and AML-related positions, AML information and training, internal AML auditing, implementation of customer identification systems, AML co-operation with justice agencies and law enforcement agencies, reporting to public security agencies, suspicious transaction reporting, assisting the PBC and its branches in conducting AML investigations, implementation of decisions made by the PBC and its branches regarding temporary freezing of accounts, and reporting of suspected crime to PBC. According to the actual needs of an entity or demands of a particular situation, the PBC can conduct off-site AML information collection and analysis.

2.4 Analysis of Current AML Arrangements in Chinese Financial Institutions

As mentioned earlier, the current *Chinese AML Law* is a 'skeleton like' law, which mainly focuses on administrative cooperation, with many details lacking. In order to enhance AML implementation in financial institutions, great efforts have been made since 2007 in the financial sector to close the loopholes in the current AML provisions.

For example, the PBC published the *Notice for the Purpose of Further Strengthening the Anti-Money Laundering Work in Chinese Financial Institutions* on 30 December 2008. It pointed out specific objectives concerning customer risk-grading and

enhanced CDD policies to be conducted in 2009 and following years.¹²⁶ The Notice was sent to a range of banking institutions, including the Shanghai Headquarters of the PBC, all branches and business management departments of the PBC, and all its central sub-branches in provincial capitals and sub-provincial cities, all policy banks, state-owned commercial banks and joint-stock commercial banks, as well as the comparatively recently established (March 2008) China Postal Savings Bank.

More specifically, the PBC notice requires financial institutions to refine their operating rules for AML, and to improve their internal control systems for AML, to carry out on-going CDD and effectively prevent ML risks. It also mandates the improved monitoring and analysis of AML intelligence and the quality and effectiveness of LVTR as well as STR via a CDD and an RBA.¹²⁷ The notice ostensibly shows the government's determination to develop a secure and transparent financial system, and to create pressure on financial institutions to establish their internal control and risk management systems.

The CBRC revealed great improvements in its fight against bank crimes in its 2007 annual report. Banking institutions were now required to include the measures for the prevention and mitigation of bank crimes into their day-to-day regulatory work. By organising on-site investigation and providing instructions to the CBRC's local offices and commercial banks, both the total number of criminal cases and the number of cases involving a cash value of more than CNY 1 million were evidently reduced as 'in 2007, altogether 169 cases were identified by banking institutions, up 19.9 per cent, preventing CNY 1.64 million in potential losses, up by 24 per cent'.¹²⁸

The Chinese AML program was also extended to the securities and insurance

¹²⁶ 中国人民银行 [People's Bank of China], *Strengthening AML in Chinese Financial Institutions: Notice 391*, above n 2.

¹²⁷ Ibid.

¹²⁸ 中国银行监督管理委员会 [China Banking Regulatory Commission (CBRC)], 《中国银行监督管理委员会 2007 年年度报告》 [CBRC 2007 Annual Report], April 2008, 76.

industries in 2007. Insurance companies were required to establish AML leading committees and designated departments in charge of AML. Also both the insurance sector and securities sector were required to submit large-value and suspicious transactions reports. Under the legislation, China's brokerage, future traders and insurers have been required to report foreign currency transactions worth USD 10,000 or more, or CNY currency payment transactions worth CNY 50,000 or more, to the FIU since 1 October 2007. The *PBC's 2007 Annual Report* shows that 34,700 and 4,139 STRs have been reported by the securities industry and insurance sectors respectively.¹²⁹

2.4.1 Contents of AML Arrangements on Chinese Financial Institutions

The current AML regime in China is based on CDD procedures, reporting systems for large-value payments and suspicious transactions, recordkeeping systems, internal control systems, and the provision of AML information and training. The *Chinese AML Law* applies territorial principles in its implementation, that is, the law can only be enforced within Chinese jurisdiction.

In regard to offshore branches of Chinese legal entities, the laws of the country where those branches are located, should be followed. However, this does not prevent offshore branches from complying with Chinese domestic legislation if the Chinese law applied a higher standard. In addition, Chinese legal entities located in mainland China can also be punished or fined under the Chinese legislation if their overseas branches are found to be in breach of the local AML law in foreign jurisdictions. The breach by the off shore branch is also regarded as a breach of the Chinese domestic law.

2.4.1.1 Customer Due Diligence (CDD)

Customer identity identification is the first step in combating ML in the financial

¹²⁹ 中国人民银行 [People's Bank of China], 《2007 年中国反洗钱报告》 [*Anti-Money Laundering Annual Report (2007)*], 4 September 2008, 21.

institutions. It is one of the AML's compulsory requirements in China, and financial institutions are obliged to verify the identification of customers. The main legal documents concerning customer identification in China are the *Chinese Anti-Money Laundering Law*,¹³⁰ the *Provisions on Anti-Money Laundering by Financial Institutions*, the *Administrative Rules for Customer's Identity Identification*, and the *Administrative Rules for Customer Information-Keeping and Transaction Record-Keeping*.

The basic principles for the validation of customer identity are authenticity, validity, and integrity. When identifying the authenticity of a customer's identity documents or the real purpose of transactions, financial institutions should confirm the customer's name is consistent with the name on the valid documents. Financial institutions can also ask for assistance from the Public Security department or the Industrial and Commercial Administration department to verify the authenticity of the customer's information. The key customer information includes the customer's identification documents, transaction details, purpose of the transaction, the nature of the transaction, and the customer's transaction records. The financial institution should determine the customer's occupational situation, business background, the purpose of the transaction, the nature of the transaction and the origin of the funds, and prohibit any anonymous transactions. Also, the financial institution should perform extended customer identification measures on high-risk businesses and customers on the basis of risk control, according to the need for risk management and prudential operation,

¹³⁰ 《中华人民共和国反洗钱法》 [Anti-Money Laundering Law of the People's Republic of China]. More specifically, Article 16 of the *Chinese AML Law* requires that 'a financial institution shall establish a client's identity through the identification system according to the relevant provisions'. Article 17 states that 'where a financial institution verifies the identity of its clients through a third party, it shall be guaranteed that the third party has adopted the measures for client identification as required by the present Law. Where any third party fails to adopt the measures for the client identity verification as prescribed by the present Law, the financial institution shall bear the liabilities for its failure to perform the obligation of clarifying the client's identity'. And Article 18 states that 'where a financial institution conducts the verification of its client's identity, it may, where it so requires, verify the relevant identity information with such departments as the Public Security organ and the Administrative Department for Industry and Commerce'.

and conduct simplified CDD on low-risk businesses and customer.

2.4.1.2 Reporting Systems for Large Value Payments and Suspicious Transactions

According to Article 20 of the *Chinese AML Law*, a financial institution shall, in accordance with the relevant provisions, implement a reporting system for large sum transactions and doubtful transactions. Where any single transaction handled by a financial institution, or when the accumulated transactions within a prescribed time limit exceeds the prescribed sum, or where any doubtful transaction is found, it shall be reported to the FIU in a timely manner.¹³¹

Reporting systems for large value payments and suspicious transactions are systems which require financial institutions to report financial transaction information to the AML administrative department when a prescribed amount of money is exceeded or when a transaction is suspected of involving ML occurs in daily business operations. Generally speaking, there are four parts to suspicious transactions reporting:

- 1) the personal information of the customer involved in the suspicious transactions (for example, full name, ID name and number, residential address, telephone number, bank account, and so on) or the full company information of the company involved in the suspicious transactions (for example, the name of company; the full name, ID name and number of legal person or responsible person; certificate of account opening; company address; registered capital of company; scope of business; key client; and so on);
- 2) detailed information of the suspicious activities;
- 3) the reasonable ground for identifying an activity as suspicious; and
- 4) the customer's explanation. If the customer provides answers to any enquiries, the explanations should be taken into consideration when identifying whether the activity is suspicious or not, and the customer's explanation should also be reported to the related authority.¹³²

¹³¹ Ibid.

¹³² 严立新, 张震 [Yan Lixin and Zhang Zhen], above n 71, 101.

Till the end of 2007, AML regulated entities — in particular, 279 banks, 243 securities companies, and 90 insurance companies — engaged in the ‘headquarter to headquarter’ reporting system to the FIU. The participation rate in each financial sector is: 90.6 per cent in the banking sector, 73 per cent in the securities sector, and 84.1 per cent in the insurance sector.¹³³

2.4.1.3 Recordkeeping Systems

Article 19 of the *Chinese AML Law* stipulates that;

[A] financial institution shall establish a preservation system for its clients’ identity materials and transactional records. While a business relationship exists, any change to a client’s identity details shall be updated in a timely manner. Upon conclusion of any business relationship or transaction, the relevant client’s identification materials or client’s transaction information shall be kept for at least 5 years. Where a financial institution goes bankrupt or is dissolved, it shall transfer the relevant client identification materials and client transactional records to the institution designated by the relevant department of the State Council.¹³⁴

The specific requirements for record keeping in the banking industry, securities industry, and insurance industry in practice are described in the following paragraphs.

Transaction records that should be kept in the banking industry include data records or business certificates of each financial service for remittance, transfer, deposits and withdrawals, money exchange, settlement, and loss reporting, and so on, and any associated contract, bill of document, business letters, and other documents.¹³⁵

Transaction records that should be kept by the securities industry include data records or business certificates for each financial service by the securities commission, bargain, liquation, trust transfers, designated withdrawal transactions, non-transactional account transfers, account freezing and unfreezing, and so on, and

¹³³ 马经 [Ma Jing], above n 67, 33.

¹³⁴ 《中华人民共和国反洗钱法》 [Anti-Money Laundering Law of the People’s Republic of China].

¹³⁵ 马经 [Ma Jing], above n 67, 182.

associated contract, bill of document, business letters, and other documents. All the above-mentioned documents should — as a minimum — contain the time of transaction, the venue of the transaction, the type of currency, the amount of the transaction, the origin and flow of the transacted capital, and the methods of capital withdrawal.¹³⁶

Transaction records that should be kept in the insurance industry include data records or business certificates for each financial service involving insurance acceptance, changing, endorsement, claiming, and contract completion, and so on, and associated contracts, bill of document, business letters, and other documents.¹³⁷

2.4.1.4 AML internal control systems

In order to ensure the implementation of national AML legislation and AML-related departmental rules, to ensure the full AML compliances by financial institutions and its employees, and to ensure that the financial institution's practitioners will not participate in, engage in or be involved in any ML activities, a financial institution shall establish and improve its internal control system for AML, and the principal of the financial institution thereof shall be responsible for the effective implementation of its internal control system for AML.

Article 15 of the *Chinese AML Law* requires financial institution to establish a special institution of AML or designate an internal department to take charge of AML.¹³⁸

Indeed, AML internal control within a financial institution embraces the following:

- 1) establish a specialised AML department or designate an existing unit as responsible for the AML work;
- 2) design internal AML operating procedures, which should cover ML related risks in all lines of business;
- 3) set up an internal regulatory department within the institution (such as an

¹³⁶ Ibid 184.

¹³⁷ Ibid 189.

¹³⁸ 《中华人民共和国反洗钱法》[Anti-Money Laundering Law of the People's Republic of China].

internal auditing department), supervise the internal AML units and staff, and conduct regular internal audits on AML works; and

- 4) create proper incentive and penalty mechanisms, taking into account the results of AML work in the financial institution staff's evaluation system, in order to motivate a positive and responsible attitude that will enhance AML performance.

After setting up specific institutions to take the responsibility for controlling internal AML systems, the following three principles should be complied with.

- (1) *Comprehensive principle* — the AML internal system should penetrate all the business processes and steps, covering every related institution, department, and staff position, and should ensure that all operations concerning AML work have been recorded;
- (2) *Prudential principle* — AML internal control systems should be based on ML risk prevention, prudential operation, and compliance development. All lines of business should represent the requirement of 'priority of internal control'. This particularly applies to the business of newly established institutions and newly opened services; and
- (3) *Effective principle* — Financial institutions should amend AML internal control systems regularly in the light of updated national legislation, policies, and administrative rules for financial institutions, and also with the development of the social economy. They should also ensure the internal control systems have been fully implemented and any problems resolved. No financial institution is immune from the requirement of establishing an internal control system.

2.4.1.5 AML Awareness and Staff Training in Chinese Financial Institutions

Apart from the legislated AML obligations, financial institutions should conduct all necessary AML awareness activities. The target of AML awareness activities provided by financial institutions includes both existing customers and potential customers.

Customers may be given information via direct ‘face to face’ contacts with financial institution employees, AML information hand-outs, or ‘hot-line’ consultations. One suggested method is for financial institutions to add details of the risks of ML into application documents or contracts used for opening an account.

The main aims for developing AML awareness is to let the customers know about the economic and social harm resulting from ML, the urgency and need for AML measures, and the obligations of financial institutions in combating ML, and finally to enable the customers to actively cooperate with and assist financial institutions in their duty to comply with AML rules. Basically, the content of AML awareness programs is expected to cover:

- 1) the basic features of ML;
- 2) citizen’s AML obligations;
- 3) AML-related legislation;
- 4) the latest progress in Chinese AML measures;
- 5) the AML tasks performed by financial institutions;
- 6) other awareness material.

In practice, most of the above mentioned awareness activities have not been fully developed as yet. Indeed, in regard to the dissemination of AML awareness by Chinese financial institutions, such institutions should put more effort into developing more direct communications between staff and clients, providing AML information handbooks, formulating specific items on the risk of ML in the account-opening process or other related processes, and into conducting professional AML training, as well as into the design of special AML pages on the financial institution’s websites, and so on.

In regard to AML staff training, financial institutions can design detailed and varied forms and methods for AML training that best suit their own conditions. These methods could include regular training, irregular training, ‘face to face’ training, and

online training. Staff at all levels should be educated to build up an awareness of risk management, and to be clear about what responsibilities they have concerning AML work. Training programs should enable the AML-related employees to have a sound understanding of the specific requirements of all the AML law, legislation, rules and guidance, and grasp the essential skills needed to verify customer identification and to identify suspicious transactions.

2.5 Comment and Conclusion

Age-old problems accompanying the evolution of ML techniques and methods in China should not be neglected. In particular, the close linkages between the underground banking sector, private lending business and ML should not be neglected in any analysis. There are multiple reasons for the presence of underground banks in China; however, the fundamental one is the extreme difficulty of obtaining investment finance encountered by most SMEs and private enterprises. This problem has not been solved by financial reform. On the other hand, huge amounts of privately owned capital cannot find an appropriate investment market. The conflict between private enterprise's demand for finance and the search by private capital for investment opportunities provides a secure business niche for underground banks, meeting a huge market demand that cannot be met by the formal financial system.

The problem of ML is further aggravated by the fact that China's economic activity remains largely cash-based. It is difficult to trace and monitor the money flow. Current cash settlements mainly focus on cash withdrawal, however, there is almost no monitoring of cash deposits.¹³⁹ The 'real name' system for bank savings presents a certain deterrent to criminals, but due to the limited restrictions on personal cash transactions, settlement monitoring on cash-withdrawal is not effective by its nature. The acceleration and growth of RMB settlement systems will complicate the Chinese AML trend as well.

¹³⁹ Current Chinese regulation of cash management does not include natural persons in the area of cash management, and has loop-holes in large scale cash deposits and withdrawals.

In its battle against ML, the Chinese government has put intensive efforts into the revision of AML legislation, the development of AML institutional controls, and AML program development. However, the actual functioning of Chinese AML working systems is continually subject to practical difficulties. For example, the gathering and dissemination of AML information had and still has some problems that hinder the collection of full and rounded information, real time data processing, and the free flow of information. It is still a huge task for the Chinese government to further improve its national AML mechanisms, and this will be discussed in the following chapters.

Chapter 3. THE ECONOMIC, POLITICAL, LEGAL, AND CULTURAL FACTORS OF ANTI-MONEY LAUNDERING EFFECTIVENESS IN CHINESE FINANCIAL INSTITUTIONS

The AML performance of financial institutions depends on a country's level of economic and financial development, the financial systems in use, technical conditions, the degree of innovation, and other factors such as the social psychology and the cultural background of the economy being considered. The following detailed indicators have been identified by FATF and these may be taken into account by both AML authorities and reporting entities to increase the effectiveness AML processes in practice, including the political environment, the legal environment, the economic structure, cultural factors, and size and geographical spread of the financial services industry.¹⁴⁰

In the relatively recent process of establishing a socialist market economy, the financial infrastructure of mainland China is so tenuous that it cannot hope to stop all ML, and there are also a variety of other unique factors in China that further promote the spread of ML.¹⁴¹ These factors include imperfect legislation and weak systems, official corruption, 'out-of-ordered' competition in financial markets, illegal loan activities in rural areas, limited financial supervision, and unprofessional practitioners in the banking and other financial industries. As a result of China's transition economy, the imbalanced economic structure is closely linked to the top-down economic reform and an unsound legal system.

This chapter analyses the economic, political, legal, and cultural factors which limit

¹⁴⁰ Financial Action Task Force on Money Laundering (FATF), *Guidance on the RBA to Combating ML/TF*, above n 47.

¹⁴¹ 沈仲平, 张爱晓 [Shen Zhongping and Zhang Aixiao] 《反洗钱法律与法规—内地与香港之比较》 [*Anti-Money Laundering Legislation and Regulation-Comparison between Mainland China and Hong Kong*] in 刘明祥, 冯军 (编) [Liu Mingxiang and Feng Jun (eds)] 《金融犯罪的全球考察》 [*Global Examination on Financial Crimes*] (中国人民大学出版社 [People's University of China Press], 2008) 342.

the effectiveness of AML activities in Chinese financial institutions, such as the unsound economic environment in the financial industry, inherent limitations and practical issues faced by transition countries, delayed and powerless criminal justice operations against financial crimes, negative effects from traditional Chinese culture, and the deficient AML informal system in China.

3.1 The Economic Environment in the Chinese Financial Industry

China's financial structure has greatly changed over the past 30 years. At the beginning of reform and 'opening up', China's financial institutions consisted of mainly state-owned banks. Currently, the number of non-bank financial institutions has greatly increased, and China has already established the basis for a modern financial service system. Most importantly, China agreed to allow foreign-owned banks to provide domestic currency services to domestic residents without geographic restrictions from 11 December 2006.

However, development of China's financial system can be only characterised as 'deep but narrow'. It is evident that China's modern financial service system is still in the early stage of development.¹⁴² Development of various financial institutions is relatively imbalanced, and, in particular, the development of small and medium financial institutions and non-bank financial institutions is lagging behind. In short, financial institutions need to constantly improve the system to meet the requirement of a sustained and healthy national economy.

3.1.1 Reform of China's Financial Structure

¹⁴² See, Barry Naughton, *The Chinese Economy: Transitions and Growth* (MIT Press, 2007) 465. In developed economies banks have increasingly moved away from a focus on lending and toward a fee for service model; but in China, fee income in 2004 was only 0.17% of assets, one-quarter to one-fifth the level of that in other Asian economies. Because of low fee income and high bad-debt expenses, total return on assets for Chinese commercial banks was only 0.44% in 2004, about one-third of the level in other Asian economies. Among the potential areas for increased fee earnings, perhaps the most lucrative is credit cards. Although Chinese banks have issued hundreds of millions of debit and cash cards, slow development of credit bureaux and clearing networks has slowed the growth of the credit card business. As a result, almost all the net income of Chinese banks comes from the interest spread between deposit and lending rates.

With the change from a planned economy to a socialist market economy, China's financial structure experienced a series of reforms designed to create an effective commercial financial system. The four state-owned commercial banks — the Industrial and Commercial Bank of China (ICBC), the Bank of China (BOC), the China Construction Bank (CCB), and the Agricultural Bank of China (ABC) — are the direct descendants of the planned-economy bank system.¹⁴³ They are huge entities, each with hundreds of thousands of employees and ranking among the top 50 largest financial institutions in the world in terms of assets. Currently, the 'Big Four' state-owned commercial banks are still the most important part of the entire financial system, accounting for 53 per cent of total banking system assets in 2005.¹⁴⁴ As of the end of 2009, China's banking sector comprises 2 policy banks and the China Development Bank (CDB), 5 large commercial banks, 143 city commercial banks, 43 rural commercial banks, 196 rural cooperative banks, 11 urban credit cooperatives, 3056 rural credit cooperatives and one postal savings bank.¹⁴⁵

In regards to the institutional structure of the bank industry, the number of new types of financial institutions has been constantly expanding. By the end of 2009, a cumulative total of 12 national joint stock commercial banks (JSCBs) (of which 11 which were set up between 1986 and 2001) and three strategic banks has been reached. The JSCBs present a sharp contrast to the big four state-owned banks. The JSCBs have younger, more highly trained staffs and considerably lower levels of bad loans on

¹⁴³ The largest in terms of assets is the Industrial and Commercial Bank of China (ICBC), which took over lending and deposit taking in the cities. The Agricultural Bank of China (ABC) did the same in the countryside; it has the largest staff and 44,000 branch offices. The China Construction Bank (CCB) focuses on project financing and took over many of the relatively skilled personnel who had been involved in investment planning in the old system. The Bank of China (BOC), which had actually maintained some overseas branches throughout the planned-economy period, handled foreign-trade and foreign-exchange transactions. It has a smaller, more qualified staff and fewer branches than the others, but the second-highest level of assets.

¹⁴⁴ Naughton, above n 142, 456.

¹⁴⁵ 中国银行监督管理委员会 [China Banking Regulatory Commission (CBRC)], 《中国银行监督管理委员会 2009 年年度报告》 [CBRC 2009 Annual Report], June 2010, 30.

their books. The JSCBs have introduced a welcome element of competition to the banking system, and they have steadily gained market share, surpassing 15 per cent of total banking-system assets by 2005 and 18 per cent in 2006, and 18 percent by end-September 2007.¹⁴⁶

Apart from the above, newly established non-bank financial institutions in China, as of the end of 2009, included four banking asset management companies, 58 trust companies, 91 finance companies of enterprise groups, 12 financial leasing companies, 10 auto-financing companies, three money brokerage firms, eight lending companies, and 16 rural mutual cooperatives.¹⁴⁷ In addition, China has increased the pace of allowing foreign financial institutions access to the Chinese financial market. By 2007, there were more than 440 business institutions or branches of 29 foreign-owned banks' in China.¹⁴⁸

Large commercial banks, JSCB and rural cooperative institutions were the three largest types of banking institutions by asset size. Respectively, these accounted for 50.9 per cent, 15.0 per cent and 11.0 per cent of total banking assets.¹⁴⁹

China's capital markets are also in the midst of a difficult period of change involving reform, new regulations, and retrenchments. In recent years, financial institutions in the securities industry have demonstrated rapid development. As of the end of 2007, a total of 106 securities companies, 59 fund management companies, 346 securities investment funds and 177 futures companies operated in China's financial market. China's insurance industry began from the year of 1980, and only had one company in the market, the People's Insurance Company of China (PICC). By 2007, China had

¹⁴⁶ 熊海帆 [Xiong Haifan], above n 86. See also Figure 3.1.1 Market Share by Assets (end-September 2007) at <http://www.chinaknowledge.com/Business/CBGdetails.aspx?subchap=4&content=15>.

¹⁴⁷ 中国银行监督管理委员会 [China Banking Regulatory Commission (CBRC)], *CBRC 2009 Annual Report*, above n 145.

¹⁴⁸ 熊海帆 [Xiong Haifan], above n 86.

¹⁴⁹ 中国银行监督管理委员会 [China Banking Regulatory Commission (CBRC)], *CBRC 2009 Annual Report*, above n 145.

developed a relatively comprehensive insurance industry, which includes 102 insurance companies (of which 43 are foreign owned), and 9 insurance asset management companies.¹⁵⁰

As financial businesses have become more and more versatile, the Chinese financial industry has developed from a one dimensional banking sector to a multi-sectoral system. However, being subject to restraint due to many different factors, each financial sector has experienced uneven development. The banking industry is the dominant financial area in China's financial sector, while at the other end the business scale, the insurance industry, the trust industry and the financial leasing industry are relatively small. As of the end of 2007, capital levels in the banking industry reached CNY 52.6 trillion, accounting for 92 per cent of the total assets of the financial sector; capital levels in securities industry reached CNY 1.7 trillion, accounting for 3 per cent of the total assets of the financial sector; and capital levels in the insurance industry reached CNY 2.9 trillion, accounting for 5 per cent of the total assets of the financial sector.¹⁵¹

The enactment of the *Chinese AML Law* can be seen as bringing China into a new era of AML systematic coordination. However, as the law only developed general principles and a basic framework for AML prevention, no detailed guidance and guidelines for implementation were provided concerning the AML work of individual parts of the financial sector. The *Administrative Rules for the Reporting of Large-Value and Suspicious RMB Payment Transactions* (2007) extended the AML reporting obligations to the securities and insurance industries; however, it was in effect a 'one size fits all' treatment. For example, Article 9 of the Rules provides a universal reporting threshold to be complied with by all financial institutions without clear distinctions amongst the agencies in the banking, securities and insurance

¹⁵⁰ 项俊波 [Xiang Junbo] 《结构经济学-从结构视角看中国经济》 [Structural Economics-Analyzing China's Economy from the Structural Perspective] (中国人民大学出版社 [People's University of China Press], 2009) 148.

¹⁵¹ Ibid 149.

industries, which in practice decreases effectiveness.¹⁵² There are no supplementary or updated provisions concerning AML in existing financial legislation such as the *Insurance Law*, *Securities Law* and the *Trust Law*. Potential conflicts between industrial preferences and AML requirements in the financial industry need to be urgently addressed; otherwise, financial institutions may be subject to confusion in practical decision-making, and increasing the AML cost while weakening AML effectiveness.

3.1.2 ‘Out of order’ competition¹⁵³ in the Chinese Financial Sectors

At present, the strategic positioning of Chinese financial institutions has become convergent. For most of the Chinese financial institutions and other big companies, their development strategy is to grow bigger and stronger. Their main focus includes capital expansion, the widespread establishment of sub-branches, attaining increasing scale and market-share, with the ultimate goal of being a national or even a global giant in the financial industry. Correspondingly, return on capital, service quality, reputation and social benefits are thought of as secondary issues.¹⁵⁴

‘Out of order’ competition (or uncontrolled competition) among financial institutions provides opportunities that can be exploited for ML activities. Currently, the main features of ‘out of order’ competition in China’s financial sector are:¹⁵⁵

- (a) Using areas beyond the scope of the banks’ saving deposit business to attract deposits. It is common to absorb corporate deposit, receive notes and drafts, and undertake settlement business on behalf of customers. Even after implementing the ‘real name’ system for savings deposits, many savings

¹⁵² 中国人民银行 [People’s Bank of China], *Administrative Rules for LV and Suspicious RMB Transaction*: Notice 2, above n 1.

¹⁵³ ‘Out of order competition’ is a transliteration of 无序竞争. It refers to financial institutions that break rules in order to compete in the financial industry, or can be regarded as uncontrolled competition.

¹⁵⁴ 唐旭 [Tang Xu] 《中国金融机构改革：理论、路径与构想》 [Reform of Chinese Financial Institutions: Theory, Method, and Ideas] (中国金融出版社 [China Financial Publishing House], 2008) 8.

¹⁵⁵ 詹昭, 柳军, 柳杰 [Zhan Zhao, Liu Jun and Liu Jie], above n 104.

institutions still accept public funds for personal storage. Commercial banks directly transfer funds from unidentified customers into savings account or pay large-value cash to customers, providing a great convenience to money launderers.

- (b) Illegally establishing and using accounts, with resultant freedom to withdraw large amounts of cash. In order to increase saving volume, many commercial banks violate accounts management rules and open more than one account for customers without carefully examining account-opening materials, and even ignore obligations of relevant reporting systems.
- (c) Illegally conducting banking transactions such as bills acceptance and bills discounting. Commercial bill markets in China are not well developed, and limited authority to accept bills is given to sub-branches by the higher authority. All the banks are facing severe competition in the businesses of bill acceptance and bill discounting. As only a few state-owned enterprises (SOEs) are the clients of such services, in order to attract clients, banks sometimes reduce interest rates at random and do not check previous transaction records of the bill-holders.
- (d) As the competition amongst some banking businesses is fierce, some banks even violate rules relating to systems of internal control, and conduct business on the basis personal relationship rather than the principles applicable.

The current regulatory content for the Chinese financial industry is not comprehensive and the scope of regulation is too narrow. A comprehensive regulatory system should cover range from the financial institution's market entry to market exit. However, Chinese financial regulations require a strict examination of financial factors on market entry, a less rigorous examination of operations once the company is established, and virtually no market exit mechanism exists in the financial industry.¹⁵⁶

¹⁵⁶ 郭纹廷 [Guo Wentin], 转轨时期中国金融监管制度变迁与金融效率研究 [Study on China's Financial Supervision System Changes and Financial Efficiency in Transition Period] (PhD Thesis, 西北大学 [Northwestern University], 2006).

More regulatory focus is placed on traditional deposit and loan business than on off-balance sheet activities. Limited attention has been paid to the monitoring and regulation of interest rate risk and exchange rate risk, supervision of internal control of financial institutions, and managing the risk that accompanies the use of innovative financial instruments.

Indeed, there is a crucial need to build up internal control and risk prevention systems to ensure adequate governance of financial institutions. Against a background of economic globalisation and rapid development of a modern financial industry, financial institutions are placed under stress by extreme competition. Thus, internal control and risk prevention both play an extremely important role in the maintenance of an institution's competitiveness while ensuring its commercial viability. In a sense, internal control capability has become one of the core elements of corporate competitiveness.

Due to excessive and 'out of order' competition among financial institutions, loose financial regulation has long been a widespread phenomenon in China. In particular, uncontrolled settlements in the banking sector create a breeding ground for ML activities. Thus, good financial supervision should also aim at protecting financial institutions from uncontrolled competition and ensure the enforcement of related laws and provisions of the financial regulations. A good financial order is a basic prerequisite for effective implementation of AML regulations.

3.1.3 Regulatory Intervention and Governmental Control

The so-called 'Chinese characteristics' are manifest in the implementation of economic marketisation guided by the state. Since 2003, by gaining capital support from the state and writing-off bad debts, the state-owned commercial banks have achieved a good financial situation and attracted capital from both the domestic and

overseas markets.¹⁵⁷ In addition, given the limitations on both disclosures of individual company information and shareholder control, the Chinese stock market is inevitably driven primarily by changes in government policy. Studies have shown that market fluctuations are better explained as reactions to government policy, particularly those that affect the market liquidity, rather than as reaction to changes in underlying fundamentals of the individual companies.¹⁵⁸

With the extensive involvement of provincial government during the evolution of the financial sector, the interests pursued by state-owned financial institutions are predominantly determined by the preferences or the interests of the various local governments. This has resulted in a very similar degree of aggregation of the financial organisations within the same administrative area, particularly those banking organisations at the same level. The adverse consequences of this regional segmentation and regional convergence of the financial structure are as follows:

- a) The structure of financial organisation is very large, heavily overstaffed and inefficient;
- b) Efficient regional capital allocation is impeded, and the formation of a unified national financial market is hindered;
- c) As local government has seriously influenced and intervened in financial activities, so financial behaviour is correspondingly distorted, resulting in the accumulation of financial risks; and
- d) The financial regulatory structure is not compatible with the pattern of financial transactions. In recent years, regulatory authorities have put great effort into restructuring financial organisations, basically setting up individual regulators in the banking, securities, and insurance industries. The ill-fit between regulatory structure and transaction structure has been greatly improved; however, coordination between the separate regulatory bodies, policy transparency, and information disclosure need to be further improved and enhanced.

¹⁵⁷ 唐旭 [Tang Xu], above n 154.

¹⁵⁸ Naughton, above n 142, 473.

In modern economic development, the government undertakes important responsibilities and the regulatory role of the government is strong. As China is experiencing rapid growth, the government plays an indispensable role in all aspects of social development, especially in the financial sector. However, government intervention in financial operations should function as an instrument to strengthen the economy, while letting the market forces play the fundamental role.¹⁵⁹ Indeed, if there is no government involvement and guidance, the market may deviate from its optimal efficiency, but if the government's power in the market is too strong, it will also affect the market operation. The balance point of coordination between government and market needs to be found through constant adjustment.

3.1.4 Imbalance of Financial Development in China

Until very recently China's financial system lagged behind the rest of the economy in the transition process. The banking sector has been one of China's most protected industries, being overregulated, dominated by state ownership, and protected from international competition. Since the early 1980s, according to official statistics, China has consistently been the fastest growing economy on earth, sustaining an average annual growth rate of 10 per cent from 1978 through to 2005 and reached 11.4 per cent in 2007, the rate of growth falling slightly to 9.6 per cent in 2008 when the judicious use of an economic stimulus package by the government ensured that growth continued through to 2009 (8.7 per cent) and 2010 (10.4 per cent) when other economies were enduring marked difficulties.¹⁶⁰ However, the Chinese economy displays both unmatched dynamism and unrivalled complexity.

3.1.4.1 Regional Imbalance of Economic Development in China

Geographically, China is normally divided as East China, Central China, West China,

¹⁵⁹ 唐旭 [Xu], above n 154.

¹⁶⁰ Naughton, above n 142, 474. For information subsequent to 2005, see Chinability website which cites as its information source the National Bureau of Statistics, the China Statistical Yearbooks, the National Bureau of Statistics plan report, and National Bureau of Statistics communiqués (last updated 5 November 2011) <<http://www.chinability.com/GDP.htm>>.

and Northeast China. In detail, East China includes Beijing, Tianjin, Hebei, Shandong, Jiangsu, Shanghai, Zhejiang, Fujian, Guangdong, and Hainan. Central China is constituted by Shanxi, Henan, Anhui, Jiangxi, Hubei, and Hunan. West China contains Chongqing, Sichuan, Guizhou, Yunnan, Tibet, Shanxi, Gansu, Qinghai, Ningxia, Xinjiang, Inner Mongolia, and Guangxi. Northeast China includes Liaoning, Jilin, and Heilongjiang.

Since the 1990s, the three East China municipalities — Shanghai, Beijing and Tianjin — have kept their top rank for per capita GDP, while the regions with lowest per capita GDP have changed every year. In 1991, the per capita GDP in top three municipalities was CNY 5490, while for Guangxi, Anhui, and Guizhou it was as low as CNY 1103. Up until 2007, the per capita GDP in the top three municipalities increased to CNY 56,503.9, while the lowest level per capita GDP was CNY 9,262.9 in the three West China provinces of Yunnan, Gansu and Guizhou.¹⁶¹ The regional GDP of the three top municipalities nearly reached the level of that in medium to high income countries. However, the three provinces with lowest per capita GDP have remained at just above the level of lower and middle income countries. Indeed, the economic gap between different regions in China, is large and growing, especially between East and West China.

3.1.4.2 Urban-Rural Differences in Economic Development

Foreign trade understandably benefits the coastal regions of China most, and the coastal provinces have grown significantly more rapidly than inland provinces on the strength of trade-related demand. The share of China's total exports produced by Guangdong, Fujian, and Hainan rose dramatically from 16 per cent in 1978 to 46 per cent during the mid-1990s. Yet China is also struggling to emerge from poverty. While the World Bank 'promoted' China from 'lower income' to 'lower middle income' status at the end of the 1990s, it should be acknowledged that it encompasses diverse regional economies that range from extreme poverty to relative prosperity. In

¹⁶¹ 项俊波 [Xiang Junbo], above n 150, 186.

large stretches of rural China peasants still struggle on the margins of subsistence, while in Shanghai, Beijing, and Guangdong a modern information economy is taking root.¹⁶²

During the last 20 years, income distribution has drastically changed, and the income gap between urban residents and rural residents is continually widening. Although there are twists and turns in the changes of income gap between urban residents and rural residents, the overall trend of the gap is to expand. From 1991 to 2011, the urban residents' per capita disposable personal income increased from CNY 1,700.6 increased to CNY 19,118, while the rural residents' per capita met personal income increased from CNY 708.6 to CNY 6,194.¹⁶³ Moving into the 21st century, the ratio between urban residents' per capital and rural residents' per capital income has rapidly increased. In particular, the rural:urban ratio reached as high as 3:11 in 2002 and further widened to 3:33 in 2007.¹⁶⁴ It can be seen that, in recent years, the urban-rural income gap, rather than being ameliorated has further enlarged.

Compared to financial institutions in urban areas, distinct differences exist in the operating environment, customer type, and capacity for risk management of rural financial institutions. With regards to coverage provided by financial services, there are still 'blind spots' in rural areas. In 2007, there were still 2868 villages and towns without any financial institutions, and 8901 villages and towns that had only one financial institution.¹⁶⁵

The crucial question of implementation will take time to unfold, especially as key reforms have only been introduced in recent years. Implementation is a challenge in

¹⁶² Naughton, above n 139, 396.

¹⁶³ 项俊波 [Xiang Junbo], above n 150, 194. The figure of 2011 is sourced from <<http://www.finance.sina.com.cn/roll/20120121/034811251825.shtml>>.

¹⁶⁴ See, *ibid*; 李泽民 [Li Zemin] 广东等10余省市推“收入倍增计划” [*More than 10 Provinces and Cities promote “Doubling Income Project”*] (28 December 2010) <<http://money.163.com/10/1228/02/6OV48IEN00253B0H.html>>.

¹⁶⁵ 项俊波 [Xiang Junbo], above n 150, 171.

any country, but it is doubly difficult in China. The age-old saying ‘the heavens are high, and the emperor is far away’ remains an apt description of the tension between centralised lawmaking and local implementation.¹⁶⁶ The Organisation for Economic Co-operation and Development (OECD) has noted that the financial system in China ‘performs inadequately in carrying out several of its basic functions in the economy’, has ‘limited scope for transferring funds among financial institutions or regions’, and that ‘the external discipline provided by the financial system has been a major weakness’.¹⁶⁷ These features lead to concern that the financial system is lagging behind other aspects of China’s economic development and may become a source of economic vulnerability.

In this regard, just as it is impossible to implement ‘one size fits all’ AML standards to all countries, for example between countries such as the US and the Philippines, the current ‘one size fits all’ AML regulation is not the best choice for China, due to the significant and widening gap between different regions. In addition to the huge differences in the scope of business, operational capacity, and the understanding of risk-management, it is also difficult to apply a risk-based AML approach to all financial institutions in China within a relatively short time.

3.2 Inherent Limitations and Practical Issues of China’s AML Effectiveness

China is currently in a critical period of social transformation, and its economic structure has undergone profound changes. The construction of the domestic financial market is facing significant challenges. There are numerous illegal financial activities, including crimes that disrupt the order of financial management and crimes of financial fraud in the Chinese financial sector. They are all relevant to AML efforts, and seriously affect the normal development of the national economy.

Since China launched economic reforms at the end of 1978, market transition has

¹⁶⁶ Lewis, above n 52, 182.

¹⁶⁷ McCusker, above n 51.

extended over more than 30 years. China's economy has been transformed by successive waves of economic reform. By the mid-1990s, China had successfully moved away from the command economy and adopted a functioning market economy, and experienced in-depth business cooperation with the whole world. For more than a decade China has been one of the world's most important destinations for FDI. Investment began to pour into China after 1992, and annual inflows have been over USD 40 billion since 1996. Trending steadily upward, FDI inflows were at 63 billion dollars in both 2004 and 2005,¹⁶⁸ and it is reported China received USD 129.6 billion inflow of "hot money" during the first half of 2008.¹⁶⁹ There is no doubt that the global manufacturing networks created by FDI in China will continue to play a critical role in the world economy, and it means there is a huge flow of capital into and out of China making suspicious transactions less obvious.

As of the end of 2007, Chinese banks held shares in nine foreign financial institutions, had set up 60 branches in 29 different countries and regions, including Hong Kong, Macao, the US, Japan, Britain and Singapore, and the total assets of overseas Chinese banks had reached USD 267.4 billion (almost CNY 1684.6 billion).¹⁷⁰ Similarly, by the end of 2007, Chinese insurance companies had set up 24 business institutions and nine representative offices or liaison offices in different regions, including Hong Kong, Macao, Southeast Asia, Europe and North America.¹⁷¹ After joining FATF, the goal of financial institutions' expansion strategies can only be further developed if China brings its AML system into line with global criteria.

3.2.1 Unique Features of AML Practice in Transition Countries

Developed countries in Europe and the US have served as the designers and standard setters for AML systems since the late 1980s. These jurisdictions have mature

¹⁶⁸ Naughton, above n 142, 401.

¹⁶⁹ Michael F Martin and Wayne M Morrison, 'China's Hot Money Problems', *CRS Report for Congress* (21 July 2008) < <http://www.fas.org/sgp/crs/row/RS22921.pdf> >.

¹⁷⁰ 项俊波 [Xiang Junbo], above n 150, 153.

¹⁷¹ Ibid 154.

legislative systems, adequate regulation mechanisms in the market economy, and advanced financial systems. Owing to these advantages coupled with currency restrictions, combating ML and tracing capital flows are relatively simple. Transition countries, on the other hand, in an operating environment that is attempting to cope with drastic social change and social turbulence, face a string of inherent limitations and practical issues in combating ML. These can include complicated political conflicts and disputes involving sectional interests, various social problems, severe corruption, unsound and/or competing legislative systems, and lagging financial systems, and so on. Table 3.1 illustrates the list of AML legislation in transition countries in order of enactment. It reveals that China has started its AML work relatively later than many other transition countries, let alone compared to the developed countries in the AML area.

Table 3.1: Enactment of AML Law of Transition Countries in Temporal Order

Country/Territory*	AML Law Year of Enactment	Country/Territory *	Time of AML Law Enactment
Slovakia*	1994	Armenia	2004
Slovenia*	1994	Bosnia-Herzegovina*	2004
Czech Republic*	1996	Georgia*	2004
Bulgaria*	1998	Mongolia*	2004
Croatia*	1998	Vietnam	June 2005
Latvia*	1998	China	October 2006
Romania*	1999	Uzbekistan	2006
Estonia*	1999	Kyrgyzstan*	November 2006
Albania*	2000	Moldova*	2007
Belarus*	2000	Azerbaijan	2008
Poland*	2000	Turkmenistan	May 2009 signed by the president
Russia*	2001	Kazakhstan	August 2009 signed by the president
Serbia*	2002	Tajikistan	In discussion
Ukraine*	2002	Hong Kong*	1989
Hungary*	2003	Taiwan*	1996

*standing for the formal members of the Egmont Group

Source of Table 3.1: Information sourced from respective FATF Mutual Evaluation Reports

In recent years, the international community has made great efforts to ensure that countries comply with the *Financial Action Task Force* (FATF) 40+9

Recommendations. Most transition countries, as FATF required, passed domestic AML legislation, set up an FIU, focused on information disclosure and transparency in financial institutions, and established international cooperation and information sharing systems. However, due to their hasty compliance with enacting legislation to combat ML, many transition countries (mainly the Commonwealth of Independent States (CIS) countries and China) presented unique features in regards to AML practice which are vastly different to the problems that exist in the developed countries. Pertinent to the unique features in transition countries' AML compliance, Berglund et al argued that the full adoption of developed AML assessment criteria in transition countries, which are characterised by figures for investigations, prosecutions, and criminalisation, are not comprehensive enough. Berglund suggested that assessment should also cover figures for the imposition of penalties, including the seizure and confiscation of criminal proceeds.¹⁷² Apart from these, AML regime effectiveness in transition countries should also be judged according to two new dimensions: whether rigorous AML tools are both adopted and implemented, and how fairly and regularly they are used.¹⁷³

3.2.1.1 Strategy of 'Adopt but not Enforce'

The assessments of AML effectiveness of countries are mainly conducted by FATF and FATF-style organisations in accordance with international AML standards and methodologies. The results of the assessments are published in a public report, which provides recommendations and suggestions on changes and improvements, and also foreshadows a designated time for future reporting. As the most common recommendation for AML improvements is in relation to unsound and irregular or non-FATF compliant AML-related legislation, many countries' responses take the form of drafting and passing some pertinent provisions very soon after the assessment report has been delivered. However, limited by a variety of objective and subjective

¹⁷² Christofer Berglund, Michael Jonsson, Christian N. Larson, and Elias Götz, 'Combating Money Laundering in Eurasia: Lessons from Kyrgyzstan and Georgia' (2008) 6(3) *China and Eurasia Forum Quarterly* 21, 22.

¹⁷³ Jun Tang and Lishan Ai, 'Combating Money Laundering in Transition Countries: the Inherent Limitations and Practical Issues' (2010) 1 (3) *Journal of Money Laundering Control* 215, 216.

hindrances, such newly-updated provisions normally cannot be effectively put into practice.

It is common for transition countries to apply the ‘adopt but not enforce’ strategy in developing AML practice, that is, they draft and approve legislation on paper, but then use particular national conditions as excuses not to provide full practical implementation of the AML legislation.¹⁷⁴ In fact, one of the driving motivations in adopting this strategy is that authorities in transition countries can conduct AML work as a political gesture or use its legislative action as ‘game chips’ in exchange for political and economic support from developed countries.

By considering the experience of China joining the FATF, it is obvious that the US government has used financial cooperation as a diplomatic lever. The Chinese membership of FATF was used as an important bargaining chip in the second US-China Strategic and Economic Dialogue (SED).¹⁷⁵ Indeed, the financial services industry is always one of the core topics between these two countries’ SED negotiations. In the second SED, the US made very few commitments to the Chinese, with one of these being that the US ‘strongly supports China becoming an official member of FATF in FATF’s 2006 conference’.¹⁷⁶ It can be seen that this support was given in exchange for concessions from the Chinese in other areas of negotiation.

In addition, in order to encourage China to join FATF, the US government linked China’s FATF membership with permission for Chinese banks to set up branches in the US, even though the Chinese AML system did not meet FATF standard at that time. In the *Order of Approving Establishment of a Branch of China Merchants Bank*

¹⁷⁴ Ibid 218.

¹⁷⁵ 宋国友 [Song Guoyou], 《美国与中国参与国际金融组织: 以中国加入 FATF 为例》[The US Role in China joining the Financial Action Task Force: A Case Study of China’s FATF Membership] (2008) 10 国际问题论坛 *International Forum* 63.

¹⁷⁶ 车玉明, 胡芳 [Che Yuming and Hu Fang] ‘第二次中美战略经济对话联合情况说明’ [Report of the Second U.S.-China Strategy and Economic Dialogue], 新华社 *Xinhua News Agency* (online), 25 May 2007, 111 <http://news.xinhuanet.com/world/2007-05/26/content_6152819.htm>.

(CMB) made by the Federal Reserve System, the US representatives clearly stated that ‘the Chinese government has enhanced its AML regime’ and ‘China is a member of FATF’, and that the CMB ‘has implemented measures consistent with the recommendations of FATF and that it has put in place policies, procedures, and controls to ensure ongoing compliance with all statutory and regulatory requirements’.¹⁷⁷ In this case, joining FATF was seen as a key prerequisite in gaining approval for the establishment of a branch of a Chinese bank in the US.

3.2.1.2 Political Confrontation between Transition and Developed Countries

The global financial system often refers to the application of AML mechanisms and these are usually pioneered by the US and other developed countries. When AML-related issues start to become a key tool in the international financial arena, the relationship between transition countries and developed countries sometimes becomes interesting. For example, on the one hand, Russia and China have been regarded as potential opponents in political, economic and ideological aspects by developed countries for a long time. On the other hand, as the US, the UK and Canada and some other developed countries are recipient countries and transfer destinations of stolen assets and ML activities from Russia and China, their financial institutions, perhaps without intention, have become the biggest beneficiaries in the process of the loss of state assets and capital flight from transition countries.¹⁷⁸

Few cases can be found in relation to the Western countries actively providing assistance in searching for and returning the capital ‘lost’ from transition countries. Limited sources include the Stolen Asset Recovery Initiative (StARI) initiated by the World Bank and UNODC,¹⁷⁹ which aims at helping resources-abundant countries

¹⁷⁷ Federal Reserve System, *Order Approving Establishment of a Branch*, November 2007.

¹⁷⁸ 宋国友 [Song Guoyou], above n 175.

¹⁷⁹ The Stolen Asset Recovery Initiative (StARI) was launched jointly by the World Bank and United Nations Office on Drugs and Crime (UNODC) on 17 September 2007 in New York City. StARI’s objective is to reduce barriers to asset recovery and thereby encourage and facilitate more systematic and timely return of stolen assets. StARI emphasises that developed and developing countries share a joint responsibility in tackling corruption and that international collaboration and collective action are needed to facilitate asset recovery and prevent asset theft.

prevent the corruption of government officials, and the Extractive Industries Transparency Initiative (EITI), co-hosted by the UK and the IMF.¹⁸⁰ It is also very hard to require the Western world to assist in tracing criminal proceeds generated by corruption.¹⁸¹ Even where the return of illegal flight capital has been provided, it is only a tiny fraction of the huge amounts of lost capital that have flowed into Western countries. Although the US-dominated international AML systems have been in place for a long time, global ML activities have not apparently been restrained. On the contrary, the volume of ML has increased over time.¹⁸² Apart from reasons of economic development and the continuing evolution and adoption of new ML methods, the large profits transferred from transition countries into Western financial institutions may also be a critical factor.

According to the assessment made by the Centre for Research on Globalisation in 2001, over the period of a decade, between USD 2.5 trillion and USD 5 trillion of criminal proceeds have been laundered by US banks and circulated in the US financial circles. The Centre estimated that USD 100 billion per year has been laundered into US and European banks, and at least half of the funds were facilitated by US banks. Brookings Institution also estimated ‘the flow of corrupt money out of developing (Third World) and transitional (ex-Communist) economies into Western coffers at USD \$20 to \$40 billion a year and the flow stemming from trans-priced trade at USD \$80 billion a year or more’, and this estimation did not include illegal

¹⁸⁰ The Extractive Industries Transparency Initiative (EITI) sets a global standard for transparency in oil, gas and mining. It is an effort to help the EITI countries to get rid of so-called ‘resource curse’ closely linked with poverty, conflict, and corruption. EITI was launched by the UK government in 2005, and its supporting international organisations include the United Nations, European Union, African Union, Organisation for Economic Co-operation and Development (OECD), World Bank Group, and European Bank for Reconstruction and Development (EBRD), and so on, as well as 46 of the world’s largest oil, gas and mining companies. Kazakhstan and Kyrgyzstan in Central Asia have joined EITI.

¹⁸¹ In April 1986, the Philippine government officially asked mutual legal assistance from Switzerland to recover the USD 13 billion transferred by the former President of the Philippines, Ferdinand Marcos. According to this requirement, Switzerland authority froze a total saving of USD 0.6 billion. Until 1997, the Swiss Federal Supreme Court made final judgment of returning the frozen capital with interest together of USD 65.8 million back on the account designated by the Philippine National Bank.

¹⁸² The US State Department INCSR for 2008 states that, based on IMF estimates, money laundering today may range somewhere between USD 2.1–3.6 trillion, compared to USD 300–500 billion ten years ago.

transfers of real estate and securities titles, wire fraud, and so on.¹⁸³

3.2.1.3 Transition Countries' AML Practice Influenced by Other Political Issues

It is a cause of criticism that transition countries often use AML mechanisms to target political opponents or enhance economic controls. In some transition countries, the first group subject to investigation is usually opposition leaders.¹⁸⁴ Interestingly, the *Shuibian Chen Case* in Chinese Taipei was also seen as an example of the Yingjiu Ma government using AML as political weapon to harass opponents.¹⁸⁵ The first complainant and the person who requested that Switzerland assist investigations into the Chen family and disclosed information regarding capital flows to the Chinese Taipei media was a legislator from the Kuoming Party.¹⁸⁶ There is a lack of confirmed evidence to show such 'selective implementations' occur in China, however, many of the key individuals in financial institutions and the broader business community are closely linked to senior members of the administration. Politicians' families are often also major players in the business community. Laws and regulations are applied selectively, often favouring some participants while being used to the detriment of others.¹⁸⁷

¹⁸³ James Petras, 'Dirty Money: Foundation of US Growth and Empire-Size and Scope of Money Laundering by US Banks' (Centre for Research on Globalisation, Binghamton University, 19 May 2001).

¹⁸⁴ One of the first convictions on a charge of money laundering in Uzbekistan was of opposition leader, Sanjar Umarov. He was sentenced in March 2006 to 15 years in prison, less than a year after he openly criticised the Uzbek government and rumours circulated that he might one day seek to succeed President Karimov. A number of human rights activists including Mutabar Tojiboeva and Nodira Hidoyatova have also been convicted of economic crimes in Uzbekistan; In Kazakhstan, President Nazarbayev's former son-in-law, Rakhat Aliyev, was charged with money laundering and the abduction of two bank officials by Kazakh police in August 2007; Kazakhstan's former Prime Minister, Akezhan Kazhegeldin, was convicted and sentenced in absentia to 10 years imprisonment for embezzlement, bribery and tax evasion in 2001. Ironically, when the government of Kazakhstan asked Swiss officials look into Kazhegeldin's foreign bank accounts, Geneva widened its investigation and wound up freezing an account believed to belong to a senior government representative, resulting in the notorious 'Kazakhgate' scandal involving USD 1.1 billion and a massive presidential 'secret fund' in Switzerland. In Armenia, Alexander Arzumanyan, an opposition leader and former Minister of Foreign Affairs, was arrested on 7 May 2007, five days before parliamentary elections. Similar circumstances surround the prosecution of former Defence Minister, Irakli Okruashvili, in Georgia. Soon after his dismissal in late 2006, Okruashvili formed an opposition party and unleashed sharp criticism against the incumbent government. On 27 September 2007, Okruashvili was arrested on charges of money laundering, corruption and abuse of office.

¹⁸⁵ Shuibian Chen is the former President of Democratic Progressive Party and the former leader of Chinese Taipei. Yingjiu Ma is the current President of Kuoming Party and the leader of Chinese Taipei.

¹⁸⁶ Tang and Ai, 'Combating ML in Transition Countries', above n 173, 223.

¹⁸⁷ Broome, above n 17.

In regard to political issues related to China's AML practices, in some cases international cooperation and communication with international bodies has been stymied. It has been calculated that up to December 2008, 180 countries and territories of the world had criminalised ML offences under their domestic law, and 107 countries and territories of the world had joined the Egmont Group of Financial Intelligence Units. Indeed, without the role of international FIU groups, the effectiveness of AML information systems would be severely impeded.

China is in the process of becoming a formal member of the Egmont Group, and looking forward to the promotion of AML activities via international assistance with financial intelligence. However, political issues have, to a degree, blocked the entrance to the international FIU group. When Chinese Taipei registered its membership of the Egmont Group in 1998, the region used 'Taiwan' as the original membership name rather than 'Chinese Taipei'. This has created a long term problem in negotiations between the Egmont Group and the government of mainland China.¹⁸⁸ In fact, despite all the entrance requirements having already been met, it can be seen that China will not be willing to become a formal member of the Egmont Group until this sensitive issue has been resolved. In fact, the founding of a Eurasian Group on Combating Money Laundering and Financing of Terrorism (EAG) in 2004 and the long 'hibernation' of China's membership of APG from 1997 to 2009 are both, for different reasons, related to political issues.¹⁸⁹

3.2.2 Institutional Conflict of the AML Regulation System in the Chinese Financial Sector

3.2.2.1 Conflicts among the PBC, the CBRC, the CSRC and the CIRC

When the PBC implements its guiding role for the entire Chinese AML regime, the

¹⁸⁸ Tang and Ai, 'Combating ML in Transition Countries', above n 173, 223.

¹⁸⁹ China was actually a founding member of Asia/Pacific Group on Money Laundering (APG) in 1997; however, it has formally played its role in the organisation since July 2009.

central bank faces inherent dilemmas arising from institutional conflicts, which in turn affect the effectiveness of AML policy and actions.

China has been undertaking financial reform since 1979 (see Table 3.2), and the PBC's responsibility as the nation's central or reserve bank or 'bank of country'¹⁹⁰ has been gradually weakened. The primary function of the central bank should be as a 'bank of country', with the responsibility of supervising and managing business compliance within the overall banking system. In the past, Chinese residents only engaged in financial investments if they held bank deposits. At that time, the majority of financial assets were held by the 'big four' banks, and therefore, as long as the big four banks were under tight supervision, the whole financial system of China came under the control of PBC.

As China's capital markets and money markets have continuously developed, Chinese investors now can take advantage of the availability of bank deposits, stocks, bonds, and insurance policies, and so on. With this increasing variety of financial instruments and financial services, the divide between banking financial institutions and non-bank financial institution in terms of regulation has become obvious. Indeed, with the rapid development that has occurred in the non-bank financial institutions, the supervision of the whole financial industry can no longer be subject to the sole control of a central bank. As a result, the CSRC was created in 1992 and CIRC in 1998 respectively, and have jointly served as national institutions supervising financial enterprises along with PBC, the CSRC in relation to the securities industry and CIRC in relation to insurance industry entities. The PBC's responsibility to supervise the financial industry can be seen to have been diluted by this growth in the number of supervising entities.

¹⁹⁰ So-called bank of country signifies the central bank of a country which normally does not engage in profit-seeking business operated by general commercial banking institutions, such as deposits and loans services, but only functions as a regulatory and executive institution of a country, and, in the case of China, to formulate and promulgate legislation to standardise and supervise all types of business activities in banking sector.

Table 3.2: Important Events in Chinese Financial Reform

1979	Bank of China (BOC) began its systematic program of reform
1979	Chinese People's Construction Bank separated from the Ministry of Finance (later changing its name to the China Construction Bank (CCB) in March 1996)
1979	Agricultural Bank of China (ABC) recommenced business
1980	People's Insurance Company of China (PICC) recommenced its domestic insurance business
1984	The establishment of the Industrial and Commercial Bank of China (ICBC)
1992	The establishment of the China Securities Regulatory Commission (CSRC)
1998	The establishment of the China Insurance Regulatory Commission (CIRC)
1998	The enforcement of great regional branches of the People's Bank of China (PBC) ¹⁹¹
2003	The establishment of the China Banking Regulatory Commission (CBRC)

In 2003, the CBRC was formally set up. This regulatory body predominantly focuses on regulation and supervision in the banking industry. The CBRC was instructed to keep regulatory oversight independent from the monetary policy functions of the central bank (that is, the PBC). This was an important administrative step on the way to establishing an 'arm's length', regulatory relationship with a diverse group of banks. This is essential for the next stage of financial sector reform in China.¹⁹² The establishment of the CBRC completes the 'separate operation, separate supervision' framework for the Chinese banking, securities, and insurance sectors. The separate framework has significant influence on increasing the individual competitiveness of each sector, and plays an important role in financial risk control. The main supervisory duties of the CBRC are:

- 1) Protecting the interests of depositors and financial consumers through prudential and effective regulation;
- 2) Increasing market confidence through prudential and effective regulation;
- 3) Enhancing the public's awareness of modern finance by means of propaganda and training on financial knowledge and disclosure about relevant information;
- 4) Reducing occurrences of financial crimes, and maintaining financial stability.

¹⁹¹ In 1998, China enforced regional branch system reform of the People's Bank of China, which deletes the provincial branch management, and builds nine large regional branches and 21 local offices instead.

¹⁹² Naughton, above n 142, 460.

The dilemma is that on the one hand, the regulatory responsibility of the PBC has been weakened, and, on the other hand, AML operations require the central bank (or another regulator) to regulate AML compliance in all financial sectors, especially the non-bank financial institutions. The institutional structure hides problems. Under China's current financial regulation model, the banking industry, the securities industry and the insurance industry are subject to separate operational supervision, that is, the CBRC, CSRC and CIRC provide regulatory guidelines for their respective sectors. As previously mentioned, the PBC is mainly in charge of the formulation and implementation of the country's monetary policies. In practice, these 'four carriages' have no subordinate relationship, and the policies and services formulated in each sector are independent.¹⁹³

Concerning the different roles played by the PBC, CBRC, CSRC, and CIRC, institutional structural loopholes are predominantly concentrated between PBC and CBRC. The purpose of establishing the CBRC was to take over most of regulatory functions from PBC, thus giving the latter more space to fulfil its role as an 'issuing bank',¹⁹⁴ and central or 'bank of banks'.¹⁹⁵ The CBRC is supposed to be the primary institution charged with regulating all types of business activities throughout the entire banking industry; however, in regard to AML regulation, the CBRC has had to return the regulatory function to the PBC, which to a degree negates the reasons and original goals for establishing the CBRC. Actually, it is virtually an open-secret within the China's financial regulation circles that the CBRC dislikes discussing AML issues, and 'passes the ball' to PBC. Conflict is always accompanied with self interest, and it is not hard to imagine how ineffective cooperation is when conflicts between the

¹⁹³ 严立新 [Yan Lixin], 银行反洗钱机制 [Anti-Money Laundering Mechanism in Banking Sector] (PhD Thesis, 复旦大学 [Fudan University], 2006).

¹⁹⁴ The term 'issuing bank' refers to the central bank which independently develops and implements monetary policy to manage and control the issue of currency by a country, and monitors the total volume of monetary credit in a timely manner by using monetary policy instruments, including deposit reserve ratio, rediscount, and open market operations.

¹⁹⁵ The term 'bank of banks' means that when commercial banks confront difficulties in their business operations, the central bank assists them to get out of trouble quickly through a series of relief measures, enabling them to resume normal operations, and prevent commercial banks from falling prey to large-scale bankruptcy which may cause the banking crisis.

participants are deep-rooted and both sides just ‘turn a blind eye’ to resolving them.

3.2.2.2 Institutional Conflict among the PBC, CAMLMAC and the AMLB

The Chinese FIU functions have been divided between two PBC units: the Anti-Money Laundering Bureau (AMLB) and the China Anti-Money Laundering Monitoring and Analysis Center (CAMLMAC). CAMLMAC specialises in data collection, processing and analysis. Its function is to receive and analyse STRs and LVTRs, and transfer STRs to the AMLB after analysis. AMLB organises and coordinates China’s AML affairs, undertakes administrative investigation, report dissemination, and policy oversight, and makes decisions about whether to carry out an administrative investigation into a STR or to disseminate a STR to the MPS or other law enforcement agencies as directed by AML legislation.

In terms of specific responsibilities, it can be seen that the administrative status of the AMLB should be higher than CAMLMAC, and the latter should be placed under the Anti-Money Laundering Bureau. However, technically, CAMLMAC operates on a parallel level to the AMLB, as both of them are subsidiary departments of the PBC. This division of the FIU functions results in the timing of reporting and investigation being inevitably slowed. With such a complicated reporting process, timely coordination of AML work and the flows from CAMLMAC to MPS and then onwards to the local policing agency are impeded.

CAMLMAC plays an important role as an information disseminator in this model, responsible for sending information upwards and downwards. However, the Centre is not tasked with the responsibilities of ensuring a quick response, the conduct of investigations, the sourcing of evidence, and the taking of other compulsory measures. Its structure and function is still very different to the FIU model as defined by FATF and the Egmont Group.

In fact, at present, the Centre has not yet become financially independent. Its budget is drawn from funds that PBC has allocated for anti-counterfeiting work. It is not uncommon for the FIUs of other countries to be attached to a governmental institution (often the central bank), but the personnel and capital resources are usually independently allocated or at least identified in the overall institutional budget. A lack of an independent budget for AML work has, to some extent, affected the independence of the Chinese AML-related organisations. Finally, since the inter-institutional structure of the AML bodies is so intricate and on such a large-scale, involving specialised departments and financial institutions and non-financial institutions, the AML responsibilities of each body have become overlapping. The institutional structure may blur the AML obligations and duties of each party, and result in resource wastes, and thus reduce the effectiveness of AML activities.

3.2.3 Imperfect Judicial Practice on Money Laundering Crime in China

3.2.3.1 Unproductive Criminalisation of Money Laundering Crime

AML operations are similar to ‘the management of broken windows conducted by government’.¹⁹⁶ Regardless of whether it is due to the government’s negligence, staff misconduct, the financial institution’s intentional or unintentional involvement, or the money launderer’s cunning, as long as the crime is not properly punished, this will inevitably be regarded as an encouragement to criminals desiring to undertake ML activity, and also undermine AML work *per se*. If black money sourced from corruption, smuggling, drug-trafficking, organised crime and other serious crimes can evade the regulations and controls set by government departments, and criminals are not given their due punishment, and illegally acquired income can be easily laundered,

¹⁹⁶ The ‘broken windows’ theory is a criminological theory of the norm-setting effects of urban vandalism on additional criminal and anti-social behaviour. The theory states that monitoring and maintaining urban environments in good condition may prevent further vandalism as well as an escalation into more serious crime. The theory was introduced in a 1982 article by social scientists James Q Wilson and George L Kelling. Since then it has been the subject of great debate both within the social sciences and in the broader public forum. The theory has been used as a motivation for several reforms in criminal policy.

law-abiding citizens will think that social system is unreasonable, and that resource allocation is irrational.¹⁹⁷ In that case, a strong driving force to implement AML work cannot be formed, and low risk and high profits will attract more people to ML. If such social expectations extend widely among the public, the destructive power is much greater than can be imagined. Hence, AML work launched by the government is not only against specific ML crimes, but also aims to maintain social order.

A country's AML measures include both the suppression of criminals and administrative prevention. Criminal suppression includes the criminalisation of ML, adoption of criminal forfeiture and so on. Administrative prevention covers AML obligations of financial institutions and non-financial institutions, AML organisations and other related systems, and their actual operation.

Although the scope of predicate crimes for ML has been widened, criminalisation of ML crimes has remained the same since the *Chinese Criminal Law 1997*. As China's economic and social environment has undergone significant changes, the amount of criminal proceeds and the circumstances of crime are not the same as they used to be, and it is plausible to strengthen the severity of punishment. For example, the current AML legislation prescribes a financial penalty ratio of between only 5 and 20 per cent of the amount of the money laundered. Although it is penalty in addition to confiscation of the criminal proceeds, it is hardly likely to provide deterrence. Compared to the actual economic loss arising out from ML crimes, the penalty ratio is demonstrably low, and should be appropriately increased to increase its deterrence value.

In recent years, China has made significant progress in enacting AML legislation and setting up appropriate institutions. With the deepening of China's AML operations, there have been a number of criminal cases of ML crimes in Chinese judicial practice.

¹⁹⁷ 朱宝明 [Zhu Baoming], 反洗钱若干问题的经济理论分析 [Economic Research on Several Questions of Anti-Money Laundering] (PhD Thesis, 暨南大学 [Jinan University], 2005).

According to data provided by the PBC, the ML crimes were first criminalised in 2004. Since then, there has been one case in 2005 and another in 2006, a further two in 2007 and four in 2008 (see Table 3.3), five in 2009, and 18 in 2010.¹⁹⁸ It should be noted that entire sentences imposed of many cases will also include prison sentences, not merely the fines, however, in judicial practice, the penalties were far from satisfactory.

Table 3.3: Criminalised Cases of Money-Laundering Crime in China

Year of the Case	Case name	Amount of money involved in the case	Predicate crime	Amount of financial fine / other action
2004	<i>Guangdong Wang Zhao Case</i> ¹⁹⁹	CNY 5.2 million	Drug-Related Crime	Fine of CNY 275,000/ Prison sentence of 1.5 years
2005	<i>Fujian Cai Jianli and Cai Huaize Case</i> ²⁰⁰	CNY 10.1 million	Drug-Related Crime	Fine of CNY 330,000/ Prison sentence of 3 years; Fine of CNY 175,000/Prison sentence of 2.5 years
2006	<i>Guangxi Huang Guangrui Case</i> ²⁰¹	CNY 143 million	Crime of Smuggling	Confiscation of CNY 1 million; Fine of CNY 6 million; Prison sentence of 5 years

¹⁹⁸ See, 中国人民银行 [People's Bank of China],《2009 年中国反洗钱报告》[*Anti-Money Laundering Annual Report* (2009)], June 2010, 29; 中国人民银行 [People's Bank of China], 《2010 年中国反洗钱报告》 [Anti-Money Laundering Annual Report (2010)], May 2012.

¹⁹⁹ See, 最高人民法院 [Supreme People's Court],《刑事审判参考》 [Criminal Trials Reference] (法律出版社[Law Press], 2004) 15–17. This case is the first criminalised case of money laundering crime in the history of China's criminal law.

²⁰⁰ See, 中国人民银行 [People's Bank of China],《2005 年中国反洗钱报告》[*Anti-Money Laundering Annual Report* (2005)], 24 August 2006, 44–5. This case is the second criminalised case of money laundering crime in the history of China's criminal law.

²⁰¹ See, 中国人民银行 [People's Bank of China],《2006 年中国反洗钱报告》 [Anti-Money Laundering Annual Report (2006)], 5 November 2007, 54–5. This case is the third criminalised case of money laundering crime in the history of China's criminal law, and is the first one for which the predicate crime for money laundering is the crime of smuggling.

2007	<i>Shanghai Pan Rumin Case</i> ²⁰²	CNY 1.17 million	Crime of Financial Fraud	Fine of CNY 120,000 and prison sentence of 6 years together for 5 criminals
2007	<i>Jiangsu Zhenjiang Tan Tong Case</i> ²⁰³	CNY 800,000	Crime of Smuggling	Fine of CNY 50,000/ Prison sentence of 3 years
2008	<i>Yunnan Yang Dongqing and Liu Anqing Case</i> ²⁰⁴	CNY 5.96 million	Drug-Related Crime	No financial fine/ Prison sentence of 5 years together for 2 criminals
2008	<i>Chongqing Fu Shangfang Case</i> ²⁰⁵	CNY 22.26 million	Crime of Corruption or Bribery	Fine of CNY 500,000/ Prison sentence of 3 years
2008	<i>Sichuan Chengdu Yang Shiming Case</i> ²⁰⁶	CNY 240 million	Crime of Financial Fraud	Fine of CNY 5.1 million/ Prison sentence of 9 years
2008	<i>Jiangsu Wuxi</i>	CNY 1.52	Crime of	Fine of CNY

²⁰² 李强 [Li Qiang] 《反洗钱法》实施后全国首例洗钱罪案宣判 [The First Criminalized Money-Laundering Crime in China after the Enactment of Chinese AML Law] (23 October 2007) <<http://law-star.com/cacnew/200710/55008253.htm>>. This case is the first criminalised case of money laundering crime in Shanghai.

²⁰³ 法治江苏 [Rule of Law in Jiangsu] 全国最大走私医疗器械案在镇江宣判 [The Biggest Scale of Smuggling Medical Equipments Case is Criminalised in Jiangsu] (13 December 2007) <http://www.jiangsu.gov.cn/fzjs/fzdt/200712/t20071213_186712.htm>.

²⁰⁴ 史广林 [Shi Guanglin] 《云南通报首例涉毒洗钱案件》 [The First Drug-Related Money Laundering Crime is Universally Announced within Yunnan] (26 June 2008) <<http://www.yn.chinanews.com.cn/html/shehui/20080626/61967.html>>. This case is the first money laundering case criminalised in Yunan where the predicate crime is drug-related crime. It is worth mentioning that criminals have transferred, concealed, and converted most of the criminal proceeds under fake names, which makes confiscation hard to implement, and thus, no verdict for financial fine is made.

²⁰⁵ 苏曼丽 [Su Manli] ‘新中国首例腐败洗钱案宣判’ [China’s First Corruption-Related Money Laundering Crime is Criminalised], 新京报 *The Beijing News* (online), 2 August 2008 <<http://news.cnfol.com/080802/101,1277,4530864,00.shtml>>. This case is the first criminalised ML case in China where the predicate crime is the crime of corruption or bribery.

²⁰⁶ 谷萍 [Gu Ping] 全国最大洗钱案一审案值达到 2.4 亿 [First Trial of the Most Serious Money-Laundering Case Identifies Case —Crime Proceeds Involved Reach CNY 240 Million] (27 August 2008) <<http://news.xhby.net/system/2008/08/27/010326683.shtml>>. The financial fine in this case is the heaviest financial penalty for money laundering crime in China so far.

	<i>Duan Yinfang Case</i> ²⁰⁷	million	Smuggling	150,000/ Prison sentence of 1 year
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3.2.3.2 Ineffective Confiscation System for Money Laundering Crime

One reason for financial institutions' passive attitude towards AML cooperation is that there is no incentive to prosecute. The immediate need is to overcome this lack of incentive. It is essential that the importance of tracing and confiscating proceeds of crime is recognised as a major deterrent and to develop mechanisms so that confiscated criminal assets can be used as AML funding. From the above examples of criminal cases, it is obvious that in China, the forfeiture and confiscation system for ML crime lacks deterrent force. Compared to the amounts of money involved in particular crimes, the amount involved in terms of fines imposed upon convicted offenders is extremely small. The ineffective penalties imposed by the criminal justice system also affect the effectiveness of AML administrative prevention.

Confiscation for ML crimes is formulated in Article 191 of the *Chinese Criminal Law*.

[T]he incomes obtained from the commission of the aforementioned crimes as well as the proceeds generated therefrom shall be confiscated, and the offender shall be sentenced to a fixed term of imprisonment of not more than five years or detention, and/or a fine of from 5% up to 20% of the amount of laundered money shall be imposed. If the circumstances are serious, [the offender] shall be sentenced to a fixed term of imprisonment of not less than five years but not more than ten years, and a fine of from 5% up to 20% of the amount of laundered money shall be imposed...²⁰⁸

Shortcomings in the current confiscation system include the prescriptive ambiguity of relevant provisions, as well as practical difficulties in relation to burden of proof, and obstacles that exist in relation to international cooperation. These weaknesses restrict the preventive role and result in penalties imposed in the forfeiture and confiscation

²⁰⁷ 任晓 [Ren Xiao] '天网行动'第六例洗钱案宣判 [The Sixth Money Laundering Case of 'Heaven Net Actions' is Criminalised], 中国证券报 *China Securities Journal* 15 October 2008.

²⁰⁸ 《中华人民共和国刑法修正案（六）》 [Criminal Law of the People's Republic of China (VI)].

system being difficult to collect.

Compared to international standards concerning criminal confiscation of criminal proceeds involved in ML, the scope of confiscation in China's judicial system is relatively narrow. In reality, it is difficult to carry out criminal confiscation when illicit proceeds involved in the case have been concealed, transferred, or intermingled with property acquired from legitimate sources, or have even vanished. Article 5 of the *UN Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances* (1988) defines the main objects of criminal confiscation, and the *UN Convention against Organized Crime* (2000) and the *UN Convention against Corruption* (2005) also adopted the same definition:

- a) If proceeds have been transformed or converted into other property, such property shall be liable to the measures referred to in this article, instead of the proceeds.
- b) If proceeds have been intermingled with property acquired from legitimate sources, such property shall, without prejudice to any powers relating to seizure or freezing, be liable to confiscation up to the assessed value of the intermingled proceeds.
- c) Income or other benefits derived from:
 - i) Proceeds;
 - ii) Property into which proceeds have been transformed or converted;
 - iii) Property with which proceeds have been intermingled shall also be liable to the measures referred to this article, in the same manner and to the same extent as proceeds.²⁰⁹

The above-listed manifestations of ML are the objects of criminal confiscation; however, none of them is stated in specific provisions of China's confiscation system. Thus, transferred proceeds and intermingled financial assets will easily slip through the net. This reduces the criminal power to suppress ML crimes and hinders the judicial practice of criminal confiscation. Confiscation of criminal proceeds only

²⁰⁹ See, United Nations Office on Drugs and Crime (UNODC), *UN Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances*, 20 December 1988, 1582 UNTS 164 (entered into force 11 November 1990) Article 5; United Nations Office on Drugs and Crime (UNODC), *UN Convention against Organized Crime* (2000) A/RES/55/25, Article 12; and United Nations Office on Drugs and Crime (UNODC), *UN Convention against Corruption* (2005) Article 31.

relates to criminal proceedings, that is, confiscation can only be implemented after criminal trials. As the burden of proof requires that evidence is clear and proven, criminal proceeds cannot be confiscated if the burden of proof fails to meet evidentiary standards. In addition, when criminal suspect is tried in absentia, such as when a fugitive or missing person, the court cannot make a forfeiture verdict, and, therefore, corresponding related international judicial cooperation in regard to the confiscation of the criminal proceeds cannot then be undertaken.

In addition, China's legislation requires that confiscated property and other financial fines should be forwarded to the treasury, and cannot be misused or used for personal purposes. *The UN Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances* (1988) states that the value of proceeds or property confiscated, or funds derived from the sale of such proceeds or property, or a substantial part thereof, may be 1) apportioned to intergovernmental bodies specializing in the fight against illicit traffic in and abuse of narcotic drugs and psychotropic substance; and 2) shared with other parties, on a regular or 'case by case' basis, in accordance with domestic law, administrative procedures or bilateral or multilateral agreements entered into for this purpose.²¹⁰ Indeed, the long-term fight against ML activities needs ongoing financial support. If the confiscated assets can be specifically used in combating ML, or shared with other AML-related departments, then national AML work will be positively promoted.

3.2.4 Goals of China's AML Practice

Corruption has severely interfered with the effective operation of AML mechanisms. It is recognised that there is a positive correlation between the ineffectiveness of AML activities and the seriousness and extent of corruption in a country. As the specific international organisation with the highest authority that is tasked with corruption

²¹⁰ United Nations Office on Drugs and Crime (UNODC), *UN Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances*, 20 December 1988, 1582 UNTS 164 (entered into force 11 November 1990) Article 5.

control, Transparency International (TI) publishes the Corruption Perceptions Index (CPI) each year.²¹¹ China's CPI Score appears to have fallen only very slightly over time — its 2009 Score was 3.6 and ranked 79th globally, its 2010 Score was 3.5 and ranked 78th, and its 2011 Score was 3.6 and ranked 75th in 2011 computed to 3.2 and 78th in 2001 — which, despite the inherent statistical problems associated with the changing source materials used to compose the score and ranking, indicates that corruption remains a very serious problem in China.

Measures to prevent corruption are a priority of the Communist Party of China and the Chinese government. Ouyang Weimin, the former director of the Chinese FIU, pointed out that the primary task in the prevention of ML is to fight corruption.²¹² However, with regards to the limited ML cases prosecuted so far, only one related to a crime involving corruption. Furthermore, no information was provided by government or main-stream media regarding the contributions of the Chinese AML monitoring system in uncovering, tracing, and assisting in the prosecution of any corruption cases. Obviously, the Chinese AML monitoring system has deviated from its designated primary goal.

One reason for this is that the understanding of anti-corruption is too narrow in China and most people only regard corruption as corrupt decisions or bribery of government officials, ignoring the fact that numerous managers of SOEs embezzled state-owned assets in the process of the privatisation reform of these enterprises. In October 2000,

²¹¹ The Corruption Perception Index (CPI) reflects the observations and analysis on global corruption levels from the perspectives of the business person, academics, and risk analysers all over the world. It consists of the following sources: the Gallup Organisation, Political and Economic Risk Consultancy, and World Economic Forum, and so on. The CPI ranks countries on a scale from 0 (perceived to be highly corrupt) to 10 (perceived to have low levels of corruption). In particular, 8.0–10.0 represents relatively integrity; 5.0–8.0 represents low-grade corruption; 2.5–5.0 represents relatively high-grade corruption; and 0–2.5 represents extreme corruption.

See Transparency International, *Corruption Perceptions Index*, (2005, 2009, 2010 and 2011) <http://www.transparency.org/policy_research/surveys_indices/cpi>.

²¹² 詹昭, 柳军, 柳杰 [Zhan Zhao, Liu Jun and Liu Jie], above n 104, 27.

a Conference on Combating Money Laundering and Financial Crime was held at Vancouver. At this conference, there was a trend to broaden the definition of sources of illicit funds for laundering, and extend the traditional ML concept from ‘laundering black into white’ to now include ‘laundering white to black’, encompassing:

- a) Using legitimate funds for illicit purposes, for example. laundering legitimate bank loans for smuggling;
- b) Laundering legitimate funds to another kind of fund which appears to be lawful, for example, embezzling and transferring state owned capital to a personal account or under a person’s name. Under this category, the process of laundering is a criminal offence; and
- c) Moving legitimate funds out of one jurisdiction to evade regulation, for example, foreign-owned companies may transfer their legal profit out of China.²¹³

Attention was paid to the widened definition of corruption 10 years ago; however, there has not been any associated amendments made to current Chinese legislation or included in AML regulatory arrangements so far. For many years, what was originally state-owned capital has been deliberately abused, embezzled, transferred, and laundered by business managers and nominated controllers of SOEs. This is an even more serious problem than corruption or bribery of government officials. Judicial actions should be urgently taken to recover state owned capital; otherwise, the incidence of corruption may even increase.

In addition, according to the available PBC’s annual AML reports so far from 2005 to 2009,²¹⁴ the most successful result of AML in these years is the destruction of a large

²¹³ 严立新, 张震 [Yan Lixin and Zhang Zhen], above n 71, 6.

²¹⁴ See, 中国人民银行 [People’s Bank of China], 《2005 年中国反洗钱报告》 [*Anti-Money Laundering Annual Report* (2005)], 24 August 2006; 中国人民银行 [People’s Bank of China], 《2006 年中国反洗钱报告》 [*Anti-Money Laundering Annual Report* (2006)], 5 November 2007; 中国人民银行 [People’s Bank of China], 《2007 年中国反洗钱报告》 [*Anti-Money Laundering Annual Report* (2007)], 4 September 2008; 中国人民银行 [People’s Bank of China], 《2008 年中国反洗钱报告》 [*Anti-Money Laundering Annual Report* (2008)], September 2009; 中国人民银行 [People’s Bank of

number of underground banks. Since the enactment of *Chinese Anti-Money Laundering Provisions* (2003), the main targets were underground banks in the coastal regions of the Southeast China. Chinese critics claimed that the PBC was intensely interested in using AML legislation to assist state owned commercial banks retain their monopolistic positions in the financial markets.²¹⁵

Under the environment of financial monopoly in China, the operation and prosperity of underground banking actually meets the legitimate demands of large numbers of enterprises and individuals. The existence of underground banks, to a degree, is beneficial to economic development and residents' livelihoods. Current financial control measures served the aim of maintaining the monopoly of a few enterprises, but the financial control *per se* makes formal markets ineffective, and creates a huge additional market as the demand for social-economic development grows. Some scholars even suggest that underground banks in China's southeast coast areas should be legalised.²¹⁶

3.3 Deficient AML Information System and Lack of Supportive Informal AML Environment in China

The most popular sources for obtaining knowledge about ML for most Chinese people are gangster movies or TV series made in Hong Kong or Chinese Taipei. The whole society has not formed basic concepts and an overall opinion of AML, and the meaning and importance of AML operations have not been fully understood by the general public. Financial institutions implement their AML obligations in daily practice, while customers often complain about the tedious due diligence process and do not recognise the examination process is a core element of AML compliance. As there is no systematic and practical system of AML propaganda or publicity provided

China], 《2009 年中国反洗钱报告》 [*Anti-Money Laundering Annual Report* (2009)], June 2010.

²¹⁵ 秋风 [Qiu Feng], '地下钱庄与金融秩序' [Underground Banks and Financial Order], 中国经营报 *China Business Journal* (Beijing), 18 August 2007.

²¹⁶ 许小年 [Xu Xiaonian], 《在 2008 浙商大会上的演进》 [Speech at the 2008 Zhejiang Business Conference] (2008) 6 浙商 *Zhejiang Business*.

to the whole society to help the public to realise the seriousness of ML and to correct their understandings of AML activities and their importance to the community in general.

In addition, in order to survive in a high-risk industry, asymmetric information between financial service providers and the ordinary customers is a common problem. Due to the lack of correct information disclosure by financial institutions, it is difficult for members of the public to distinguish between a ‘good bank’ and a ‘bad bank’. A possible solution is that financial institutions could disclose relevant financial statements to the public by using credit ratings to enable customers to distinguish ‘banks in stable condition’ and ‘banks with risks’, thus helping guide capital and funds to flow in a more secure and appropriate direction.²¹⁷

In fact, these are manifestations of a lagging AML information system and a corresponding lack of a supportive public environment (or ‘informal AML environment’ or ‘system’) in China. Without a supportive informal environment, the basic conditions for effectively implementing formal AML system cannot be met, and the function of formal AML systems will be adversely affected as well. In particular, for a financial institution, the reputational risk of being involving in ML activities cannot be recognised if the public has no awareness of whether the institution’s involvement in ML activities is a positive or a negative thing. In such circumstances, if no financial institution would be hurt by the reputational risk associated with ML involvement, a financial institution’s motivation for combating ML will be suppressed.

Indeed, the view of New Institutional Economics (NIE) is that formal system can only play its role when social recognition is formed or when formal system is compatible with informal system. That is, without coordination with and support from the

²¹⁷ 郭纹廷 [Guo Wentin], above n 156.

informal institutional system, the formal system actually loses a sound base to fulfil its functions.²¹⁸ It reflects the unsatisfactory relationship that exists in reality between the current Chinese AML system implementation and its social environment.

3.4 Chinese Traditional Culture and AML Effectiveness

Normally, traditional culture comprises the most significant element of the social environment of a formal system. With a history stretching back thousands of years, traditional thought continues to affect the minds of the Chinese people and their daily lives. In order to foster an informal AML system in China, an AML culture should be developed that gradually supersedes the values of traditional culture, and provides a better social environment in which to implement the formal AML system. Moreover, the effectiveness of a formal AML regulation system may be able to be influenced by traditional thought and values, such as the ‘Three Cardinal Guides’, the ‘Doctrine of the Mean’, and ‘Face’ Culture.

3.4.1 The ‘Three Cardinal Guides’ and AML effectiveness

The Three Cardinal Guides refers to the idea that ‘ruler guides subject, father guides son, and husband guides wife’. It illustrates a traditional hierarchy of power. However, this is prone to negate the effectiveness of AML management of financial institutions. Firstly, guided by this theory, AML management goals may be directed by political aims rather than by considerations of effective implementation; and the operating activities, internal structure and management methodologies may become more and more administration-oriented. Secondly, again guided by this theory, autocracy may assume huge power within AML management, and few democratic opinions will be heard. Particular manifestations include the dominance of individual decisions made by the leaders in an essentially patriarchal system where, despite many decades of communist imposed gender equality, those in powerful positions (often male) are accorded additional importance as are their decisions. Thirdly, AML management

²¹⁸ 熊海帆 [Xiong Haifan], above n 86.

decisions may be made more in the light of interpersonal relationships than legal systems, reflecting the enduring importance of kinship and similar ties. That is, with regards to corporate management systems, an irrational ethical ideology may become the driving force, with loyalties to ‘group’ rather than adherence to legal requirements predominating, and in the meantime, corporate governance rules may lose their focus.

The Three Cardinal Guides clearly represent a command hierarchy, and it is a core idea in Confucianism. Xunzi (Xun Zi) (313–238 BCE), for example, stated that the ruler and the leaders in society have greater responsibility than other members of society for the education of the people.²¹⁹ Confucian thinkers believe that the ideal society was built upon the exemplary and paradigmatic commitment of the government to the people.²²⁰ It provides a profound grounding for why most organisations, institutions and companies at all levels in China prefer to use a rule-based system in their business management and compliance activities. The deep-rooted ‘command and follow’ model stems from thousands of years of cultural practice. This presents a significant challenge for Chinese regulators in terms of the education and cultivation of AML practitioners to adapt to a new, innovative and independent behaviour model, which would fully stimulate each practitioner to exert their individual potential in AML activities. Transforming the AML rule-based approach to an RBA requires the formation of greater pro-active attitudes amongst all participants. If it took 100 years to fully change the behaviour and thinking style of Hong Kong residents in an environment completely dominated by Western governance and education, it can only be imagined how hard it will be to bring about changes that will bolster advanced AML performance in mainland China.

3.4.2 The ‘Doctrine of the Mean’ and AML effectiveness

Stemming from Confucianism, the Doctrine of the Mean claims that individual virtue is increased by maintaining a neutral attitude towards everything. In regard to AML

²¹⁹ Karyn L Lai, *An Introduction to Chinese Philosophy* (Cambridge University Press, 2008) 44.

²²⁰ Ibid 47.

compliance within financial institutions, this same thought may generate a corporate culture that moves towards a neutral point between the aims of compliance and profit-seeking. This may result in minimal requirements being enforced, and no additional contributions being encouraged. Financial institutions influenced by such a philosophy prefer to act under a set of regulations rather than design innovative measures of their own.

An advanced AML model requires financial institutions to develop their own standard operating procedures on the basis of risk-ranking, risk-analysis, and risk-management. As an active response, in December 2009 the Chinese AML authorities published the national AML strategic development guidelines.²²¹ The national AML strategy of a country is based on political guidance with the highest authority being the government, and deals with AML arrangements, implementation, and operations. According to the guidelines, by 2012 pertinent AML actions will be conducted on the basis of a risk-rating system, and a risk-based AML approach will be in operation in China. However, how long it will take Chinese regulators to establish a balancing point between governmental command and individual innovation and in which way AML will evolve are unknown.

The latest AML theory (post 2007) suggests that countries like China should apply a RBA to combating ML, whereas Chinese traditional thought, to a degree, encourages dictatorial implementation. For instance, according to the view of Mozi (Mo Tzu) (468-376 BCE), the common people are not expected to engage in or contribute to decisions about standards. Mozi also outlined an elaborate system to maintain uniformity: the common people are responsible for the everyday maintenance of these standards; they are required to inform the appropriate higher-level authority about exemplary instances of standards, or breaches of it. Accordingly there would be rewards given or punishments meted out in order to encourage adherence to the

²²¹ 中国人民银行 [People's Bank of China], 《中国 2008–2012 年反洗钱战略》 [*China's Anti-Money Laundering Strategic Development Guidelines* (2008–2012)], December 2009.

standard.²²²

If interpreting ‘the common people’ as ‘regulated entities’ and ‘the appropriate higher-level authority’ as ‘the AML competent authorities’, it can be seen that the Chinese AML system before 2007 corresponds organisationally to Mozi’s theory, except for the lack of rewards for exemplary AML compliance by the regulated entities. Thus, a direct and complete transformation from a rule-based system to risk-based system in a relatively short time, for example from 2008 to 2012, is nearly impossible. A more practicable choice would involve the development of a ‘rule-based but risk-oriented’ AML approach that would take cultural factors in China into consideration.

3.4.3 Chinese ‘Face’ Culture and AML Effectiveness

‘Face’ is something that can be lost, maintained or enhanced. ‘Face’ represents ‘prestige, dignity, honour, respect and status of an individual or community.’²²³ From feudal times till the present day, loss of face is the most humiliating thing for most Chinese people. No matter what class a person belongs to, they particularly care about protecting and increasing face.

Face culture does not only apply to individuals, but to entire organisations or groups. Indeed, another important cultural reality is ‘we’ always comes before ‘I’ in China. The interests of the nation, company or family as a group always come before those of an individual. In China, it is common for supervisors and others to make decisions that affect others, without consulting them, because they believe they are acting in the best interests of the group.

²²² Lai, above n 219, 64.

²²³ Michael Carr, ‘Chinese "Face" in Japanese and English (Part 2)’ (1993) 85 *Review of Liberal Arts* 69, 90.

Under the influence of face culture, any discoveries of internal misconduct concerning AML compliance or wrongdoings by managers of financial institutions (especially institutions at the local level) may be concealed and covered up in their reports as this is not only believed to be in the best interests of the entity and an action that reflects loyalty to the group and the goals of the hierarchy but also involves ‘saving face’ for the organisation. The significant financial impacts that arise from these problems may be ignored as the loss of face is seen as more important to the financial institutions. In this case, compliance deficiencies at local level are not reported and resolved in a timely manner, unless supervision from higher levels is really effective.

3.5 Comment and Conclusion

AML effectiveness in Chinese financial institutions is interrelated with a number of economic, political, legal, and cultural factors, such as the economic environment. Inherent problems arise from the nature of the transition country, the development level of its informal AML system, and enduring aspects of traditional culture.

Amongst all of these factors, the still developing economic environment may present the most significant impact on effective AML implementation. The further evolution of a balanced economic environment will substantially enhance the effectiveness of AML policy and actions. While the deep-rooted problems that exist in the current financial system remain, AML effectiveness will be sub-optimal. The main problems include:

- (1) The lagging behind of reform of financial system, and the existence of unpredictable factors in financial operations. The vulnerability and instability of financial systems has become increasingly obvious.
 - (2) The presence of inadequate regulatory experience of financial authorities, and less evolved regulatory methods and techniques.
 - (3) The slow progress of reform of state-owned commercial banks, and a lack of formation of self-restraint by business activities, which increases business risk.
- Improper protection provided by government to the financial industry, is

actually a type of discrimination against other industries, and is unfair and inconsistent with market principles.

- (4) Uncontrolled operations in financial markets, especially in capital markets. If problems accumulate in the capital market, it will seriously affect investors' confidence in China's economy.
- (5) Highly inconsistent regional financial development. China is facing economic structural imbalances. Fewer financial supports are provided to weak regions (Western regions) and weak industries (agriculture industry), which directly affects the development of these areas. In particular, the big four state-owned commercial banks removed some branches from the remote areas, reducing access to formal financial institutions in such regions. Indeed, scarce financial resources have become a key hindrance to economic development in these areas.

Apart from having an unsatisfactory domestic economic environment, as a transition country China has similar inherent limitations and practical issues to other transition countries in implementing AML practice. Institutional conflicts among the key AML authorities and the ineffective judicial prosecution of ML crimes also results in the serious diminution of AML effectiveness in Chinese financial institutions. In addition, although China stipulates financial sanctions for ML crimes, when compared to the potential criminal proceeds involved in a crime, the amount of the financial penalty is relatively low and so lacks deterrent power.

Indeed, various factors affect AML effectiveness in various Chinese financial institutions. However, as China has been involved in the second stage of implementing its AML strategic approach (which has a greater focus on implementing an RBA), greater progress will be made in building up a more favourable environment for the formal AML system, which will also benefit informal AML systems. The national AML strategy itself is not a legally binding document, but represents the state's supreme will to fight against ML crime. It plays guiding, declaratory and preventive roles for the entire AML regime. It is significant that China has made AML

such an important policy objective in its national strategy. However, considering practical limitations — such as the imbalanced economic development in different regions in China, and the huge impact of Chinese traditional cultural norms on AML implementation — Chinese AML authorities and regulating entities are facing a huge challenge to successfully inculcate a risk-based AML approach in the Chinese financial sectors. Thus, in order to actually put the national AML strategy into action, not only does the social environment need to be optimised, but also the implementation capacity of each financial institution should be further strengthened.

Chapter 4. THE IMPLEMENTING FACTORS AFFECTING ANTI-MONEY LAUNDERING EFFECTIVENESS IN CHINESE FINANCIAL INSTITUTIONS

The volume of money flowing through financial institutions makes it possible to channel huge amounts of illicit money via such institutions, and the highly internationalised financial system is favoured by money launderers to transfer proceeds from one jurisdiction to another easily and quickly. Traditional bank secrecy laws provide criminals with a relatively safe environment, and these features make financial institutions particularly attractive to money launderers. That is the reason why all preventive AML measures adopted internationally and domestically mainly focus on financial institutions.

Apart from setting up comprehensive AML legislation, another aspect of any AML program is putting legislation into practice in an effective way. However, there are hurdles in the path of AML practice that confront by financial institutions. This chapter focuses on the implementing factors within financial institutions which may impact on AML effectiveness, including the enforceability of AML programs, AML internal control systems, and competing interests concerning AML practice for the regulators and the financial institutions.

4.1 Weak Enforceability of the AML Program in Chinese Financial Institutions

Weak AML enforceability in Chinese financial institutions may be attributable to a number of factors:

- 1) lack of understanding of best practice;
- 2) lack of relevant practical experience;
- 3) lack of internal control;
- 4) lack of sufficient training;
- 5) lack of technical ability; and

6) lack of organisational talent.²²⁴

Because every single step of an AML program is linked, practical enforcement requires a range of responses, from CDD to the reporting of suspicious transactions under a thorough system of internal examination set up by the management of the financial institutions. In this regard, deficiencies in practice should be identified, adjusted, and finally avoided.

4.1.1 International Standard of CDD and Overall Chinese Practice

Customer due diligence (CDD), a western commercial term, refers to a regular investigative procedure in relation to a customer's background which is conducted by financial institutions prior to signing a commercial agreement with a new customer, with the aim of assessing the potential risk that may exist in the proposed business relationship. Translation of this term varies between mainland China, Hong Kong and Chinese Taipei, with current translations including 'customer endeavour', the 'customer check', 'reasonable examination of the customer', and 'customer liable scrutiny'. In short, from the literal explanation, CDD includes two meanings at least: a) due obligation and duty, and b) making diligent efforts to voluntarily obtain sufficient information. Although there are still different expressions for CDD in the business area in China, according to a series of relevant reports published by governmental agencies, CDD is expressed universally as 'customer responsible investigation' (Kehu Jingzhi Diaocha) with regard to AML activities.²²⁵

To prevent ML risk at the front-line, it would be wise for most financial institutions to require all new clients to have their identity checked at the outset, divide customers into different risk-rating categories, and re-examine risk factors under these specific circumstances. International requirements for CDD cover a broad spectrum, and they

²²⁴ International Organization of Securities Commissions (IOSCO), *Investment Management Risk Assessment: Management Culture and Effectiveness*, October 2002.

²²⁵ Tang and Ai, 'International Standards of CDD and Chinese Practice', above n 59, 407

have been successfully implemented in many developed countries. However, Chinese CDD practice still has a long way to catch up with international standards.

4.1.1.1 Global Requirements for ‘Know Your Customer’ and CDD

As the very first linkage between financial institutions and customers, CDD has been placed in a primary position in all standard guidelines issued by international organisations in the fields of banking regulation and AML. Recommendations 5 to 9 of the 2003 FATF *Forty Recommendations*, for example, stipulate that financial institutions should conduct CDD in order to prevent ML. In particular, Recommendation 5 suggests financial institutions should not keep anonymous accounts or accounts obviously opened in fictitious names.²²⁶ When carrying out transactions, financial institutions should undertake measures for CDD, including identifying and verifying the identity of customers. The Sixth Recommendation proposes financial institutions perform not only normal due diligence measures on PEPs, but also some special regulation and monitoring of the source of funds and the business relationships of these people.²²⁷ Recommendation 7 states that financial institutions should, in addition to performing normal due diligence, put in place appropriate measures in relation to cross-border correspondent banking and similar business activity, and also undertake additional controlling measures in relation to them.²²⁸ The Eighth Recommendation pays special attention to ML threats arise from new or developing technologies which may be used to obscure customer identity.²²⁹ Recommendation 9 stipulates that countries may permit financial institutions to rely upon intermediaries or other parties to perform CDD measures or introductory services under certain conditions.²³⁰

According to FATF, what merits attention is the need to both identify and determine the structure of an entity. The FATF *Forty Recommendations* and its interpretative

²²⁶ FATF, *Forty Recommendations*, above n 7, 2.

²²⁷ Ibid 3.

²²⁸ Ibid 4.

²²⁹ Ibid.

²³⁰ Ibid.

notes emphasise the need to confirm the identification of the customer, the beneficial owner²³¹ and the trustee and verify identification documents, authorisation, the actual beneficiaries and the control structure of the entity.

The FATF document also requires financial institutions to perform EDD on higher risk categories of customers, while they may conduct simplified procedures for lower risk customers. In the FATF methodology manual, non-resident customers, PEPs, private banking and legal persons or arrangements that are personal asset holding vehicles, such as trusts, are recognised as having higher risk. On the other hand, examples of customers where the risk may be lower could include financial institutions under rigorous regulation, public companies, life insurance policies, and insurance policies for pension schemes. Where the financial institution fails to satisfactorily complete CDD measures, FATF requests it ‘to terminate the business relationship and to consider making a suspicious transaction report’²³²

With regard to CDD, the most comprehensive definition appears in the *Customer Due Diligence for Banks* issued by BCBS in January 2001.²³³ This 21 page document outlines the requirement of KYC, and makes the implementation of adequate due diligence on new and existing customers as the key part of banking control policies. The BCBS holds that KYC is not only significant to AML, but also has more prudential meaning for banking regulation. The inadequacy or absence of KYC standards can give rise to serious risks, including to those to reputation, as well as operational, legal and concentration risks, any one of which can result in significant financial losses to banks.

²³¹ Andrew Haynes, ‘Money Laundering: From Failure to Absurdity’ (2008) 11(4) *Journal of Money Laundering Control* 303, 313. ‘Beneficial owner’ means any individual who in respect to anybody other than a company whose securities are listed on a regulated market, ultimately owns or controls (whether through direct or indirect ownership or control, including through bearer share holdings) more than 25 per cent of the shares or voting rights in the body.

²³² FATF, *Forty Recommendations*, above n 7, 20.

²³³ Basel Committee on Banking Supervision (BCBS), *Customer Due Diligence for Banks*, October 2001.

According to the Basel Committee's *Customer Due Diligence for Banks*, banks should implement effective practices and procedures for KYC, which are essential elements of managing risks. Such essential elements should start with the banks internal control and risk management procedures, including: a) a customer acceptance policy; b) customer identification; c) on-going monitoring of high risk accounts; and d) risk management.²³⁴ More specifically, the BCBS requires banks to adopt clear acceptance policies on high-risk customers, and to enforce stricter due diligence measures on them. In regard to new customer identification, the BCBS recommends that banks obtain verified information regarding customer identity and the purpose of related transactions. The adequacy and essence of customer information depends on which category of customers (individual, enterprise, and so on) applies to the new customer and the anticipated amount of money in the account. There are also special requirements outlined in the document with regard to implementing CDD measures on PEPs and also to deal with non 'face to face' business developed with new technologies such as the electronic banking system. Concerning the on-going monitoring of accounts and transactions, the BCBS states that:

[B]anks can only effectively control and reduce their risk if they have an understanding of normal and reasonable account activity of their customers so that they have a means of identifying transactions which fall outside the regular pattern of an account's activity.²³⁵

The BCBS also states that on-going monitoring mainly targets higher risk accounts. In regard to the aspect of risk management, the BCBS particularly emphasises the roles of internal audit and employee training programs.

The Bank Secrecy Act/Anti-Money Laundering Examination Manual published by the Federal Financial Institutions Examination Council (FFIEC) also emphasises the

²³⁴ Ibid 5.

²³⁵ Ibid 13.

important role of CDD. FFIEC states that:

[T]he objective of CDD should be enable the bank to predict with relative certainty the types of transactions in which a customer is likely to engage, and these processes assist the bank in determining when transactions are potentially suspicious.²³⁶

CDD requires financial institutions firstly identify customers' identity, and then assess the relative risks in relation to customers, including the need to take additional due diligence measures as well as enhanced ongoing monitoring procedures for high-risk customers.

Indeed, CDD is not a single and static step, but one that operates constantly in every procedure of bank business, and one that should be adjusted dynamically according to changes in risk intensity. That is, 'banks should not only establish the identity of their customers, but should also monitor account activity to determine those transactions that do not conform with the normal or expected transactions for that customer or type of account'.²³⁷ Meanwhile, in order to increase efficiency, the intensity of KYC procedure, apart from essential criteria, can be tailored or adjusted according to the risk intensity.

4.1.1.2 Customer Due Diligence Practice in Chinese Financial Institutions

As a key requirement of the measures to prevent ML in the 2003 FATF *Forty Recommendations*, CDD has been strongly emphasised by regulatory departments and financial institutions. In response to international AML standards, many countries (including China) choose to partly enforce these provisions in accordance with their own national conditions. This is especially true of some transition countries. However, as numerous commercial banks in China have gradually moved from SOEs to limited entities, implementing both a shareholding system as well as an internationalisation

²³⁶ Federal Financial Institutions Examination Council (FFIEC), *Bank Secrecy Act/Anti-Money Laundering Examination Manual* (2008) 59.

²³⁷ Ibid 5.

strategy, it is necessary to fully implement relevant international standards relating to CDD practice.

Since 2003, China has launched a number of AML strategies for financial institutions. In particular, since China enacted its *Anti-Money Laundering Law* and became a FATF member in 2007, the requirements for CDD and KYC in Chinese financial institutions have been updated constantly. From the perspective of legislation, China has established legislative provisions and regulations which generally achieve international standards. However, on a practical operational and technological level, it still has a lot of work to do.

FATF conducted its first official evaluation of the Chinese AML system in 2006, and published its mutual evaluation report in 2007. In this report, FATF assessed Chinese AML measures and CDD practice concerning Recommendations 5 to 8 of the 2003 FATF *Forty Recommendations*.²³⁸ The detailed comments are as follows:

Table 4.1: FATF's Comments on Chinese CDD Practice

	Rating	Summary of Factors Underlying the Rating
R.5	PC	<ul style="list-style-type: none"> *No legal obligation to identify and verify the beneficial owner; *Only the banking sector is subject to specific requirements relating to the identification of legal persons; *No specific and comprehensive legal requirement to conduct ongoing due diligence (for example, financial institutions are not obligated to develop a risk profile of the customer or determine the source of his/her funds); *No enhanced due diligence (EDD) requirements or guidelines for high risk categories of customers; *No requirement to consider filing an STR when CDD requirements cannot be complied with; *The first generation ID cards are prone to forgery and the duplication of numbers is a serious problem; *There is no explicit requirement to determine whether the customer is acting on behalf of another person; *There are no rules or a threshold for handling occasional

²³⁸ Financial Action Task Force on Money Laundering (FATF), *First Mutual Evaluation Report*, above n 53, 81-82.

		transactions;
R.6	NC	No AML requirements in relation to foreign PEPs
R.7	PC	*There is no requirement for banks' respondent institutions with regard to AML; *There is no requirement to document the respective AML responsibilities within correspondent relationships;
R.8	LC	There are no requirements related to non 'face to face' business in the insurance sector, even though some online insurance business does exist.

PC = Partially Compliant; NC = Non-Compliant; LC = Largely Compliant

In response to these comments, the PBC, together with the CBRC, the CSRC, and the CIRC, published *Administrative Measures on Customer Identity Identification and Materials and Transaction Recording of Financial Institutions* (referred to as the 'Administrative Measures on Customer Identification' hereafter) in June 2007, and established relative legislative rules in accord with requirements made by FATF.

In particular, Article 8 of the *Administrative Measures on Customer Identity Identification* sets up an explicit threshold with regard to occasional transactions as the amount of a single sum of cash deposit or withdrawal reaches CNY 50,000 or more or an equivalent value of USD 10,000 or more in a foreign currency. Articles 7, 11, 15, and 21 require financial institutions to identify the person who is in actual control and the beneficial owner. Article 18 requires financial institutions to establish each customer's risk profile, and to adjust risk profiles on the basis of on-going monitoring. Article 19 and 22 impose requirements about on-going CDD measures and verification of customer's identity. Article 6 specifically regulates CDD rules on cross-border agencies. Article 19 in particular requires foreign PEPs to explain the source of funds and the purpose of transactions.²³⁹ In fact, the administrative measures on customer identification respond to every comment made in the FATF mutual examination report concerning CDD rules. Even compared to the latest international standard on CDD published by international organisations and some of the developed countries outside

²³⁹ 中国人民银行 [People's Bank of China], 《金融机构客户身份资料及交易记录保存管理办法》 [*Administrative Measures on Customer Identity Identification and Materials and Transaction Recording of Financial Institutions*], Notice 2 [2007], 21 June 2007.

of the FATF, this document can be regarded as reaching an advanced level internationally. However, the high level of legislation does not equate to soundness of CDD compliance in financial institutions. Instead, it varies according to conditions existing in different regions and departments in China, and thus full-scale compliance still needs to be strengthened in the longer term.

4.1.2 Areas which Need to be Strengthened in Chinese CDD Practice

4.1.2.1 Account-opening CDD and Customer Information Verification

Generally, there are two different types of CDD: a) CDD at the moment of the acceptance of a relationship; and b) CDD during the lifetime of a relationship with a customer, usually referred to as on-going CDD. At the moment of accepting a customer, CDD must always take place. It depends on the risk of a customer, how intensive the CDD has to be. A financial institution has to be sure that a prospective customer is who he, she or the company claims to be. The second requirement of CDD is to ensure that when a relationship with a customer has been established, transactions can be monitored and the financial institution is convinced that the personal or business activities of the customer are in line with reasonable expectations or assumptions.²⁴⁰

The first possibility for a customer to be examined in relation to qualifying as a client will be during the customer acceptance phase. A customer acceptance program should be implemented in a standardised way; applicable for all kinds of customers and all kind of products and services; based on standards which are understood by all the employees of the institution; and which are easy to report; and easy to audit.²⁴¹ In fact, the phenomenon of ‘opening multiple accounts by the same person’ is prevalent in China, and the proportion of currency transactions is extremely high. At the end of 2003, the annual currency flow in China amounted to 16.9 per cent of GDP that year,

²⁴⁰ De Wit, above n 49, 158.

²⁴¹ Ibid 162.

and was 8 times the proportion in the US.²⁴² For all kinds of reasons, CDD is the critical link for Chinese financial institutions to detect suspicious customers and transactions associated with them.

Although the *Administrative Measures on Real-name Identification of Customer Identity* were implemented in 2007, the document used to establish identity should be carefully checked. The identification card of Chinese residents can be largely confirmed; however, identity documents like military identification are still difficult for financial institutions to verify. Once the documents that are useful to prove identity have been obtained and a photocopy of the document concerned has been placed on file, the initial identity checking requirements have been met. However, it should be borne in mind that any criminal seeking to launder money will have no difficulty at all in satisfying these requirements. They will either have fake or real documents in the name they are using. It means that possession of ‘proof’ of identity is not a reason for a financial institution’s to lower its guard when it comes to suspicious activity by a customer.

Checking on new clients is included in the ‘front office’ AML compliance by Chinese financial institutions; however, many front office staff lack adequate academic backgrounds and are not knowledgeable about ML risks. Thus, training for front office staff is a critical element for the entire AML program. To be specific, the identity of new client should be checked in any of the following situations:

- * the creation of a business relationship;
- * the carrying out of an occasional transaction;
- * suspicion of ML or terrorist financing; and
- * upon doubts being raised as to the veracity or adequacy of documents, data or information previously obtained for the purpose of identification or verification.

²⁴² 严立新, 张震 [Yan Lixin and Zhang Zhen], above n 71, 211.

With regard to the new customer identification and re-examination of suspicious customers, in the second half of 2007 China's banking, securities, and insurance sectors conducted initial identification on 448.73 million customers, and 3.43 million problems were identified. Verification of 12.32 million customers was conducted, and 719 customers were confirmed to be involved in ML during the process. This is a very low proportion which may mean that the initial customer identification is effective enough, or it may also mean that the re-examination process is not effective enough. Most suspicious customers examined via verification were in banking institutions (accounting for 74.36 per cent of the total), followed by insurance institutions (21.68 per cent), the securities sector (3.94 per cent), and only 0.02 per cent occurred in non-financial institutions such as trusts and accounting companies.²⁴³

4.1.2.2 Social Environmental Support of Customer's identities

It is interesting that Chinese financial institutions normally have specific details about the capital flow situation regarding the top 30 most frequent transactions, for example, where the capital comes from and where it goes; however, they know little or nothing about the background of the account holders. In this regard, information provided by policing agencies, commercial and business agencies, tax agencies, or the customs department is helpful in mapping the background of the monitored target.

Currently, other circles of society apart from financial sectors in China are still in an adaptive phase with regard to the requirement for CDD investigation, and correspondingly lack a strong willingness to cooperate. As the limitations and inadequacies of obtaining information only from internal departments of financial institutions emerge, it becomes obvious that the verification techniques used in a single sector are not enough to support accurate and adequate CDD requirements. In fact, the channels for collecting information by internal departments of financial

²⁴³ 唐旭, 师永彦, 曹作义 [Tang Xu, Shi Yongyan, and Cao Zuoyi], 《中国反洗钱有效性研究》 [Research of China's Anti-Money Laundering Effectiveness] (2009) 8 金融研究 *Financial Research* 1, 11.

institutions and the investigative techniques in banks are both limited. Combined with the lack of progress in establishing a coherent information database, a similar situation exists in regard to the investigation of accounts of the actual person controlling the account and the also in determining the real beneficiary. Therefore, all-round implementation of CDD measures in China needs to be assisted and developed through the allocation of comprehensive social resources.

4.1.2.3 Customer Identification in Non ‘Face to Face’ Transactions

New payment methods and technological innovation have brought financial service industries into a new era. Increasingly, transactions are conducted via non-traditional channels. Customers do not have to physically contact financial service providers, and can even perform transactions beyond geographic limits. Article 8 of the 2003 FATF *Forty Recommendations* requests financial institutions to ‘pay special attention to any money laundering threats that may arise from new or developing technologies that might favour anonymity’.²⁴⁴ In response to this provision, Article 17 of the *Administrative Measures on Customer Identification* requires Chinese financial institutions to strengthen customer identification in non ‘face to face’ transactions, such as transactions conducted by using telephone, internet and ATM services. In recent years, it has been shown that customers are increasingly prone to transfer funds online, and use EFTPOS machines in arbitrage transaction to evade the withdrawal limit of ATM services. As the only proof of customer identity, the registered information left by customers on the occasion of opening an account is absolutely inconsistent with the accuracy and adequacy of CDD requirements. Unfortunately, a set of feasible methods for determining the real identification of online customers and controlling their online transactions has not yet been determined.

4.1.2.4 Customer Due Diligence for a Third Party

Financial institutions usually undertake the obligation of identifying customers directly; however, the business relationship between customers and financial

²⁴⁴ FATF, *Forty Recommendations*, above n 7, 4.

institutions is sometimes conducted via intermediary institutions or a third party. For instance, customers purchase an insurance policy from an insurance brokerage company, or a securities company introduces a customer to a futures brokerage company, or a financial institution entrusts the business of issuing credit cards to a professional company, or a customer applies for a bank mortgage loan through a lawyer, and so on. In these instances, financial institutions may not be able to check the customer's personal identification, because doing so will create high costs to the financial institutions, and thus, financial institutions may ask an intermediary institution or third-party for assistance in performing CDD measures.

Apart from paying attention to normal customer identification and related information collection, international organisations and developed countries have paid special attention to customer risk rating, identification of the beneficial owner, the 'on behalf', and the actual owner. They have also enhanced CDD measures taken in regard to high-risk customers, and brought into consideration any changes to a customer's risk status. In order to assess the current effectiveness of China's AML policies, the AMLB of the PBC conducted a project based upon around 9,000 questionnaires, with this survey carried out from October to December in 2008. According to the responses provided to these questionnaires, the customer identification system of China's financial institutions is primarily conducted during the account-opening in financial services (when some 81.55 per cent 'of instances of account opening' are subject to CDD). Identification for non 'face to face' businesses is lower, at 58.68 per cent, while risk-rating management is undertaken for just 56.51 per cent of accounts, continuous customer identification measures (59.75 per cent), identification of agent (64.41 per cent), re-examination of customer identification under special circumstances (51.26 per cent), and customer identification via a third party (32.74 per cent).²⁴⁵ The results of the questionnaire clearly show that more attention should be paid to CDD by a third party. Although financial institutional compliance with AML regulation is rated

²⁴⁵ 唐旭, 师永彦, 曹作义 [Tang Xu, Shi Yongyan, and Cao Zuoyi], above n 243, 12.

as ‘largely effective’ in respect of internal control, customer identification, large-value transactions and suspicious transaction reporting, and in regard to the record-keeping of identity (ID) information and transactions, the project results cannot be seen as indicating the compliance level of the entire Chinese financial sectors because only the banking sector of China was included. The AML effectiveness in the Chinese securities and insurance industries is questionable as they presently lack the basic systems for a scientific AML assessment.

4.1.3 Reports Overload and Preventive Reporting

The flow of AML reporting within a Chinese financial institution refers to the financial institution’s networks or branches detecting and determining large-value and suspicious transactions involving ML offences, completing relevant reporting forms on the basis of the information collected regarding customer transaction, submitting prepared reports to the AML office at branch level after basic assessment and examination, and then having staff of AML office at branch level deliver final reports to the central bank after follow up investigation. However, the current situation regarding ML reporting in China is that vast numbers of reports contain little information. The number of STRs and LVTRs do not indicate the quality of the reporting, since in itself, the number of reports is neither an index of success or failure regarding a financial institution’s AML conformity. A rise in the number of reports may serve as an indicator that reflects an increased stringency in the AML regime; however, the quality of reporting varies under different situations. If financial institutions simply aim to protect themselves against government sanctions by filing reports, the increase in numbers may not represent improved diligence.²⁴⁶

To reiterate, a low number of suspicious activity reporting (SAR) can mean either (a) low risk in the industry, perhaps because good preventive action has eliminated many illicit attempts at the source; or (b) an industry ‘in denial’ about the risks that are

²⁴⁶ Reuter and Truman, *Chasing Dirty Money*, above n 16, 106.

generated by their activities. Conversely a high number of SARs can mean that the industry is taking active steps to deal with problems, or that some or all firms are reporting suspicions without much analysis. The latter can be either to ward off potential criticism from regulators and the media for not reporting enough, or because they have insufficient compliance resources to carry out their internal review role properly.²⁴⁷

Ideally, reporting requirements for large-value transactions and suspicious transactions should be performed in a standard way, and the duties of suspicious transaction determination, and analysis and examination within the AML department, should be clearly specified. Financial institutions should have follow up analysis on any suspicious transactions thought to be crime related and undertake associated special reporting. AML reporting should be as accurate as possible and conducted in a timely manner, and over-reporting and false reporting should be avoided as much as possible, resulting in a gradual increase in the quality of AML reporting. However, the reality is quite often far from the ideal scenario.

The number of China's LVTRs and STRs has multiplied within a few years. However, the poor quality of intelligence, together with the excessive quantity of STRs, has affected the monitoring and analysis of suspicious transactions and transfer of suspected criminal information. Since the PBC promoted the STR system in 2003 and established CAMLMAC in 2004, the number of STRs submitted by Chinese commercial institutions has increased explosively year by year from 2004 to 2006, with China becoming the world's largest STRs producer. FATF pointed out that the current STR regime operates with very little input from the reporting institutions to determine if there are underlying indicators of possible malfeasance, resulting in over 5 million STRs just in 2004–2005.²⁴⁸

²⁴⁷ Michael Levi, 'E-Gaming and Money Laundering Risks: A European Overview' (2009) 10 *ERA Forum* 533.

²⁴⁸ FATF, *First Mutual Evaluation Report*, above n 53, 7.

In fact, the number of transaction reports submitted to CAMLMAC in 2005 has exceeded the sum of STRs from the 16 leading AML countries, including the US, UK, Japan, and Switzerland.²⁴⁹ More recently, the *Anti-Money Laundering Annual Report* (2009) published by the PBC stated that in 2009 the total number of submitted STRs from 964 Chinese financial institutions was 4.293 million,²⁵⁰ which equaled the total number of STRs made in the US from 1996 to 2006. However, even with the huge number of STRs, little valuable information is gained. For example, of the over 4 million STRs sent by financial institutions, only 156 reports were passed on to law enforcement agencies, and just 5 cases were prosecuted as ML crime in 2009.²⁵¹ However, the extremely high volume of STRs does not reflect the actual incidence of ML offences in China, and conversely, the small number of cases prosecuted does not show that the number of ML crimes is low. Therefore, the critical problem is the effectiveness of the suspicious reporting system and the information analysis capacity of financial institutions.

In November 2008, 5 financial institutions in Yantai, a Chinese coastal city, reported 17,743 CNY STRs and 767 foreign currency STRs, involving CNY 108.16 billion and USD 1.47 billion respectively. It was determined that of these SARs, 10,814 reports were repeatedly made. It is unacceptable that, in one particular case, the same suspicious transaction had been reported 9 times. If the duplicated reports were not counted, the CNY STRs and foreign currency STRs would be 7392 and 304 respectively, and involve the amounts CNY 25.47 billion and USD 550 million.²⁵² In another words, the scale of the problem was tripled due to duplication of reports. The main cause of this problem is that some indicators have been incorrectly designed in

²⁴⁹ 师永彦 [Shi Yongyan], 《对我国可疑交易报告数量增长过快的分析》 [Analysis on Possible Reasons for Rapid Increase in Suspicious Transactions Reporting] (2007) 19 中国金融 *China Finance* 44, 44–5.

²⁵⁰ 中国人民银行 [People's Bank of China], 《2009 年中国反洗钱报告》 [*Anti-Money Laundering Annual Report* (2009)], June 2010, 23.

²⁵¹ Ibid.

²⁵² 张众 [Zhang Zhong], 《提高反洗钱可疑交易报告质量的思考》 [Thoughts about Improving the Quality of AML Suspicious Transactions Reporting] (2009) 3 金融发展研究 *Journal of Financial Development Research* 85.

AML data analysis system, including definitional terms such as ‘short-term’ and ‘frequent’. The same transaction may be reported automatically in different electronic monitoring periods. The AML workers at the base level depend too highly on computer systems when conducting manual data analysis rather than closely examining the reports following SARs requirements.

Indeed, Chinese financial institutions rely upon the analysis made through information systems, and hardly conduct the necessary manual identification. A better way of reporting would be that in cases where there are only slight grounds for making an STR, then attach a file note to make clear the reasons for concern. It may be that as time goes by a succession of other minor issues may arise and eventually there will be sufficient grounds for making a report. The quality of STR by financial institutions should be scientifically examined. A key point in increasing the SARs quality involves manual report analysis being conducted on the basis of both KYC rules and customer risk grading, with this then being supplemented by electronic analysis.

4.1.4 Automatic Analysis and Manual Examination of Suspicious Transactions

The most important factors in AML procedures are human resources and technical resources. International KYC rules have become increasingly rigorous, and the determination of suspicious transactions requires subjective standards, which result in a heavy workload for AML staff, who often have to deal with excessive numbers of customers, transactions, and associated reports. Due to the amount and complexity of information, suspicious information is hard to detect through staff vigilance. In this regard, AML technical systems can supplement manual work to a degree, and increase the overall efficiency of the system. However, human ability remains the key factor in successful risk control to prevent ML, and this human judgement is irreplaceable in AML work. AML staff determine the direction of research and development, decide on purchases, optimise AML techniques, plan how to apply technical advances to

AML practice, and identify and fix any problems with AML technical deficiency.

Table 4.2: Types of Money Laundering (ML) Control Reporting²⁵³

	ML	Non-ML
Reporting	True positive	False positive
Non-reporting	False negative	True negative

Due to a lack of staff experience and deficiencies in technical assistance, the challenge faced by reporting entities in China currently is their high false positive rate (FPR) resulting in the inefficiencies due to voluminous data sets. In the face of heavy fines for failure to comply with the AML reporting system, financial institutions usually choose to over report rather minimise false negative errors. Besides, with the information asymmetry in relation to ML, it is difficult to detect and report cases of ML. This asymmetry or incomplete information includes such features as the nature of the customer, the financial institutions' diligence in performing AML compliance, and environmental factors independent of the customer or financial institutions, produced by financial institutions, supervisory authorities and customers.²⁵⁴

From the technical perspective, challenges concerning AML reporting therefore include the difficulty of distinguishing between 'true positive' or 'false positive' reports, and how can reporting authorities distinguish between 'true positive' and current non reported 'true negative' reports? Developed countries, which have had AML programs running for over 20 years, are gradually evolving from ML prevention based on the factors in CDD to the application of artificial intelligence (AI) technology. Indeed, some AI, data-mining techniques, and neural networking have been used to raise the quality and accuracy of ML control reporting, especially in developed countries. However, in China, even the traditional CDD has not been completely and actively complied with by financial practitioners, let alone any implementation of the high-tech AI explorations.

²⁵³ Zengan Gao, and Mao Ye, 'A Framework for Data Mining-Based Anti-Money Laundering Research' (2007) 10(2) *Journal of Money Laundering Control* 170, 175.

²⁵⁴ Masciandaro and Filotto, above n 29, 135.

To reduce the FPR, reporting entities should employ adequate techniques, including statistical analysis, neural networks, decision trees, fuzzy logic, and genetic algorithms, and create internal talent pools containing multi-disciplinary staff who specialise in informatics and computer science, thus improving not only the quantity of reporting but also the quality.²⁵⁵ Research shows that data-mining can help AML analysis by reducing data preparation time, and determine detection priorities, improve FPR, and lessen the pressure on personnel, training, and budgets.²⁵⁶ As data-mining in the context of AML is still a young and challenging field, both the FIU and financial institutions need to further enhance the technical capacity to use these new techniques (such as rule-based reasoning, blackboard, and many other aspects of AI technology) to separate genuine suspect transactions regarding ML offences from irrelevant information, strengthen the training in AI models, and build a strong financial database supported by all AML-related institutions without legal or competitive hurdles.

However, in AML practice, decision-making cannot depend fully on automatic analysis. For example, the 18 indicators of suspicious transactions in the banking sector listed by the PBC are quantified as (at most) 8 or 9 indicators in the automatic process, meaning there has to be ‘manual’ analysis. It is said that the automatic system, via ‘blacklist’ database filters, targets around 10,000 transactions everyday, of which 99 per cent are determined as ‘false hits’ with manual analysis.²⁵⁷

Employees must be trained so that they are capable of spotting transactions that are suspicious and that they know the relevant laws. ML report officers (MLRO), who

²⁵⁵ Gao and Ye, above n 253, 174.

²⁵⁶ Ibid 170.

²⁵⁷ 耿伟 [Geng Wei], 《反洗钱工作中人员与技术的互动》 [The Interaction of AML Staff and AML Techniques], Chinese Anti-Money Laundering Annual Forum, 26 November 2010. This is from presentation at the Chinese Anti-Money Laundering Annual Forum hosted by the China Centre for Anti-Money Laundering Studies (Fudan University) in Shanghai on 26 November 2010. Geng Wei is the chief compliance officer at the head office of Bank of China.

represent the knowledge available for manual analysis in financial institutions, should understand the following factors affect quality of analysis.²⁵⁸

- 1) What is the task;
- 2) Employees engaged in analysis have to manage themselves;
- 3) Continuing innovation has to be part of the work;
- 4) Continuous learning and training must be undertaken; and
- 5) Productivity is not — at least not primarily — a matter of the quantity of output, but quality is the essence of the output.

Working on AML reporting therefore begins with the MLROs asking themselves: ‘What is my task?’, ‘What should it be?’, ‘What should I be expected contribute?’, and ‘What hampers me in doing my task?’. Asking these questions and taking action as a result of the answers usually doubles or triples the work productivity and effectiveness. Sometimes, the main trouble is defining what the task is and how it should be done.

Although human resources and technical resources are equally important to financial institutions, Chinese financial institutions do not currently invest generously in either of these areas. Compared to annual spending of hundreds of millions CNY in AML technical research and development (R&D) in foreign-owned financial institutions, Chinese financial institutions have demonstrated an unwillingness to purchase often expensive software from external resources, or to conduct AML research and development internally. In addition, AML related human resources receive less funding than other business areas in Chinese financial institutions as well. There is no standard criterion for AML staffing levels provided by AML authorities, and how many staff employed for AML work is totally up to the financial institution. Currently, the best practice model is that of the Industrial and Commercial Bank of China (ICBC) with two to four AML staff per branch. Other big banks, such as the Bank of China

²⁵⁸ Peter F Drucker, ‘Knowledge-Worker Productivity: The Biggest Challenge’ (Winter 1999) 41(2) *California Management Review* 79, 84.

(BOC), usually only allocate one to two AML staff per branch.²⁵⁹ Lack of sufficient input both in technical resources and human resources means that the quality and effectiveness of AML reporting will be definitely impeded. This problem will be even worse for the grass-roots financial institutions in the less-developed areas in China.

4.2 Inadequate Internal Control in Chinese Financial Institutions

A institution's 'internal control system' refers to the dynamic processes and mechanisms established by financial institutions to meet operational and management goals, while efficiently avoiding and controlling risk via a series of rules, procedures and measures. These would involve the conduct of pre-transaction measures, current transaction controls, and post transaction supervision regarding market risks, legislative risks, and operational risks. The financial institutions' internal controls in relation to AML consist of the policies, procedures, and processes designed to limit risks and to achieve compliance with the AML program.

Generally, there are three aspects that should be considered when designing an AML internal control system. First, financial institutions should integrate AML requirements into their daily operational processes and management systems, making AML work a central part of risk management systems in the financial institution. This will allow AML work to be considered as the systematic base for lowering the risk of becoming involved with ML activities and be instrumental in maintaining the financial institution's reputation. Second, the design of the AML internal control system should ensure that the institution can effectively detect, determine, and report suspicious transactions through KYC rules and other basic AML measures, and as a result assist AML authorities and law enforcement agencies in combating ML crimes. Finally, the AML internal control systems should be in line with the financial institution's scale of operations, business scope, and risk features, becoming a solid base for dealing with any unpredictable or sudden incidences that may occur in the

²⁵⁹ 耿伟 [Geng Wei], above n 257.

institution. Indeed, a comprehensive internal control system should have strengths regarding the following aspects: the presence of an AML professional team, internal staff screening, compliance outcome monitoring, and an AML corporate culture.

4.2.1 Weak AML Professional Teams in Chinese Financial Institutions

Through cooperation between the financial regulation departments and financial institutions, Chinese commercial banks have established AML internal systems encompassing KYC rules, transaction reporting system, and record keeping systems. Development of AML activities has become a serious concern of large-scale commercial banks in China. The BOC, for example, launched its AML strategies earlier than other Chinese banks. The *Anti-Money Laundering Manual of Bank of China* was published in 1998, and this focuses on KYC rules, the determination of suspicious transactions, record keeping of internal transactions, and improvement of the internal control system. Since 2001, AML implementation and operation has been covered in the scope of BOC branches' performance examination.²⁶⁰

In addition, the AML Leading Group of the ICBC held its first meeting on 22 January, 2002. At this meeting, ICBC proposed plans for AML structures within the institution, designed to undertake the core tasks of AML work, and specified AML associated requirements and measures. Presidents of the ICBC Head Office were appointed as the head and deputy head of the ICBC AML Leading Group, and other group members were general managers of relevant departments within the institution. The main responsibilities of the AML Leading Group include the analysis of AML issues, designing internal AML policies, the supervision and examination of AML implementation, investigation and updating of AML measures, cultivation of staff's AML awareness, and the development of domestic and international AML cooperation. The ICBC designed a set of AML guiding documents, including seven AML internal control measures, the *AML Provisions* issued by the ICBC Head Office

²⁶⁰ 詹昭, 柳军, 柳杰 [Zhan Zhao, Liu Jun and Liu Jie], above n 104, 113.

in 2007, and the *AML Working Principles* designed by the ICBC Shanghai Branch were released in 2008 and supplemented and updated relevant provisions.²⁶¹

Although internal control systems are built into Chinese financial institutions, the development of AML professionalism is still weak. Under the *Chinese AML Law*, financial institutions are not required to establish specific AML departments within the institution, but are given a choice between establishing a specialised AML department or designating an existing internal department to take charge of AML operations. To some degree, this weakens the important focus on AML procedures. In practice, AML tasks are normally allocated to the legal and compliance department, the accounting department, the capital settlement department, the audit department, or the safety and security department. AML specialised departments or a designated department should be equipped with the necessary administrative and technical staff, and provided with requisite financial guarantees and technical support. The AML department should also be independent, that is, it should not directly intervene in or be a participant in normal business activities of other business departments. In reality, however, for most Chinese financial institutions, independent governance with sufficient supports for AML work is not well developed.

Seen from the perspective of the institutional structure, financial institutions establish AML working groups as required at all levels within the institution, and normally appoint the senior responsible person of the company as the head of its AML working group. However, the vast majority of Chinese financial institutions do not have a specific AML department. Instead, AML activities are allocated to an existing department (in most cases the compliance department), and the staff of this department take on the assigned AML activities as a part of their overall responsibilities (rendering AML essentially a part-time job). Only a small number of financial institutions have established a specialised AML department with full-time AML officers. For example, the Shanghai Branch of the Industrial and Commercial

²⁶¹ Ibid 112.

Bank of China has an AML office equipped with two full-time AML staff. By the end of 2007, there were 189,123 full-time and part-time AML personnel in China's banking, securities, and insurance sectors. Of these, 7.5 per cent were full-time AML personnel and 92.5 per cent were part-time AML personnel, and most of these AML personnel are in banking institutions.²⁶²

Due to this lack of AML-specialised departments and full-time AML workers within the institutions, the effectiveness of AML works is difficult to maintain. The major duty of the existing AML working group and AML part-time staff is not analysis of AML relevant data and information but daily routine activities. For the AML part-time staff, AML activities are only a part of their multiple responsibilities and tasks so it becomes difficult for them to participate in detailed AML activities, or to play a significant role in analysing and reporting suspected ML offences.²⁶³ The work of ML information reporting is primarily performed by front-line counter staff or marketing personnel, and usually there is no other specialised AML expert to conduct further analysis and filtering regarding the reported information.

4.2.2 Weak Screening of Staff

According to Australian AML experience, an AML program must contain risk identification, risk mitigation, CDD, enhanced CDD, suspicions reporting, AML risk awareness training programs, employee due diligence, third party due diligence, a compliance program, record keeping, board oversight, and independent reviews.²⁶⁴ Compared to the Australian criteria, the current AML programs in China are relatively simple, and the list of requisite elements are shorter. Overwhelmingly focusing on business expansion, some Chinese financial institutions break rules to achieve their profit goals, resulting in uncontrolled competition and even unethical competition in

²⁶² 唐旭, 师永彦, 曹作义 [Tang Xu, Shi Yongyan, and Cao Zuoyi], above n 243, 10.

²⁶³ Interview with Ping He, Professor of Law, East China University of Political Science and Law (Shanghai, 26 November 2010).

²⁶⁴ CCH, *The Essential Guide to the Australian Anti-Money Laundering Reforms* (2006).

the financial market.

When staff within a financial institution collaborate with criminals to transfer or launder illicit funds, the operation is usually conducted via highly complex methods and is hard to detect. Once such dealings are publicly revealed, it causes a huge social impact and a loss of public trust. Employee screening plays a significant role in internal AML control in two ways. Firstly, the risk of committing criminal activities by internal staff within a financial institution can be controlled through employee screening. Staff monitoring can also increase the sense of responsibility of a financial institution's employees for full implementation of AML obligations, and caution them not becoming involved in criminal wrongdoing.

Weak points and loopholes within the internal management of financial institutions facilitate criminal abuse of financial channels. Compliance culture and compliance management should be constantly maintained, and the internal control systems should ensure that every employee complies with legislation and rules within the business. It is necessary for financial institutions to screen staff, and to undertake crisis awareness training so that employees are able to determine the sectors most vulnerable to criminal activities so as to eliminate rule-breakers, corrupt persons and fraudsters inside the financial institution.

4.2.3 Insufficient Monitoring of AML Compliance Outcomes

AML compliance departments are mainly in charge of supervising, examining, and assessing the effectiveness and soundness of AML internal systems in all lines of business in AML-related departments and associated subsidiary units. AML compliance departments should provide feedback on problems that have been identified and report these directly to the institution's principal. All AML-related operating units should examine the quality of AML work within the unit, and ensure subordinate units implement all AML requirements in accordance with the operating

unit's guidance. All the operating units should report to the compliance department when compliance risks have been identified. The internal auditing department should conduct internal audits of the entire institution and associated sub-units, assessing the general compliance risks, and report these audit results to the AML compliance department.

AML compliance outcomes should be regularly monitored by both internal and external sources. On-site examination and off-site supervision represent major assessment indicators regarding the quality of AML compliance; however, internal AML assessment is a 'mysterious land' for many financial institutions with AML assessments not to be disclosed in any event.

4.2.3.1 External and Internal AML Assessment in Chinese Financial Institutions

The PBC pays great attention to AML on-site examinations. In the second year of its first request for financial institutions to implement their AML obligations and establish special AML regulatory departments, the PBC carried out on-site examinations of all banking institutions, and extended the coverage of on-site examination to all bank outlets within three years, greatly increasing the awareness within financial institutions of the need for AML compliance. According to statistics, from 2004 to 2008 the PBC conducted AML on-site examinations for a total of 16,948 financial institutions. Of these, 14,271 were banking institutions, 384 were securities and futures financial institutions, and 2293 were insurance institutions. After the examinations, the PBC issued warnings to, and imposed fines and other sanctions on 1996 financial institutions for violations, with the total amount of fines reaching CNY 143,843,500.²⁶⁵ The main purpose of the external AML assessment was not to impose fines on financial institutions that failed to meet compliance requirement, but to let financial institutions know where the weaknesses existed in their AML internal controls, and requiring them to make corresponding progress in strengthening these.

²⁶⁵ 唐旭, 师永彦, 曹作义 [Tang Xu, Shi Yongyan, and Cao Zuoyi], above n 243, 5.

For internal AML assessment, financial institutions should supervise and examine the following aspects within the institution: 1) whether the institutional structure is sound and effective; 2) whether the internal control system is sound and effective; 3) whether AML operations systems are implemented; 4) whether the system of supervision is sound; and 5) whether an AML training system is in place. Measurements are needed for management, especially for the organised entrepreneurial decisions called ‘long range planning’.²⁶⁶ It is necessary for the financial institutions to know how to translate from business needs, business results and business decisions into AML functional capacity and specialised effort.

4.2.3.2 Tasks of Compliance Officers

The effectiveness of AML internal control within a financial institution mainly rests on the role played by the compliance officer. The compliance officer must keep in mind that the AML strategies are important to the bank’s long term interest.

In Chinese financial institutions, compliance officers are the key personnel in the dissemination of AML information within their own institutions. Compliance officers are chosen from a high management level in Chinese financial institutions. Normally, they are not designated solely as ML compliance officers, and AML review is only a small part of job of their daily work. This brings into question how much time they spend in meeting with staff, discussing experiences and concerns, observing actual practices, and dealing with issues ‘on the ground’.

With regards to internal control, most financial institutions have added AML-related content to the institution’s business strategy and policy, and consider development of AML work as an indicator used for management assessment. As different financial institutions are differentiated from each other on the basis of the scale and nature of

²⁶⁶ Peter F Drucker, ‘Long-Range Planning: Challenge to Management Science’ (April 1959) 5(3) *Management Science* 238, 247.

business, internal control systems of different institutions are correspondingly distinct. Generally, relatively large-scale financial institutions have already gained a good reputation at the national or even international level. They have relatively sound management structures within their institution, and are highly responsive to international AML trends, and thus they are more proactive in regard to AML activities. However, for the relatively small-scale financial institutions, the strategic focus is ‘how to become bigger and stronger’. The primary goal is to survive in a highly competitive market. For these businesses, achievement is primary and AML work is less important and little attention is paid to AML implementation by employees ‘from top to bottom’ of the entity.

Most of the senior management and employees of the financial institutions at the grass-root level think that AML work is a responsibility of the government and the PBC, and not for small financial institutions. In addition, coordination and cooperation among governmental departments and financial institutions is not fully developed, especially at the local level.

In some regions, local government officers argue that AML work will impact on the amount of inflow of foreign capital, reduce local fiscal revenue, and subsequently influence the pace of local economic development. Thus, for these financial institutions at a lower level, compliance officers may not be trained to fully take on the role of ‘compliance officer’, and they may not have the full capacity to assess commercial realities and potential risks in regards to AML considerations, particularly where institutions are widespread over large areas in China as is the case for many companies.²⁶⁷ It may be safe to say, that in this way, there are compliance officers in Chinese financial institutions; however, some of them may be ‘compliance officers’ in name only and fail to act in this role.

4.2.4 Immature AML Culture in Chinese Financial Institutions

²⁶⁷ Broome, above n 17.

In recent years, especially after the implementation of the *Chinese AML Law*, the importance of AML work has been realised by staff in Chinese financial institutions. This recognition of the importance of AML includes an acknowledgement of the financial institutions' obligation to combat ML. Obligations imposed by AML legislation require financial institutions to increase the staff's AML awareness through particular measures, such as internal control and AML training. In addition to this trend, international AML action requires that all the large-scale financial institutions universally subscribe to the orthodoxy that AML activities are an important channel for maintaining sustainable development, and maintaining and enhancing the reputation of the financial institution.

The PBC announced 2005 as the 'Year of AML Awareness'. From 2005 to 2007, the PBC and local financial institutions carried out more than 50,000 AML awareness programs involving some 5.19 million participants, and 96,000 AML training sessions of various kinds, which have trained 4.469 million staff of the PBC, AML-related departments and financial institutions, so increasing the pool of AML professionals.²⁶⁸ According to a survey which covered 180 financial institutions in Shanghai in 2009, more than 95 per cent of the participating institutions had organised specific AML training programs, including seminars, learning via television, and lectures by AML professional guest speakers. Most financial institutions spend more than 5 days on AML training each year, and 90 per cent of the participating institutions think that these training programs enhance AML staff's operational skills to a certain degree.²⁶⁹

Granted, five days AML training annually is not enough to keep pace with new trends in combating ML. However, it is understandable that for small institutions, and particularly the small businesses that are now being brought into the AML network, it is difficult to budget for expensive internal training programs or to engage outside

²⁶⁸ 唐旭, 师永彦, 曹作义 [Tang Xu, Shi Yongyan, and Cao Zuoyi], above n 243, 9.

²⁶⁹ Interview with Ping He, above n 263.

consultants. However, the bottom line is that training is essential and must be provided.²⁷⁰

Indeed, lifting broader public awareness of AML is an important aspect of the AML compliance program which will make financial institutions' compliance much easier. Financial institution personnel can play a key role in this process at point of contact with customers while institutions can address broader awareness raising operations. Customers need to be aware of the existence of AML regulations with which the financial institutions are bound to comply, and with the relative obligations of recording and reporting for financial institution personnel. Financial institutions should further increase the level of public awareness or customer awareness within a reasonable time period, and thus reduce the negative impact of the regulations on the banks in commercial terms. In fact, the more widespread is awareness of the regulations, the lower the expected compliance costs to the financial institutions.²⁷¹ However, this increasing level of awareness should be maintained and built upon; and customers must be properly informed. Appropriate education methods to assist financial institutions' AML compliance should be used. For instance, by making AML brochures or handouts available in banks, by putting up AML posters in the financial institutions, and hosting public AML lectures. These AML awareness activities should be designed to encompass the main information about AML, including the seriousness of ML predicate offences, the nature of ML offences, and the negative effect of ML on the whole of society.

AML awareness activity is not as simple as displaying a banner on which is printed 'AML is the obligation of every citizen', but rather should also suggest how citizens can assist the government in combating this kind of crime. Citizens need to be told and educated as how they should cooperate with financial institutions by voluntarily providing correct and adequate information when they are asked to do so, and without

²⁷⁰ Broome, above n 17.

²⁷¹ Masciandaro and Filotto, above n 29, 138.

seeing this as questioning their integrity. People need to know that the financial institutions are not being hostile to their customers. However, this is not an easy goal to achieve. Therefore, financial institutions should constantly undertake the AML awareness activities until public awareness of the value of AML activities is recognised by the vast majority of Chinese citizens. Until this occurs the costs of AML awareness activities should be borne willingly, though these may be relatively high to financial institutions.

Apart from the evolution of a supportive AML culture amongst the general public, the existence of a cooperative culture within financial institutions in regards to AML is also critical. Attitudes to AML activities in Chinese financial institutions can be described as passive, and there is little recognition of the importance of corporate culture in combating ML. It is recommended that senior management create a culture of AML compliance and ensure staff adherence to the financial institutions' AML policies, procedures and processes. It is crucial that all staff with duties relevant to AML work — namely, new staff, front-line staff, compliance staff, and staff dealing with new customers — fully understand the need for these policies and that they implement KYC policies consistently.²⁷² Failure to do so could see the development of serious problems involving both risks to reputation and bank operations. It will, however, take time for financial practitioners at all level in China to accept the advanced concepts of corporate governance, and the need for an AML corporate culture and bring about the changes in staff behaviour that will provide long lasting benefits for both financial regulators and financial institutions.

4.3 Differing AML Priorities of the Regulators and the Regulated

In classical economic theory two basic forces determine the behaviour of an individual. First, every individual acts rationally and aims to maximise his personal utility. Second, the personal utility of an economic venture is mainly determined by its

²⁷² Basel Committee on Banking Supervision (BCBS), above n 233, 14.

expected costs and revenues, which in turn are governed by the fundamental laws of supply and demand.²⁷³ The following table illustrates the general motives for and capabilities to act of both AML authorities and the financial institutions they oversee.

Table 4.3: Motive and Ability to Act

AML Authorities	Financial Institutions
<p>* Motive to act</p> <ul style="list-style-type: none"> — Public (political) pressure — Government interest — Power threatened 	<p>* Motive to act</p> <ul style="list-style-type: none"> — Public/government pressure — Business interest — Power threatened
<p>* Ability to act</p> <ul style="list-style-type: none"> — Resources — Police power 	<p>* Ability to act</p> <ul style="list-style-type: none"> — Resource — Not bound by jurisdiction — Data; fewer privacy rights — Speed
<p>* Limits on ability to act</p> <ul style="list-style-type: none"> — Resources — Jurisdiction boundaries — Privacy rights — Speed 	<p>* Limits on ability to act</p> <ul style="list-style-type: none"> — Resources — Lack of police powers

AML regulation and compliance need to adapt to market developments and technical changes; however, mostly there is inevitable gap between when the regulations are introduced and when they are implemented. AML regulations pertain to specific issues, and normally are a reaction to the nature of the evolving ML activities. In China, every single rule, guideline, provision or legislation concerning AML work has to be produced by a time-consuming and inefficient process of political examination. In this regard, although the regulatory innovation and countermeasures *per se* are effective, delays involved in implementing regulations significantly impact on the practical quality of AML policy.

The relationship between financial institutions and regulators is often seen as a ‘them

²⁷³ Geiger and Wuensch, above n 30, 93.

and us' situation. The institutions believe that the regulators do not understand the commercial realities, while regulators often perceive the institutions as being willing to cut corners and being unprepared to devote sufficient resources to ensure compliance occurs. Of course, in most cases neither of these extreme perceptions is accurate. Whatever might be the general position in relation to the regulation of the financial sector, effective responses to ML require the development of cohesive and cooperative relationships between the regulators and the regulated institutions.²⁷⁴

4.3.1 AML Costs for the Regulators and the Regulated

AML costs are borne by both the regulators and the regulated. For the regulators, the costs of setting up formal AML systems are divided into legislative costs and implementation costs. The former refers to costs involved in formulating AML legislation in the financial sector. This initial input can be considered as a fixed cost. However, regulatory bodies are more concerned about implementation costs, which occur with the long-term input provided by the regulators with the aim of ensuring the normal operations of AML programs in the financial sector. This includes the costs of constant supervision, activities involving investigation and judicial activities, costs involved with institutional changes, employee recruitment, equipment and infrastructure and relationship coordination.

For example, by the end of 2005, full-time and part-time AML employees in the PBC at all levels numbered greater than 4000.²⁷⁵ In addition, in order to efficiently coordinate AML cooperation among different AML competent bodies, the government needs to host and participate in a series of seminars, training programs, symposiums and conferences, which involves further spending. According to internal statistics from the banking sector, the average cost for financial institutions to complete an STR is around CNY 80, and the average cost for CAMLMAC to make an

²⁷⁴ Broome, above n 17.

²⁷⁵ 熊海帆 [Xiong Haifan], above n 86, 213.

initial analysis on a report that has been submitted is more than CNY 120.²⁷⁶ Given the huge number of STRs made by financial institutions, both the compliance cost for the reporting agencies and the implementation costs for the AML regulators are considerable.

For the regulated, AML costs are generally compliance costs borne by the financial institutions, including initial costs and recurrent costs. In detail, there are four different types AML regulation costs:²⁷⁷

- a) Opportunity costs — AML regulation may prevent a bank from engaging in certain profitable activities. For example, branch-licensing regulations may prohibit a bank from opening branches in areas where profitable business opportunities may exist. The profit forgone is an opportunity cost of the regulation.
- b) Operating costs — Regulations may require that banks perform certain actions. Costs arising from these actions are operating costs. For example, the AML legislation imposes certain record keeping and reporting requirements on the banks which would give rise to operating costs.

The operating costs can be further broken down in two types:

- i) Start up costs — These are incurred only once so as to conform to the regulation, for example, information technology costs, legal and other professional/consultant advice, and so on.
 - ii) On-going costs — These are incurred on an on-going or regular basis. These may include salaries of staff engaged in compliance work, stationary expenses, attending to customer complaints under the regulation, and so on.
- c) Total costs — These refer to the cost of all the activities required under the regulations. In the context of AML procedures, the cost of meeting expenses incurred in this regard, attending to customer complaints under the regulation, and so on.
 - d) Incremental costs — These are the costs involved in actions that would be implemented as a matter of best practice whether the regulation were there or not. If the cost of such activities is subtracted from the total costs then the

²⁷⁶ Ibid.

²⁷⁷ Milind Sathye, 'Estimating the Cost of Compliance of AML/CTF for Financial Institutions in Australia' (2008) 15(4) *Journal of Financial Crime* 347, 354.

remaining costs would be classified as incremental cost. It represents the cost of activities that are ‘add on’, and due to the specific regulation. Training costs due to the AML can be considered to be an incremental cost.

The capacity to understand customer information, such as the scope of the business, the capital scale of the company, and the regular trading partners, determines the effectiveness of detection of suspicious transactions and the quality of AML information. As principal participants in AML activities, financial institutions face the dilemma of balancing AML output quality with the costs of effective AML measures. This is the core issue that financial institutions face. They can miss valuable information amongst the numerous transaction details they filter, even though the detection process requires financial institutions to invest large amounts in large implementation costs. Due to the problems of scale and financial capacity, not all the financial institutions are willing to bear the increasingly significant cost involved in combating ML. It seems that defensive reporting is a ‘reasonable’ choice for financial institutions, even though it increases the working costs of the AML department yet does not guarantee effective AML results.

It was reported that to enhance the implementation of the *Chinese AML Law* and *Provisions on Anti-Money Laundering by Financial Institutions*, bank institutions in Sichuan Province should set up a team of MLROs in 2008. It covered more than 1700 reporting officers in the entire province, and 13 local financial institutions developed the LVTR software as required. If the wage income per one reporter is calculated as CNY 1500 per month (actual salary would certainly be more than this figure), the total payment for the 1700 reporting officers is CNY 2.25 million each month; and this figure does not include the cost of equipment purchase.²⁷⁸ If Sichuan, an inland province, devoted that much money to combating ML, then the AML costs for financial institutions in coastal cities would be considerably greater. It is clear that in economic theory and in most business practice, manual workers are seen as a cost. However, as mentioned before, AML professionals are valuable for maintaining

²⁷⁸ 熊海帆 [Xiong Haifan], above n 86, 215.

business quality, and they must be considered as a capital asset. Costs need to be controlled and reduced, while assets need to be made to grow. If financial institutions are willing to change their view of 'cost', the conflict between AML cost and AML revenue will be mitigated.

Indeed, the cost of regulation rests on the economies of scale of the different financial institutions located in different areas. The burden for small banks is more than double that for bigger banks. Regulations may affect firms differently within an industry, depending upon the services they are providing and the scale of their operations. The impact of AML, for example, on banks and smaller financial institutions like credit unions would differ as the latter do not provide several of the services that banks provide and their operations are confined to local areas rather than nation-wide or internationally. In this regard, a 'one size fits all' approach to the estimation of compliance costs and financial impacts on firms affected by regulations may not be appropriate.

4.3.2 Challenges of Equal Compliance during the Global Financial Crisis

In theory, AML implementation will be ensured and the costs of AML compliance will be returned in a sound cooperative relationship between the regulator and the regulated. However, an unbalanced 'cost / profit' game causes a so-called 'collaboration paradox' between the two sides, that is, financial institutions are forced to cooperate with the government, but they are not happy to cooperate fully.

The competing interests of regulatory bodies and financial institutions are understandable. As rational enterprises, financial institutions have the goal of maximising profit and achieving sustainable growth, maximising the return on capital invested. Whether the capital stems from illicit origins or not, when it enters the financial system, financial institutions can gain potential benefits from it. Actively participating in AML work, not only means the amount on deposit will be reduced,

but also that human and material costs will be increased, initially adversely affecting the economic interest of the institution. To balance the competing interests and improve the effectiveness and quality of AML task, regulatory authorities should ‘identify a strategy which will reduce the expected costs of regulation and increase the expected gains from it’.²⁷⁹ On their part, regulatory bodies consider the effectiveness of AML regulation, and the need to increase the integrity of the banking and financial institutions. The competing interests dilemma is that the objectives for regulatory bodies are, conversely, the costs of regulation imposed on the banking and financial systems, and such costs are subject to increases as the rules become stricter.²⁸⁰ Thus, the central bank and commercial banks may be subject to opposing forces regarding AML.

In particular, during the global financial crisis, AML in the financial industry may have lost its priority focus, and this is not only the case for China, but possibly for the entire world. The problem is that there may be risk that banks and other financial institutions do not comply with regulations on AML in order to avoid losing competitiveness under the pressures of the global financial crisis or other financial crises. This greater laxity in the regulatory environment may be made use of by money launderers (including the self-launderers), leaving ‘bad seeds’ of greater risks for the future when the crisis abates. Currently, the core interest of financial institutions may simply be their survival in the difficult economic times: they do not worry about ML but how to stay economically viable. Therefore, more aggressive and even unethical competition may occur and occur more frequently among financial institutions.

The growing volume and complexity of business transactions will also increase the risks and vulnerability of the financial and service industries to ML. The goals of an enterprise are profit and sustainable growth. Potentially, and even more serious, is that

²⁷⁹ Masciandaro and Filotto, above n 29, 138.

²⁸⁰ Masciandaro, ‘ML: The Economics of Regulation’, above n 27, 232.

financial institutions may use this laxity of rules as a means of attracting potential clients. It is reasonable to argue

[T]he disorderly and keen competition in the Chinese market economy may continue to indirectly encourage the financial institutions to relax customer identification and suspicious transactions reporting in order to keep their business clients at the expense of public interest.²⁸¹

This is definitely deleterious to fair competition in the financial markets, to the soundness of the financial sectors, and to the security and integrity of the financial industry as a whole.

Financial institutions may consider the incentives for and against complying with AML regulations. If state intervention into the market, such as through AML rules, affects all market participants in the same way, the relative competitive position of a single participant is not influenced. In that case, regulation fosters or hampers the wellbeing of the economy without changing the relative wellbeing of the each member. On the other hand, if intervention affects different market participants in different ways, certain competitors may face an advantages or disadvantages.²⁸²

With regard to the implementation of AML obligations, unequal competition among different financial institutions should be avoided, that is, it should be determined whether financial institutions can comply with the AML regulation on the same level. As mentioned previously, uniform conduct concerning AML is difficult to achieve, even between two branches of the same bank in the same area, and greater discrepancies occur among financial institutions with more distinctly different characteristics in terms of types of services, institution size, geographic spread, customer base, and so on. From the viewpoint of the customers, they will probably display a preference for the financial institutions that have a lighter burden in

²⁸¹ Alain Sham, 'Money Laundering Laws and Regulations: China and Hong Kong' (2006) 9(4) *Journal of Money Laundering Control* 379, 395.

²⁸² Geiger and Wuensch, above n 30, 95.

requirements such as in customer provision of information. Thus, the more diligent financial institutions are in exercising AML duties, the higher the AML compliance costs can be for them. Consequently, this could trigger a ‘competition in laxity’ among financial institutions. Crucially, the success of AML regulations will depend on how acceptable these are to the regulated entities, so the effectiveness of regulation thus depends on the ability to positively influence the decision making of financial institutions employees and management in regards to AML measures.²⁸³

It is vital for the entire financial market to build a sound compliance culture which ensures different financial institutions comply with the AML program in the same way so that they do not resort to ‘regulatory laxity’ to attract potential customers, and correspondingly impair their counterparts’ interests (and those of the entire system in the longer term). The problem is whether financial institutions and the regulatory authority can set up a ‘win-win’ situation with the different financial institutions acting fairly under AML requirements and not contributing to each other’s deterioration or demise.

4.3.3 Lack of Positive Incentive Mechanisms for Combating ML

Financial institutions are involved in the battle against ML in a threefold manner: first, they are commercial institutions, aiming to implement solid AML and compliance policies to demonstrate to the outside world that they are taking these matters seriously. Second, the financial institutions act as an inspection agency, having to monitor their customers and employees. And thirdly, banks themselves are monitored by regulators as they are also potential offenders.²⁸⁴

Failure to see the benefits of complying with AML regulations, financial institutions

²⁸³ Masciandaro and Filotto, above n 29, 133.

²⁸⁴ Antoinette Verhage, ‘Compliance and AML in Belgium: A Booming Sector with Growing Pains’ (2009) 12(2) *Journal of Money Laundering Control* 113, 120.

have to take the following AML compliance costs into consideration:²⁸⁵

- * internal rules regarding measures against ML;
- * central function manager;
- * verification of identity;
- * routine processes for scrutinising transactions;
- * routine processes for preserving documents;
- * routine processes for training employees in respect of ML issues;
- * obligations to report suspicious transactions to the FIU;
- * internal ML register;
- * technical equipment to detect ML;
- * information about the payer following the transfer of money; and
- * calculated costs due to the implementation of the AML program.

Indeed, financial institutions would face legal sanctions if the authorities detect the presence of illegal transactions through means other than the reporting of anomalies, and if they fail to meet the required compliance standards, heavy penalties will be imposed on financial institutions. AML compliance-related incentives should be developed as having only punitive motivations will make the passive attitude held by financial institutions worse.

The difficulty in devising incentives is that AML legislation is thought to be strict and rigid in combating ML offences with relatively similar obligations for all financial institutions. AML authorities hold the viewpoint that ‘there should not be any bargains in combating money laundering, since via AML work, financial institutions can enhance internal control and increase reputation for themselves’, ‘AML work promotes the improvement of the financial environment of the country, and it is the best return for individual financial institution, thus, there is no need of extra awards or provide bonuses’, and ‘the AML restraint mechanism is far from perfect, therefore, it

²⁸⁵ Dan Magnusson, ‘The Costs of Implementing the Anti-Money Laundering Regulations in Sweden’ (2009) 12(2) *Journal of Money Laundering Control* 101, 105.

is too early to build an AML incentive mechanism in China'.²⁸⁶ However, any system that only has a restraint mechanism or only has incentive mechanism is a less than scientific, unsound, and inequitable system.

Compulsory intervention, without a doubt, plays the major role of standardising AML behaviour in financial institutions and enhancing AML efforts in the short term. However, without providing incentive mechanisms, AML actions in financial institutions are predominantly 'passively' performed and the long-term goals of effectiveness in combating ML are hard to attain.

4.4 Comment and Conclusion

In general, three main shortcomings threaten financial security as well as disturbing the effectiveness of compliance with AML regulations in China. These are the lack of innovation and precautionary capacity in regard to risk management, the lack of incentive mechanisms within the governance structures for financial institutions, and the weak internal controls of financial institutions owing to the long term neglect of management. While strengthening the strategies affecting the financial institutions is important, regulatory innovation within the regulatory and supervisory agencies is just as important.

As mentioned, Chinese regulators now face a series of challenges to improve AML effectiveness, such as the informal remittance system which provides a range of financial business services, a complex regulatory structure with institutional conflicts, and different levels of financial institutions from regional banks providing basic financial services to large-scale listed companies providing advanced financial products. Regulatory innovation should take these issues into serious consideration. The AML authorities, according to the PBC, should establish a framework that balances conflicts and differences. One focus is in dealing with the problems of

²⁸⁶ Gao and Ye, above n 253.

misusing formal financial institutions for illicit purposes, as well as the unsound education and poor training of staff within these formal institutions, while another area of focus should be on regulatory innovation that does not create side-effects that increase the competitiveness of the informal financial system where there are no regulatory costs. Possible innovations may also create structures that could bring the informal banking system into the formal network, converting them in the long run into a part of the formal system.

Regulatory innovation does not simply mean copying the approach applied in developed countries, but developing an approach most suitable for Chinese AML practice. The ultimate goal for AML regulation is to encourage the private sector to perform AML activities not just for the activities' sake, but for the financial institutions' own interests. An RBA is possibly viable in developed countries because financial institutions in these jurisdictions are predominantly self-controlled (that is, are companies independent of government); however, the largest Chinese commercial banks are still controlled by the government although they have ostensibly transformed from SOEs to limited entities. This is true even though the traditional big four banks in China (ICBC, BOC, CCB, and ABC) in the Chinese banking industry had, by 2009, completed their transformation to a shareholding system. One thing worth mentioning is that the biggest shareholder of these four listed banks is either the Ministry of Finance or Central Huijin Investment Ltd. The latter is the largest financial investment company in China and owned by Chinese government. In fact, according to the data available at 20 February 2011, the Ministry of Finance holds a 35.33 per cent share of ICBC and a 48.15 per cent share of ABC, and Central Huijin Investment Ltd holds a 35.42 per cent share of ICBC, a 67.53 per cent share of BOC, a 57.09 per cent share of CCB, and a 48.15 per cent share of ABC.²⁸⁷ These figures also demonstrate that the key decisions regarding these four big banks are still made by the government. Under these circumstances, proper government intervention or a

²⁸⁷ 和讯网 [Hexun Wang], <<http://stockdata.stock.hexun.com>>.

rule-based approach to AML compliance is more practicable for these four banks, and the AML activities performed by these four entities will have significant model effects on other small and medium scale banks in China.

From the viewpoint of those being regulated, as it is unrealistic that a business could operate in a completely risk free environment in terms of ML, financial institutions should identify the ML risks they face, and then determine the optimum ways to reduce and manage that risk, and balance the costs to their business and customers against the risk of the business being used for ML. Implementation of effective ML strategies requires efficient, fair and effective regulation by supervisory agencies, compliance policies which are transparent and evenly applied, and an understanding on all sides of the need to apply risk management strategies in developing and implementing compliance programs.

Risk management strategies must be applied by both public and private sector organisations if efficient and effective AML systems are to operate. Financial institutions should fully understand ML vulnerabilities and risks in the Chinese banking, securities, and insurance sectors, and the regulators should foster a ML risk-rating system and an enterprise-wide AML information solution system in the Chinese financial sector based on practical analysis and existing real conditions.

Chapter 5. ANALYSIS OF MONEY LAUNDERING VULNERABILITIES IN THE CHINESE FINANCIAL SECTORS

Financial institutions can be involved in financial crime in three ways: as victims, as perpetrators, or as a knowing or unknowing instrumentality of the crime. For the first and second category, different types of fraud are included. In the third category are instances where financial institutions are used to keep or transfer funds, either wittingly or unwittingly, that represent the benefits or transmitted profits or proceeds of a crime. One of the most important examples of this third category is ML.

The fourth round of evaluations of compliance with the FATF standards includes a particular focus on the effectiveness of AML systems, the earlier detection of threats or vulnerabilities within jurisdictions and other measures to strengthen systems.²⁸⁸ However, ML vulnerabilities within specific jurisdictions consist of vulnerabilities of individual sectors within the jurisdiction. Indeed, optimal results should be achieved through the implementation of actions in the various sectors of the financial system that complement actions taken elsewhere in that system. This chapter analyses ML risks linked to financial institutions, comments on ML vulnerabilities in Chinese banking, securities, and insurance markets, and illustrates ML risks associated with mixed businesses in Chinese financial sectors.

5.1 Main Risks for Money Laundering Linked to Financial Institutions

Previously, for most Chinese financial institutions, ML risks were not seen as an independent risk that should be given special attention, but as a kind of subsidiary risk attached to the institution's credibility or reputation.²⁸⁹ However, financial innovations and technological developments have pressured financial institutions to put greater focus on ML risks isolated from the other associated risks in the financial

²⁸⁸ Financial Action Task Force on Money Laundering (FATF), *2008–2009 Financial Action Task Force Annual Report*, July 2009.

²⁸⁹ Interview with Yindi Duan, Deputy Chief, China Banking Regulatory Commission of Hubei (Wuhan, 19 August 2010).

industry. The threats of the risks of ML have to be recognised by financial institutions at all levels no matter where the institution is located.

5.1.1 Recognising the Risks of Money-Laundering Faced by Financial Institutions

ML risk refers to commercial loss and compliance risks faced by financial institutions if they engage in, assist, or facilitate ML activities, and these are generally categorised as legal, operational, reputational, and concentration risks.

Legal risks, in general, are the potential for lawsuits, adverse judgments, unenforceable contracts, fines and penalties generating losses, increased expenses for an organisation, or even the closure or cessation of business of the organisation.²⁹⁰ With regard to ML issues, legal risk is associated with not meeting the requirements of the AML legislation. Examples of some of these risks include customer verification not done properly, failure to train staff adequately, not having an AML program, failure to report suspicious matters, not submitting an AML compliance report, and not having an AML compliance officer. Indeed, reporting entities should understand and manage legal risks associated with breaches of relevant provisions of the AML legislation and AML rules. This includes the implementation of a robust compliance plan that encompasses relevant obligations and defines the control and review mechanisms needed to ensure compliance.

Operational risk refers to ‘the potential financial loss as a result of a breakdown in day-to-day operational processes’,²⁹¹ and according to the BCBS’s definition,²⁹² it is described as the potential for loss resulting from inadequate internal processes, personnel or systems or from external events. Various factors may lead the financial institution to make mistakes in daily operations due to failing to control these potential risks. A ‘rational manager’, for example, may take decisions that appear

²⁹⁰ Australian Transaction Reports and Analysis Centre (AUSTRAC), *Risk Management: A Tool for Small-to-Medium Sized Business* (2006) <http://www.austrac.gov.au/risk_management.html>.

²⁹¹ Australian Prudential Regulation Authority (APRA), *Risk & Capital Management*, November 1998, 22.

²⁹² Basel Committee on Banking Supervision (BCBS), above n 233.

nonsensical from an institution's perspective, but in fact, are perfectly reasonable from the perspective of the individual, if that manager is only motivated by the incentives that apply to him or her as an individual.²⁹³

Failure to comply with policies, regulations or laws represents a key factor that can trigger operational risk. PriceWaterhouseCoopers refers to operational risks as 'those risks that are closely related to internal processes, people and systems', and categorises ML as coming under an operational control risk in its *Generally Accepted Risk Principles*.²⁹⁴ With regard to conducting inspections of financial institutions, on-site examinations are essential for supervisors to ensure AML compliance, and correspondingly reduce the operational risk through the daily practices of the financial institution. These examinations should include the review of relevant policies, CDD procedures, customer records, and sample testing.

Reputational risk is the risk posed by inappropriate or unethical behaviour by financial institution staff that damages an institution's reputation and results in negative publicity, a decline in market confidence, and consequent business loss.²⁹⁵ Reputational risk is described as the potential that adverse publicity regarding an organisation's business practices and associations, whether this publicity be accurate or not, will cause a loss of public confidence in the integrity of the organisation.

For any financial institutions, the cost to reputation of being placed on a 'name and shame' list is apparently enough to generate responses in the correct direction.²⁹⁶ As an example, for a bank, a diminished reputation represents the potential that borrowers, depositors and investors might stop doing business with the bank because of a supposed ML scandal involving the bank. The loss of high-quality borrowers

²⁹³ Joint Forum (BCBS, IOSCO, IAIS), *Operational Risk Transfer across Financial Sectors*, August 2003, 8.

²⁹⁴ FATF, *Methodology for Assessing Compliance with the FATF 40 and the FATF 9*, above n 121, 40.

²⁹⁵ The Asia/Pacific Group on Money Laundering (APGML), *Money Laundering Impacts Development*, <http://www.apgml.org/issues/docs/30/WB_Impacts%20on%20development.pdf>.

²⁹⁶ Reuter and Truman, 'AML Overkill?', above n 72, 58.

reduces the number and scale of profitable loans and increases the risk of the overall loan portfolio. Depositors may withdraw their funds. Moreover, funds placed on deposit with a bank may not be able to be relied upon as a source of future funding once depositors learn that a bank may not be stable. Depositors may be more willing to incur large penalties rather than leave their funds in a bank whose reputation is questionable, resulting in unanticipated withdrawals, causing potential liquidity problems.

Reputation is stated to be one of the most important factors for successful businesses in the financial sector and can therefore be used as a mechanism to put pressure on the sector. In other words: taking AML measures can also serve as a marketing tool. Since the AML battle has now put severe strains on banks, reputational risks have become too high to take, and the possibility of ML has become one of the central liabilities a bank has to deal with. As effective countermeasures, self-regulatory initiatives related to corporate governance and protection of reputation have been put in place in a number of sectors and in a number of locations. The response of the Wolfsberg Group is one of many examples. These principles aim to harmonise compliance, AML regulations and KYC rules, and encourage banks to exchange information on these subjects.²⁹⁷ Under the pressure of ‘name and shame’ ranking, banks that do not follow relevant AML legislation are known in the sector and are seen as less stable

Although reputational risk has been given more attention than previously, it is still not the key consideration of risk management for most Chinese financial institutions. Unlike financial institutions in developed countries, Chinese financial institutions are reliant on credibility with the government rather than their own reputation. In fact, because the government will deal directly with the problems of a financial institution in most cases, there is no actual risk of bankruptcy or collapse faced by financial

²⁹⁷ Antoinette Verhage, ‘Between the Hammer and the Anvil? The Anti-Money Laundering-Complex and Its Interactions with the Compliance Industry’ (26 November 2008) *Crime, Law & Social Change* 9.

institutions in China. Financial institutions *per se* do not have to bear huge risks since both financial fines and administrative penalties for compliance failures are small. In the most serious situations, an individual financial institution which has failed to comply with relevant regulations will be closed down. As China's commercial banks and non-bank financial institutions spread their branches at all levels throughout the country, closure of specific outlets will not hurt the entire company.²⁹⁸ Under current Chinese regulatory practice, compliance supervision is directly connected to certain senior officers' responsibility, that is, if the financial institution has trouble with compliance, a designated senior officer will be subjected to both a financial fine and administrative sanction. Indeed, the shift of the focus of responsibility in China — where the reputational risk of the financial institution is transferred to the personal reputation of senior officers and is directly related to the personal interest of senior officers — works well. No matter what the motivation, risk management for the sake of the financial institution's reputation or the self-protection of the reputation of the senior officer, the result is that there is an increasing interest in financial companies considering their compliance more seriously.

Concentration risk is the potential for loss resulting from too much credit or loan exposure to one borrower or group of borrowers.²⁹⁹ Regulations usually restrict a bank's exposure to a single borrower or group of related borrowers. Lack of knowledge about a particular customer or who is 'behind' the customer, or what the customer's relationship is to other borrowers, can place a bank at risk in this regard. This is particularly a concern where there are related counter-parties, connected borrowers, and a common source of income or assets for repayment. Loan losses can also result, of course, from unenforceable contracts and contracts made with fictitious persons.

5.1.2 Money Laundering-Related Business Risks in Financial Institutions

²⁹⁸ Interview with Yindi Duan, above n 289.

²⁹⁹ Australian Prudential Regulation Authority (APRA), above n 291.

Increasingly, criminal activities have been perpetrated in financial sectors in recent years. Apart from the traditional areas of business normally targeted by criminals, such as saving, accounting and credit loan businesses, newer services such as insurance claims, securities investment, and interference with computer-based transactions are becoming areas of high incidence for illicit financial activities. In addition, financial crimes are no longer only concentrated in coastal and big central cities, but have also become more common in some less-developed areas.³⁰⁰

ML-related risks include the risk evaluation of financial products, customers, and markets. When analysed separately, various products produce different levels of ML risk. For example, the risk for the traditional business of deposits and withdrawals is lower than that for emerging financial services, such as stock business. Customers have different risk levels as well. Institutions have to determine the assessment of low risk customers as compared to high risk customers. Moreover, different financial markets face dissimilar ML risks. For instance, the financial institutions in Shanghai may face different risks from those faced by the institutions in the Western part of China. Therefore, risk evaluation should not be unilaterally considered, but fully evaluated dependent on circumstances. Each financial institution should establish its own unique risk profile, reflecting the characteristics of its customers, the financial products offered, geographical position, and the make-up of the transactional and delivery systems.

ML-related business risk in financial institutions refers to the risk that financial services may be used to facilitate ML.³⁰¹ More specifically, these consist of interface risk, product/service risk, customer risk, and geographical risk, with all of these linked with bank accounts or securities accounts.

³⁰⁰ 王钧, 彭月辉 [Wang Jun and Peng Yuehui] 《金融犯罪的法律构造》 [Legal Constitution of Financial Crime] in 刘明祥, 冯军 (编) [Liu Mingxiang and Feng Jun (eds)] 《金融犯罪的全球考察》 [Global Examination on Financial Crimes] (中国人民大学出版社 [People's University of China Press], 2008) 89.

³⁰¹ Australian Prudential Regulation Authority (APRA), above n 285.

Interface risk — risks posed by the product being sold or acquired and its inherent attractiveness to money launderers as a conduit for illicit activity, normally stemming from customer's consuming behaviour in relation to the product or service.³⁰² Institutions should be mindful of new or innovative services not specifically being offered by that particular institution, but that make use of the institution's services to deliver the product.

Product/service risk — risks associated with a financial product/service, especially financial innovations. The grading of product/service risk varies amongst product/service categories, such as wire transfer and electronic banking services, international funds transfers, and private banking accounts.

Customer risk — this is determined by financial institutions' AML structure and risk control capacity, and different customers bear different potential risks. This includes the source of income or wealth, their past activities and the intended nature of activities. Generally, lists of customers generated periodically on the basis of different factors that may indicate higher risk should be provided to employees. These risk factors should include but are not limited to cash volume and/or velocity, nature of business, wire transfer volume, and citizenship of principals and/or account signers.³⁰³

Having completed the initial risk rating process for customers identified through this process, all other commercial customers will be rated as low risk. Long standing relationships involving frequent client contact may present less risk from an ML perspective. On the other hand, customers with any previous involvement or record of suspicious activities should be considered as high risk. These activities should include bribery/gratuity, check fraud, commercial loan fraud, computer intrusion, consumer

³⁰² Killick and Parody, above n 48, 212.

³⁰³ Financial Action Task Force on Money Laundering (FATF), *Risk-Based Approach Guidance for the Life Insurance Sector*, October 2009, 27.

loan fraud, counterfeit check, counterfeit credit/debit card, counterfeit instrument, credit card fraud, debit card fraud, defalcation/embezzlement, false statement, misuse of position or self dealing, mortgage loan fraud, mysterious disappearance, wire transfer fraud, terrorist financing, and identity theft.

Geographic risk — as financial institutions are located in various geographic areas with these having different economic backgrounds and AML capacity, ML risks will vary from place to place. Factors that may result in a determination that an area poses a higher risk include: 1) geographic areas subject to sanctions, embargos, or statements of concern issued by international bodies or governments; 2) geographic areas lacking appropriate AML regulations and other measures; 3) geographic areas providing funding or support for terrorist activities or that have designated terrorist organisations operating within them; 4) geographic areas having significant levels of corruption, or other criminal activity; and 5) cross border elements such as when the payment party, the customer and the beneficiary of the contract are in separate jurisdictions.³⁰⁴

For example, if a jurisdiction displays high levels of ML activities, any customer from this jurisdiction should be considered as high risk or suspicious, such as high risk and non-cooperative jurisdictions are defined by FATF. The Chinese government determines high risk geographic area according to frequency of occurrence of crimes and activities related to ML activities. These include Guangdong and Fujian (smuggling), Yunnan (drug-related crime), Zhejiang (private loans), Shenzhen and Zhuhai (underground banks), Xinjiang (terrorism financing and illegal foreign exchange businesses), Gansu and Shandong (illicit gold trading), and Hubei (tax-avoidance).³⁰⁵ The general consensus is that transactions involving such high risk jurisdictions should be particularly scrutinised, and both outward and inward

³⁰⁴ Ibid.

³⁰⁵ 高增安 [Gao Zengan], 基于交易的可疑洗钱行为模式与反洗钱对策研究 [Research on Transaction-Based Suspicious Money Laundering Behavioural Patterns and Anti-Money Laundering Countermeasures] (PhD Thesis, 西南交通大学 [Southwest Jiaotong University], 2007).

transaction flows should be focused on.³⁰⁶

5.1.3 Improving AML Risk Management in Financial Institutions

For the purpose of building a better external environment for the safe operation of financial transactions and to avoid the potential risks of ML offences, a number of interrelated factors within the financial infrastructure and financial systems can provide positive support for each other. These include the ‘payment system, the legal system, corporate governance, accounting and auditing standards, the credit standing system, the AML system’ as well as, ‘the financial security network covering efficient financial careful oversight and the management supervision.’³⁰⁷ In fact, any improvement that occurs in any one of these factors will result in a corresponding improvement in the others. It is worth noting that all risks are interrelated. With lack of adequate and updated due diligence on customers, financial institutions may become subject to significant financial costs. Indeed, CDD is a key element of risk controls for banks and other non-bank financial institutions, which is closely linked with reputation, operations and legal risks faced by financial institution. Knowing the customer can reduce the likelihood of a financial institution being used as a vehicle for, or becoming a victim of, ML offences and other financial crimes, and consequently protects the reputation of financial institutions. In fact, good KYC procedures represent a core component of sound risk management. If the CDD is conducted inadequately, the risk faced by financial institutions will correspondingly increase.

A risk profile is two or three dimensional and provides a more accurate methodology through which the intensity of the customer identification process can be escalated. Of these, the following two factors requiring consideration are probably the most generic: (i) likelihood; and (ii) impact.³⁰⁸ The term ‘risk profile’ is determined by combining a

³⁰⁶ Broome, above n 17.

³⁰⁷ Yulu Chen, and Fang Wang, ‘Economic Structural Reform and China’s Financial Security — Issues, Logic and Countermeasures’ (2007) 2 *Frontiers of Economics in China* 151, 167.

³⁰⁸ Killick and Parody, above n 48.

set of factors which in this context means that in addressing these risks, every firm should look at the following for risk elements, including (where appropriate):³⁰⁹

- type and background of customer and/or beneficial owner
- the customer's and/or beneficial owner's geographical base
- the geographic sphere of the activities of the customer and/or beneficial owner
- the nature of the activities
- the means of payment as well as the type of payment (cash, wire transfer, etc)
- the source of funds
- the source of wealth
- the frequency and scale of activity
- the type and complexity of the business relationship
- whether or not payments will be made to third parties
- whether a business relationship is dormant
- any bearer arrangements
- suspicion of knowledge of ML.

When deciding whether the customer is acceptable, whether the customer should be subject to a standard approach, or whether the customer should be subject to an intensive approach, the monitoring authority needs to combine the status of a customer with the product which the customer wants to buy or is buying already. An integrated approach takes the customer and the product as well as other factors into consideration.

While financial institutions are readily able to make assessments about credit and fraud risk, assessing the ML risk in financial terms is notoriously difficult.³¹⁰ Monitoring procedures need to be established to identify unexpected changes in customer activity that could signal a need to review the customer's account activity and possibly elevate their risk rating. Certain higher risk customers may qualify for a

³⁰⁹ PayPal Australia, 'Submission for Inquiry into Cyber Crime', *Submission No 60* (2008) 7.

³¹⁰ Ross and Hannan, above n 50, 111.

lower risk rating based on a satisfactory relationship over a longer period of time. Also, periodic lists of customers, which need to be reviewed to determine whether the assigned risk continues to be appropriate, should be provided to employees dealing with related matters within the institution. The frequency of the review process will depend on the customer's initial risk rating and the procedures that the financial institution is able to implement in the back office for ongoing monitoring purposes.

In addition, to control all the risks in relation to ML, employee training programs within financial institutions should be intensified in regard to KYC policies, CDD procedures and ethical codes. Frequent internal audits and self-assessments of the internal control environment should be conducted. In addition, on-site examinations or visits should be both more frequent and more detailed. Regulators can observe the risk management practices of financial institutions through on-site examinations or visits, and provide institutions with an indication of 'best practice'.

5.2 Money Laundering Vulnerabilities in the Chinese Banking Sector

Businesses are becoming increasingly global and this will increase the risks of financial crime through use of modern technology. International AML theory holds that money launderers universally want to exploit the weaknesses of financial regulatory systems to process dirty money through legitimate economic systems, particularly where the possibility of being monitored and detected due to regulatory blind spots or regulatory weak points is relatively low. Emerging payment instruments subject to loose regulation in the banking sector are of interest as they can be exploited in any step of the three stages of ML, namely placement, layering and integration.

Additional ML risks for banks as well as new challenges for banking regulators and supervisors may be involved when the customer is absent for the purpose of physical identification. Indeed, it has been observed that 'The more automated the banking and

financial system becomes, the less ‘face to face’ contact between clients and employees and the greater the holes in the detection net.’³¹¹ Financial institutions should, therefore, have measures to cope with non ‘face to face’ transactions, and must ensure that the customer’s identity is established properly and adequately, such as through the provision of additional documentary evidence by the customer. The institution should also ensure that the first operational payments are carried out through an account opened in the customer’s name.³¹²

5.2.1 New Technologies and Money Laundering Vulnerabilities

The Australia Institute of Criminology identified some elements that will facilitate technology-enabled crime, including developments in the digitisation of information, especially relating to the widespread use of broadband services and mobile and wireless technologies, and the evolution of electronic and internet payment systems,³¹³ creating a number of vulnerabilities. Key among these is that networks and their data can be accessed remotely without physical access being required, and this facility assists both the user and the criminal.

Uncountable electronic money can be stored in one smart card or computer, and it is easy for it to be transferred quickly over long distances. Moreover, this kind of money is much more anonymous than traditional currency. The adoption of encryption techniques and the facility for remote transfer increase extraordinarily the anonymity of electronic money.³¹⁴ It is difficult to adequately implement customer identification and record keeping on electronic transactions, let alone carry out the obligations of STR on them.

Linked with a specific bank account, internet payment services may come from

³¹¹ McCusker, above n 51, 47.

³¹² John Handoll, *Capital, Payments and Money Laundering in the European Union* (Oxford University Press, 2006), 152.

³¹³ Australian Institute of Criminology (AIC), ‘Future Direction in Technology-Enabled Crime: 2007–2009’, *Research and Public Policy Series No 78*, 2007, 36.

³¹⁴ Ibid.

different parts of the world, and there are no geographic restrictions. Connections to commercial websites and internet payment systems are available everywhere in the world, and if one owns a legal bank account in a country it can be used to conduct transactions across international borders at any time. This can create problems when screening and monitoring account activities, and information technologies enable internet payment transactions to be performed automatically and with little human intervention in the process, making it more difficult for law enforcement to locate and to pursue criminals and money launderers. There are a number of features of the internet which attract criminals, including anonymity, lack of 'face to face' contact, speed of transactions, access to globalised processes and new payment technologies, and the cross border activity.³¹⁵

With the rapid development of the Chinese financial industry, various products and services based on new or developing technologies are being increasingly introduced. For example, internet users and e-Commerce have increased explosively in China during past few years, with an extremely large number of Chinese online users and an unbelievable growth in transaction volume. According to the China Internet Network Information Centre, in 2006 the population of internet users in China rose by 30 per cent to 132 million at December 2006, and the annual growth rate was about 19 per cent. This figure has been estimated to have risen to 485 million in 2011.³¹⁶ As the transacted products include high value goods, precious metals, real estate, and negotiable securities, which all happen to be good choices for integrating illicit fund into the legitimate economy, it is a real challenge for AML regulators to tell how many transactions relating to ML activities are among the massive number of online transactions.³¹⁷ Consequently, regulatory measures and technical plans with regard to regulating new technology related transactions should be established and constantly

³¹⁵ Wojciech Filipkowski, 'Cyber Laundering: An Analysis of Typology and Techniques' (Jan–June 2008) 3(1) *International Journal of Criminal Justice Sciences* 15, 18.

³¹⁶ Australian Institute of Criminology (AIC), above n 313, 15. For 2011 figures, see Reuters, *China Web Users Hit 485 Million* 19 July 2011 <<http://www.reuters.com/article/2011/07/19/us-china-internet-idUSTRE76I12020110719>>.

³¹⁷ Lixin Yan, Lishan Ai and Jun Tang, 'Risk-Based AML Regulation on Internet Payment Services in China' (2011) 14(1) *Journal of Money Laundering Control* 93, 96.

updated.

Indeed, Recommendation 8 of the 2003 FATF *Forty Recommendations* states that

[F]inancial institutions should pay special attention to any ML threats that may arise from new or developing technologies that might favour anonymity, and take measures, if needed, to prevent their use in ML schemes. In particular, financial institutions should have policies and procedures in place to address any specific risks associated with non-face-to-face business relationships or transactions.³¹⁸

FATF first delivered the specific *Report on New Payment Methods* in 2006, and then revised this to present a new version in October 2010, which noted new payment methods are substantially different from traditional transactions, and all countries should closely monitor these.

In regards to the increased ML vulnerability that accompanies these new methods of payment in the financial industry, the following aspects of risks should be considered:³¹⁹

Customer due diligence — Absence of ‘face to face’ contact is particularly common among technology based payment businesses. As recognised by FATF Recommendation 8, non ‘face to face’ transactions increase the risk of the product being used for illicit purposes by third parties.

Recording keeping — According to FATF Recommendation 10, both data related to identification and transaction records should be maintained for at least five years. These recommendations do not explicitly suggest the collection of Internet Protocol (IP) addresses of customers initiating a payment transaction through a personal

³¹⁸ FATF, *Forty Recommendations*, above n 7, 4.

³¹⁹ Financial Action Task Force on Money Laundering (FATF), *Money Laundering Using New Payment Methods*, October 2010.

computer.

*Value limits*³²⁰ — The higher the value and/or frequency of transactions, the greater the risk of ML.

Geographical limits — Cross-border functionality of new payment methods enables transactions to be conducted from jurisdictions where they may not be subject to adequate AML regulation and supervision, and where they may be outside the reach of foreign law enforcement investigations.

In China, local financial institutions will encounter more opportunities, as well as greater risks, of being used as vehicles for ML with the development of the economy, and, as a result, AML risk management needs to be strengthened by Chinese AML regulators. Efforts should be made to ensure that the new payment systems have appropriate security measures in place and include a watching brief on the potential impact of new technologies. They need to convey this knowledge to organisations. This can be done through the financial institutions own endeavours and/or through legislation and regulation to ensure the effective understanding and mitigation of the future technology-enabled crime environment.³²¹

5.2.2 Consideration of the Vulnerability of the Chinese Banking Industry to Money Laundering

ML vulnerability should be examined on the basis of sector-specific criteria for the banking, securities and insurance industries. Normally, the sector-specific criteria for the supervision of banking are the most detailed and extensive of the three sectors in recognition of the greater vulnerability of this sector. As most of the transactions in

³²⁰ See, FATF, *ML Using New Payment Methods*, above n 319, 26. The term ‘value limits’ refers to limitations on the maximum amount that can be held in an account or product; or limitations on the maximum amount per single payment transaction; or limitations on the frequency or cumulative value of permitted transactions per day/week/month/year; or a combination of the aforementioned limitations. Also the number of accounts or cards allowed per customer can be considered a type of value limit.

³²¹ Australian Institute of Criminology (AIC), above n 313, 43.

the securities and insurance markets are settled through cheques drawn on or through wire transfers from bank accounts, rigid AML programs conducted by banking institutions should benefit the securities and insurance markets. This benefit will accrue through the implementation of ongoing customer identification procedures and the checking of account activity that is inconsistent with the customer's business objective or profile.

In fact, Chinese regulators and practitioners should pay more attention to certain specific banking functions or products that are considered high risk activities and/or to particular suspicious transactions. These include private banking, offshore international activities, deposit taking facilities, wire transfer and cash management functions, transactions in which the primary beneficiary is undisclosed, traveller's cheques, official bank cheques, money orders, foreign exchange transactions, trade financing transactions with unusual pricing features, and payable through accounts.

Article 11 of *the Administrative Rules for the Reporting of Large-Value and Suspicious RMB Payment Transactions* (2006) listed 18 activities that are required to be reported as suspicious transactions by commercial banks, urban credit cooperatives, rural credit cooperatives, policy banks, trust and investment companies, with these including:³²²

- (1) Funds being moved out in large quantities after coming into a financial institution in small amounts and in many batches within a short period of time or vice versa, which obviously does not conform to identification of customer, financial position and business operations;
- (2) Receipt and payment of funds occurring between the same payee and payer

³²² 中国人民银行[People's Bank of China], *Administrative Rules for LV and Suspicious RMB Transactions*: Notice 2, above n 1. The term 'short term' refers to a period of 10 working days or less. The term 'long term' refers to a period of 1 year or more. The term 'a large number of' means that the amount of a single transaction or the accumulative amount of transaction is less than but adjacent to the threshold for large-sum transactions. The term 'frequent' means that 3 or more transactions are conducted on a single business day or a transaction is conducted each day but lasts for 3 business days or more.

frequently over the short term, and when the sum of transaction is close to the standards of LVTRs;

- (3) Legal persons, other organisations, firms created by self-employed persons frequently receiving remittance over the short term, which is obviously unrelated to their businesses; or natural persons frequently receiving remittance of legal persons and other organisations over the short term;
- (4) Bank accounts that have been idle for a long time being activated for unknown reasons or bank accounts that have been normally low in fund flows suddenly having abnormal in-flows of funds with large amounts of receipts and payments over a short period of time;
- (5) Where there is an obvious increase during a short time of flows of funds for customers or frequent receipt and payment of large amounts of funds for customers from areas, regions, countries or jurisdictions where drug trafficking, smuggling, terrorism, gambling and tax evasion through the use of an offshore financial centre are prevalent;
- (6) Several bank accounts being opened under the same accountholder's name and cancelled without proper reasons, or large amounts of receipts and payments of funds occurring before the cancellation of accounts;
- (7) Repayment of large value loans being made ahead of schedule, but not conforming to the person/entity's obvious financial position;
- (8) Most of the RMB funds of the customers for purchasing foreign currencies for overseas investment being cash or funds being transferred but not from the same bank account;
- (9) The customer asking for a 'swap transaction' between domestic and foreign currencies, but sources and purposes of the funds are suspicious;
- (10) The customer often depositing traveler's cheques written abroad or depositing drafts in foreign currencies, which do not conform to its business position;
- (11) Foreign-funded enterprises making investments in foreign currency cash, or after investment funds are in place, transferring them overseas quickly over a short period of time, which is not commensurate with their need for payment for production and operations;
- (12) Investment capital from the foreign party in foreign-funded enterprise exceeding the approved sum or the foreign direct debt borrowed being inwardly remitted from an unrelated enterprise in the third country;
- (13) Securities firms instructing the banks to transfer out funds that are unrelated to securities transactions and settlement, and which are not commensurate with their business position;
- (14) Securities firms frequently removing or borrowing foreign exchange funds in large amounts through the banks;

- (15) Insurance companies compensate or refund premiums for the same policyholders in large amounts though the banks;
- (16) Natural persons making frequent cash receipts and payments through bank accounts, or making one-time cash deposit and/or withdraw all at large values which are not consistent with the customer profile;
- (17) After having frequently received foreign exchange from overseas in their foreign exchange bank accounts, residents asking the banks to issue traveler's cheques or drafts, or non-residents asking the banks to issue traveler's cheques and/or drafts for them to bring out of the country, or frequently placing orders for and cashing traveler's cheques and drafts in large amounts after having frequently deposited foreign currencies in cash; and
- (18) Multiple residents within the border of China receiving remittance from one offshore account, where the transfer and purchase of foreign exchange is undertaken by one person or a few people.

The reporting requirements cover a range of indicators confronting China's banking sector, such as large numbers of transactions involving sums that are inconsistent with the customer profile, frequent transactions adjacent to the reporting threshold, activation or renewal of a dormant account, transactions from suspicious areas, swap transactions between CNY and foreign currencies, traveller's cheques, and transactions inwards or outwards involving a third country. However, this list of suspicious transactions is not comprehensive and has not included a series of key indicators associate with customer profile and associated account activities.

Bank customers include the persons or entities that maintain an account with the bank or those on whose behalf an account is maintained (that is, the beneficial owners) and the beneficiaries of transactions conducted by professional intermediaries. The account holder can be a customer that does not present himself or herself for interview at the bank (that is, a non 'face to face' customer) or one introduced to the bank by a third party. It may also be a legal entity (for example, a corporation or a trust) interposed between the ultimate beneficial owners and the bank, or a professional intermediary (for example, a mutual fund or a lawyer) depositing funds that it

manages for its clients.³²³

The BCBS states that:

[B]anks can only effectively control and reduce their risk if they have an understanding of the normal and reasonable account activity of their customers so that they have a means of identifying transactions which fall outside the regular pattern of an account's activity.³²⁴

For a better quality of suspicious transactions reports, examples of high-risk and/or suspicious activities should be listed, and should be included as part of AML procedures. Additional specific activities in the Chinese banking sector for which the risk of ML is relatively higher are:

- * Customers who use 'fronts' (for example, trusts, corporate, professional intermediaries) to open an account so as to hide their true identities;
- * Introduced business, where a bank may place undue reliance on the due diligence conducted by an introducer;
- * Concentration accounts³²⁵ that are frequently used to facilitate transactions for private banking, trust accounts, funds transfers and international affiliates;
- * Private banking³²⁶ operations, which by their very nature involve a large measure of confidentiality. The following factors may contribute to the vulnerabilities of private banking with regard to ML — perceived high

³²³ The Joint Forum, *Initiatives by the BCBS, IAIS and IOSCO to Combat Money Laundering and the Financing of Terrorism*, June 2003.

³²⁴ Basel Committee on Banking Supervision (BCBS), *CDD for Banks*, above 233, 13.

³²⁵ 'Concentration accounts' are internal accounts established to facilitate the processing and settlement of multiple or individual customer transactions within the bank, usually on the same day.

³²⁶ Private banking provides highly personalised and confidential products and services to well-heeled clients at fees that are often based on 'assets under management'. Private banking often operates semi-autonomously from other parts of a bank and caters to wealthy customers who seek confidentiality and personalised service.

profitability, intense competition, powerful clientele, the high level of confidentiality associated with private banking, the close relationship of trust developed between relationship managers and their clients, commission-based payment for relationship managers, a culture of secrecy and discretion developed by the relationship managers for the clients, and the relationship managers becoming client advocates to protect their clients.

- * Correspondent banking businesses, especially where banks do not fully understand the nature of the respondent banks' business, or if the respondents are shell banks or located in a jurisdiction which has poor KYC standards. Indeed, correspondent accounts might be used directly by third parties to conduct transactions on their own behalf. Banks thus ought to be particularly alert to the risks that arise from correspondent banking business.

5.3 Money Laundering Vulnerabilities in the Chinese Securities Sector

The few publicly reported instances of ML in the securities and futures market may result from the fact that in many jurisdictions, securities and futures brokers that are authorised to receive and hold customer funds do not, in most cases, accept such funds in the form of cash. For this reason, the securities and futures market may not lend themselves well to the 'placement' phase of ML. The volume and liquidity of international securities and futures trading, coupled with the increasing complexity of transactions, may render use of the securities and futures markets more attractive at the 'layering' and 'integration' stages of a ML scheme, where it may be more difficult to detect. In any event, as other financial sectors increase their defences against ML, it will be important to ensure that securities and futures markets do not become comparatively more attractive to money launderers.

5.3.1 Characteristics of the Chinese Securities Market

Since 1978, China has launched economic reforms designed to strengthen China's

economy by transforming the centrally planned economy into a market oriented economy. Having experienced ‘black market’ trading and ‘over the counter’ transactions, bonds and stocks were finally allowed to trade in the Shanghai and Shenzhen stock exchanges in late 1990 and early 1991 respectively.³²⁷

The source of all the problems in China’s stock market can be ultimately traced to the original intention of China’s government in permitting the issue of securities. This was to raise funds for the SOEs, rather than establish a trading market for securities’ holders. When the stock market was first established, a quota system was used under which the provincial government was given the responsibility of selecting their favourite SOEs for listing. This system had to be later abandoned due to its tendency to encourage corrupt practices. An observation which attests to the policy-based Chinese stock market is that almost all SOEs have good performance prior to their initial public offering (IPO), but their performance takes a turn for the worse immediately after listing.³²⁸ The irregular and policy-based Chinese stock market makes regulation in the securities sector difficult with regard to combating ML.

5.3.2 Considerations of Vulnerability to Money Laundering in the Chinese Securities Industry

Like the practice in most other countries, the securities services providers in China do not maintain cash deposit accounts for their customers. Rather, they require their customers to remit funds to them either by cheque or by wire transfer to the deposit account of the investment firm at a bank. In this end, primary detection of suspicious customers is highly reliant on the CDD conducted by banks. However, since the securities market provides versatile products which enable the conversion of investment portfolios involving both legal and illegal funds into cash and integrate criminal proceeds into the formal economic system, securities service providers have to comprehensively understand the inherent ML vulnerabilities associated with

³²⁷ Shiguang Ma, *The Efficiency of China’s Stock Market* (Ashgate, 2004) 7.

³²⁸ Nicolas Groenewold, Yanrui Wu, Sam Hak Kan Tang and Xiangmei Fan, *The Chinese Stock Market: Efficiency, Predictability and Profitability* (Edward Elgar, 2004) 5.

ongoing account activities after the initial use of securities accounts.

In addition, securities and futures transactions often involve a chain of multiple intermediaries, some of whom may be from different countries. Thus, when securities companies sign contracts with customers (for example, contracts in margin trading and stock index futures), the securities sales managers should be aware of the financial and income status, the experience of securities investment, the risk awareness and tolerance, and the investment preferences of the customer.³²⁹

The *Administrative Measures on Implementing Anti-Money Laundering Work in the Securities Sector* published by the CSRC was formally put into practice in October 2010. Regional offices of the CSRC are obliged to supervise the AML practice in the local securities business institutions under their jurisdiction, to establish information sharing system, to report the AML progress under their jurisdiction to the CSRC head-office biannually, and to report on the administrative investigations or penalties imposed on securities business institutions under their supervision as well as related significant events to the CSRC head-office in a timely manner.³³⁰

As the most detailed AML guidance in securities sector so far, Article 12 of *the Administrative Rules for the Reporting of Large-Value and Suspicious RMB Payment Transactions* (2006) listed 13 activities that are required to be reported as suspicious transactions by securities companies, futures broker companies, and fund management companies, including when.³³¹

³²⁹ 马经[Ma Jing], above n 67, 128.

³³⁰ 中国证券监督管理委员会 [China Securities Regulatory Commission], 《证券期货业反洗钱工作实施办法》 [*The Administrative Measures on Implementing Anti-Money Laundering Work in Securities Sector*], Notice 68 [2010], 1 September 2010.

³³¹ 中国人民银行 [People's Bank of China], *Administrative Rules for LV and Suspicious RMB Transactions*: Notice 2, above n 1. The term 'short period of time' refers to a period of 10 working days or less. The term 'long period of time' refers to a period of one year or more. The term 'a large sum of capital' means that the amount of a single transaction or the accumulative amount of transaction is less than but adjacent to the threshold for large-sum transactions. The term 'frequent' means that 3 or more transactions are conducted on a single business day or a transaction is conducted each day but lasts for 3 business days or more.

- (1) The customer settlement account frequently receives and pays capital in the sums close to the large-value cash transaction reporting standard without clear reasons, clearly indicating that the purpose of the operation is to evade the supervision of large-value cash transactions;
- (2) The customer without previous transactions or with a small sum of transaction demands to transfer a large sum of money to other accounts without a clear purpose or use for the transaction;
- (3) A customer whose securities account lies idle for a long period of time while the settlement account receives and pays large sums of capital frequently;
- (4) An account that has been idle for a long period of time starts operation suddenly and without clear reasons, and has a large amount of securities transactions during a short period of time;
- (5) A business relationship develops with high-risk money laundering countries or regions;
- (6) The customer buys and sells a large amounts of securities in a short period of time after opening an account and then closes the account;
- (7) The customer has none or a small amount of futures transactions for a long period of time and his or her settlement account receives and pays a large amount of capital;
- (8) The customer has no transaction for a long period of time and suddenly has frequent futures transactions during a short period of time without any clear reason, and the capital involved is enormous;
- (9) The customer frequently takes one futures contract as an object, opens at a certain price while at the same time opens in the reverse direction at approximately the same price, with the same amount or approximately the same amount before closing out and exiting to draw money;
- (10) At the completion of a business transaction involving imported commodities, a customer serves as the selling party of the futures transaction yet cannot provide completed customs declarations and tax payment receipts, or provides fabricated and false customs declarations and tax payment receipts.
- (11) The customer demands to transfer fund shares due to non-transaction reasons yet cannot provide legally certified documents;
- (12) The customer frequently processes the transfer of fund share ownership and without proper reason; and
- (13) The customer demands to change its registered information yet cannot provide the required supporting documents and materials clearing it of suspicion of fabrication and alteration.

Generally the above-listed suspicious transactions or activities target a number of

vulnerable factors in the Chinese securities sector, covering suspicions arising from cash transactions, the high volume of transactions, dormant accounts, transaction frequency, jurisdictional risks, customer identity, and fictitious trading. However, the indicators should be used on a ‘case by case’ basis because the Chinese stock market is full of speculative activities, and most of the securities transactions are irregular. The unpredictability of the market and the ease with which it is subject to manipulation made one of China’s most famous reform economists, Wu Jinglian, declare that China’s stock exchange is ‘more like a casino than a market’.³³² Under such circumstances, it is hard to determine what kinds of activities should be normal, usual, unusual, or suspicious.

For example, when a dormant account in the securities market is left unused for a long time and then a large number of transactions occur within a short period, it may involve suspicious activities. However, in China huge numbers of securities accounts are unused in bear markets and only activated in bull markets.³³³ Moreover, the monitoring of large or unusual transactions in the securities and futures markets as indicators of ML activity may be complicated by the complex trading strategies and transactions involving large sums of money, which occur frequently in those markets. Furthermore, aspects of transactions that appear ‘unusual’ in one financial sector may not be unusual in another, that is, the transaction may appear unusual to bankers but may be a routine transaction in the securities or futures markets. So far, there is no reporting threshold specifically designed for different financial sectors in China, but there is a reliance on a ‘one size fits all’ reporting requirement for all financial industries. As large sums of money are commonly involved in securities investments, it is suggested that the reporting standards in the securities industry be differentiated from those of other sectors.

Apart from the reporting rules made by the PBC, the Shanghai and Shenzhen stock

³³² Naughton, above n 142, 474.

³³³ 时延安[Shi Yanan], above n 73.

exchanges have also defined a numbers of suspicious transactions in the securities market. Some of these are possibly related to ML activities, and attention should be paid to these by counter staff in the futures companies as well. These transactions include:³³⁴

- 1) multiple securities accounts that are opened by using the same identity documents, business licences, or other documents used for proof of identity, and these accounts are served as counterparties in a large number of or frequent transactions;
- 2) multiple securities accounts that are under commission or authorised by the same institution or same agent, and these accounts are served as counterparties in a large number of or frequent transactions;
- 3) a large number of or frequent transactions conducted between two or more fixed or inter-related securities accounts;
- 4) frequent and successive transactions conducted within a specified period of time;
- 5) a large number of or frequent reverse transactions conducted at the same or similar price;
- 6) a large number of or frequent transactions conducted in the form of buying at a high price and selling at low price; and
- 7) conducting securities transactions which are inconsistent with investment analysis, prediction, or indications.

Compared to the PBC reporting rules, the suspicious transactions of ML activities defined by the Shanghai and Shenzhen stock exchanges provide a more detailed consideration of account activities, which should be added into the formal AML requirements by regulatory bodies. As China's stocks have a complicated structure which is classified by accessibility to A-shares, B-shares, H-shares and N-shares,³³⁵

³³⁴ 马经[Ma Jing], above n 65.

³³⁵ See, Shiguang Ma, *The Efficiency of China's Stock Market* (Ashgate, 2004), above n 327, 7. A-shares are allowed to traded among Chinese residents with domestic currency, RMB (CNY). The transaction currency for B-shares is USD in the Shanghai market and Hong Kong Dollar (HKD) in the Shenzhen market. B-shares were restricted to foreign investors until April 2001 when the B-shares market opened to Chinese residents, while H-shares and N-shares are available to foreign investors. A-shares and B-shares are listed on the Shanghai and Shenzhen stock exchanges, which usually exhibit different performance. H-shares and N-shares are listed on Hong Kong and overseas stock markets.

additional areas that need to be considered in the formal AML reporting system are associated with particular types of securities transactions and products, including cross-border transactions, transactions involving multiple jurisdictions or high risk jurisdictions, securities accounts set up on the basis of an introduction from one intermediary to another without adequate CDD/KYC, transactions conducted through correspondent accounts, transactions that show the customer is acting on behalf of third parties, transactions involving unrelated third parties or an unknown counterparty, internet/online accounts, and omnibus and private banking accounts.

5.3.3 Specific Factors in Vulnerability to the Risk of Money Laundering in the Securities Sector

ML in the securities and futures markets at the layering or integration stages might more likely be detected in circumstances where the suspect transactions also involve possible violations of securities and futures statutes or regulations. These include, for example, activities involving rogue employees, reciprocal trades, market manipulation, and insider trading.³³⁶ Due to the lack of information transparency and the ineffective implementation of regulation, incidences of market manipulation, securities fraud, and insider trading are not uncommon in China's stock market.

5.3.3.1 Rogue Employees

The activities of employees that are requested to take such illegal or ill-advised actions unwittingly and the activities of rogue employees who knowingly undertake activities in violation of the firm's internal controls and policies will further a customer's ML scheme. These can involve such actions as the establishment of bank and securities accounts in multiple jurisdictions on behalf of the customer and the transfer of funds and securities between such accounts in furtherance of a customer's ML scheme. While the risk of rogue employees is not unique to the securities sector,

³³⁶ See, FATF, *ML and TF in the Securities Sector*, above n 45. Insider trading is the trading of a corporation's stock or other securities by individuals with potential access to non-public information about the company. The term is frequently used to refer to a practice in which an insider or a related party trades based on material non-public information obtained during the performance of the insider's duties at the corporation or otherwise in breach of a fiduciary or other relationship of trust and confidence or where the non-public information was misappropriated from the company.

the types of activities these employees engage in may differ from those in the banking and insurance sectors.

5.3.3.2 Reciprocal Trades

Reciprocal trades in offsetting positions can generate profits in the account of one party and losses in the account of the other party. In this type of scheme, money launderers intentionally generate trading losses in a securities account into which criminal proceeds have been deposited and generated reciprocal trading profits in a seemingly unrelated securities account that cannot be easily identified or associated with the ML scheme. When the trades are liquidated, the profits are paid in the ordinary course through the clearance and settlement system from the account/party suffering the loss to the account/party earning the profit. Value can also be transferred between parties through the sale of shares in small, non-liquid issues at artificially arranged prices, without regard to a fair market value.³³⁷ Such schemes may or may not also involve an intention to generate additional profits by a manipulation of the value of the shares. These schemes often constitute a violation of the securities laws as well as a ML offence.

5.3.3.3 Market Manipulation

As mentioned earlier, China's securities market is such that any relevant implication of policy change or capital movement can influence the stock prices. Market manipulation is easily achieved by abuse of information by people with criminal intentions. Wang Jianzhong, a well-known investment consultant in China, was accused of market manipulation in November 2008. Wang Jianzhong used his influence in the investment consultant industry, and the advantage of being a special guest of TV program 'China Securities' on China Central Television (*Finance* (CCTV — 财经)), by recommending one or more stocks to the public and predicting that these would appreciate, after he had bought a large number of the stocks himself. As many people trusted his recommendations and predictions, the price went up in a short time, and Wang then sold the stocks to take a profit, and the share price was then

³³⁷ Joint Forum, *Initiatives to Combat ML and FT*, above n 323.

fell. During the period January 2007 to May 2008, Wang Jianzhong repeated this practice 55 times on 38 stocks or options, and earned more than CNY 125 million. After his prosecution, he and his Beijing Shangfang limited company had prison sentence of 7 years and a financial penalty of CNY 125 million imposed on them.³³⁸

When Wang Jianzhong came to know that the CSRC had started a criminal investigation into his activities, he asked three relatives to become involved in transferring his money. From June to September 2008, Wang Qianyi, Wang Jianhua and Zhao Zhihong, transferred Wang Jianzhong's illicit earnings of CNY 105 million, CNY 108 million, and CNY 172 million respectively. Since the three relatives are all locals of Anhui, the transferring accounts and other subsidiary accounts were all opened in Anhui, and the illicit money was ultimately transferred to Hefei (Anhui) and Anqing (Anhui). The large sums of money and frequent withdrawals of cash aroused the suspicion of the Hefei Central Branch of the PBC, and all of the three launderers were prosecuted under the ML crime in 2010.³³⁹ In fact, it was the first case of a ML crime where the predicate crime is market manipulation.

5.3.3.4 Insider Trading

Worldwide, most stock exchanges are self-regulating organisations. Market participants set up cooperative structures to police each other for mutual benefit. Unfortunately, in the Chinese market, at least until recently, widespread opportunities for collusion have inhibited the evolution of institutions for self-regulation. Three types of agents are most important to the Chinese market: managers, securities companies, and regulators. The managers of state-owned firms have a strong interest in securing an opportunity for listing. Securities companies have a monopoly over trading and listing procedures. All the securities companies until 2002 were 100 per cent state-owned companies, with these typically being owned by local governments. Securities companies had the flexibility to put parties together to make deals while

³³⁸ 曲瑞雪, [Qu Ruixue] 股市“铁嘴”汪建中的“罪与罚” [*Crime and Punishment* of Wang Jianzhong] (8 November 2010) <<http://stock.sohu.com/20101108/n277255540.shtml>>.

³³⁹ Ibid.

also holding substantial stakes themselves.³⁴⁰ The sectoral regulator, the CSRC, holds the ultimately power of permission to list, as well as regulatory approval of various transactions.

Corporate insiders are defined as company officers, directors and any beneficial owners holding more than five per cent of the company's equity securities. Holders of commercially sensitive information also include people outside the corporation as official approval for such a major activity, or 'big events', as becoming a listed company requires a number of procedures, involving various applications and examinations, and many governmental employees involved in these procedures may gain knowledge of commercially sensitive information of the listed company. The term 'big events' includes such activities as mergers and acquisitions, restructuring, issuance of securities, important contract signing, share repurchase, equity incentive, periodic reports, distribution programs, important appointments and dismissals of employees.

Current securities regulations in China do not define governmental officials in positions, who in their duties may have access to non-public information as 'insiders'. However, actual cases of illegal use of such information by governmental officials to make illicit profit through market manipulation and insider trading, such as the *Zhongshan Gongyong* (中山公用) Case and the *ST Gaotao* (ST 高陶) Case, have been perpetrated by governmental officials. The masterminds behind the *Zhongshan Gongyong Case* and the *ST Gaotao Case* respectively were the former Mayor of Zhongshan, Ms Li Qihong, and the former Director-General of the Nanjing Economic Commission, Mr Liu Chunbao.³⁴¹

³⁴⁰ Naughton, above n 142, 473.

³⁴¹ 中国证券报, [China Securities Journal], 25 June 2010.

In June 2010, the CSRC planned to promote a registration program for insiders, which program would cover both corporate insiders and governmental officials.³⁴² This program required that all people with access to inside information should provide relevant personal information and account details as requested, and should be registered under the regulatory system. All registered insiders should understand their responsibilities regarding information disclosure, information confidentiality, and information clarification, in the processes of planning and decision-making of ‘big events’. This registration program aims to deter insider trading activities, and provides a means for the detection, investigation, and prosecution after the actual incidence of insider trading or market manipulation.

5.4 Money Laundering Vulnerabilities in the Chinese Insurance Sector

The insurance sector plays a crucial role in enhancing the economic growth of a country. This sector plays an important role as both institutional investors and providers of loans to various industries. Despite playing such an important role, it is unfortunate that this sector has proven to be not adept at implementing protective measures against ML.

There are some factors that lead to the notion that the insurance sector is less susceptible to ML. First, policymakers in most countries perceive the insurance sector as an unattractive and difficult channel for ML to take place. This is due to the fact that the insurance sector offers a limited number of products and services to its clients. Secondly, there are various risk assessment methodologies which are applied before an insurance policy is issued to a customer. Such assessments appear to provide adequate control over the issuance of insurance policies. Thirdly, it is not easy to transfer money from one party to another in the insurance sector.³⁴³ However, it is

³⁴² Ibid.

³⁴³ Haemala Thanasegaran and Bala Shanmugam, ‘Exploitation of the Insurance Industry for Money Laundering: the Malaysian Perspective’ (2008) 11(2) *Journal of Money Laundering Control* 135, 137.

important that the ML vulnerabilities in the insurance sector be fully recognised by both practitioners and regulators.

5.4.1 Money Laundering Risk in the Insurance Industry

As in the other financial sectors, the insurance sector actually is highly exposed to money related criminal activities, especially ML. This sector has become an attractive venue for ML due to its very nature as a provider of reliable and 'clean' returns on the funds invested. A money launderer, who places illegal money into the insurance system and receives payment from the insurance company, has successfully legitimised his money.

ML through insurance institutions is typically carried out by disguising the origin and nature of illegal proceeds and gains obtained by buying, altering and surrendering insurance policies and filing insurance claims in ways that avert tracing by the authorities. There are variety ways of ML through insurance institutions, such as paying costly commissions to buy an insurance policy with illegal earnings and then selling the policy, and converting the illegal property by repeatedly trading it to break its ties with crime. Common methods of laundering money through insurance services include insurance policy transfer, the reinsurance business, abuse of insurance accounts, international insurance business, and bogus insurance investment.

FATF in 2005 highlighted several ML cases associated with the insurance sector worldwide. ML activities in the insurance sector are mainly related to life insurance products, general insurance, and reinsurance schemes. Examples of the type of life insurance contracts that are vulnerable to being a vehicle for laundering money are products such as unit-linked or with profit single premium contracts, single premium life insurance policies that store cash value, fixed and variable annuities, and endowment policies.³⁴⁴ Life insurance companies should be mindful of the risk

³⁴⁴ International Association of Insurance Supervisors (IAIS), *Guidance Paper on Anti-Money Laundering and Combating the Financing of Terrorism*, October 2004, 3.

associated with certain products or services not specifically being offered by life insurance companies, but that make use of the company's services to deliver the product. When a life insurance policy matures or is surrendered, funds become available to the policyholder or other beneficiaries. The beneficiary to the contract may be changed before maturity or surrender, so that payments are made by the insurer to a new beneficiary. A policy may also be used as collateral to purchase other financial instruments.³⁴⁵ These investments in themselves may be merely one part of a sophisticated web of complex transactions with their origins elsewhere in the financial system.

Examples of non-life insurance ML are also diverse. For example, a bogus claim can be made by the claimant or use arson or other destructive means in order to recover part of the illegitimate funds that were invested.³⁴⁶ Other examples include cancellation of policies for the return of the premium by an insurer's cheque, and again the overpayment of premiums with a subsequent request for a refund of the amount overpaid.³⁴⁷ ML can also occur through under-insurance, where a criminal can say that he received compensation for the full amount of the damage, when in fact he did not.

Granted, life insurance and non-life insurance can be used in different ways by money launderers. The vulnerability depends on factors such as the complexity and terms of the contract, distribution, method of payment and contract law. Insurers should take these factors into account when assessing this vulnerability. This means they should prepare a risk profile of type of business in general and of each business relationship.

5.4.2 Vulnerability Considerations of Money Laundering in the Chinese Insurance Industry

As early as 2005, the three biggest insurance companies in China, the People's Life

³⁴⁵ Ibid.

³⁴⁶ Thanasegaran and Shanmugam, above n 343, 138.

³⁴⁷ IAIS, above n 344.

Insurance Company of China (PLICC), the People's Insurance Company of China (PICC), and the Ping An Insurance (Group) Company of China Ltd were informed by FATF to prepare for examination at any time concerning AML.³⁴⁸ This demonstrates that the international community had noticed that an ML threat may exist in the insurance industry, and so it is urgent that AML actions be taken in this area. In China, insurance services may be abused for ML activities through unusual methods, such as the purchase of insurance policies, the unusual surrender of insurance policies, alterations in the contents of insurance policies, and the purchase of underground insurance policies from Hong Kong and Macao.

In particular, 'unusual insurance surrenders' refers to insurance policy holder asks to surrender the insurance that s/he bought before the maturity date without providing a reasonable explanation, and receiving a refund of part of the insurance premium or the cash surrender value.³⁴⁹ Unusual insurance surrender has long been prevalent in many economically developed areas, such as the Guangdong province and Zhejiang province. In 2003, 20 insurance policies sold by the Wenzhou branch of the China Pacific Insurance Group were subject to requests to surrender on the day after their purchase. These policies involved total insurance premiums of CNY 28.8 million. The surrender rate of life insurance policy in 2004 was 10 per cent, and the surrendered amount of insurance premiums reached CNY 30 billion. In 2006, the surrender rate of group insurance products in Shanghai was even as high as 85.59 per cent. Behind this stunning number of insurance surrenders, it seems life insurance products (especially group insurance) have been exploited by criminals for ML purposes.³⁵⁰

Suspicious signs of possible ML activities related to insurance surrender include:

- 1) the insurance buyer pays special attention to the insurance company's surrender rules rather than the guarantee function and investment revenue of the insurance

³⁴⁸ 熊海帆 [Xiong Haifan], above n 86, 2.

³⁴⁹ Ibid 101.

³⁵⁰ Ibid 102.

products;

- 2) the insurance holder claims that s/he lost the purchase receipt when requesting an insurance surrender during the ‘cooling off’ period; and
- 3) the person insists on surrendering the insurance policy with no concern for interest losses, and cannot provide a reasonable explanation for the surrender request.

Although the insurance sector in China was not covered by formal AML regulations before the enactment of the *AML Law* and new *AML Provisions by Financial Institutions*, the regulatory body in the insurance industry acknowledged that there were unusual transactions possibly indicative of ML in pertinent administrative rules and regulatory documents issued over the last decade. For example, when CIRC was just established in 1999, the organisation published *Notice No 15* (1999) concerning a series of unusual situations in life insurance market. The notice clearly requested that ‘when an insurance company pays for premium or surrenders insurance, all the transactions should be conducted through banks’, which direction is obviously related to an AML response. Later in October 2004, CIRC and the MPS published *Notice No 129* (2004) which reflected an emphasis on cracking down on illegal insurance policy transactions from abroad. This was done to mitigate the then prevalent phenomena of ‘underground insurance policies’, and to prevent dirty money being laundered by the purchase of underground insurance policies. By mid-2005, in order to standardise transaction procedures in the group insurance market, CIRC published *Notice No 62* (2005). This states that an

[I]nsurance company should require the insurer to provide the list of names of the insured person with associated certificate documents, ensuring that the insured person accepts the group insurance with full consent;

and

[W]hen the policy holder surrenders an insurance policy, the insurance

company should require the policy holder to provide a certificate which proves the insured person knows about the policy-surrender, and that all the transactions for the policy surrender should be transferred via banks to the original account.

These rules are directly aimed at ML undertaken through group insurance.³⁵¹

In addition, Article 13 of the *Administrative Rules for the Reporting of Large-Value and Suspicious RMB Payment Transactions* (2006) listed a number of activities that are required to be reported as suspicious transactions by insurance companies, including:³⁵²

- (1) Separate application but single withdrawal, or single application but separate withdrawal, without reasonable explanation being supplied;
- (2) Frequent applications, withdrawals, or alterations of insurance type and amount;
- (3) The policy holder pays unusual attention on the auditing, insurance examination, claim settlement, payment and withdrawal regulations of the insurance company instead of on the guarantee function of insurance products and the benefits of investment accounts;
- (4) The customer claims the loss of large-value invoices at the time of withdrawal and within the ‘cooling off’ period, or the same policy holder withdraws many times within a short period and the amount of loss of claims is large;
- (5) Relevant information obtained from or about the policy holder, insured and beneficiary (such as name, residential address, contact details and financial status) are not genuine;
- (6) Any obvious discrepancy between the purchased insurance product and the need presented, yet customers persist in buying even after the financial institutions and their staff explain the mismatch;

³⁵¹ Ibid 141.

³⁵² 中国人民银行 [People’s Bank of China], *Administrative Rules for LV and Suspicious RMB Transactions*: Notice 2, above n 1. The term ‘short term’ refers to a period of 10 working days or less. The term ‘long term’ refers to a period of 1 year or more. The term ‘a large number of’ means that the amount of a single transaction or the accumulative amount of transaction is less than but adjacent to the threshold for large-sum transactions. The term ‘frequent’ means that 3 or more transactions are conducted on a single business day or a transaction is conducted each day but lasts for 3 business days or more.

- (7) The customer purchases large value insurance by single payment of the premiums but this does not conform to its economic status;
- (8) For large value insurance, the customer withdraws during the ‘cooling off’ period or shortly after the effective date of insurance contract for withdrawal of cash, and requests the insurance companies to remit any premiums to be returned into a third party’s account or other accounts other than the payment account.
- (9) The customer pays no attention to the great economic costs that may be borne through withdrawal and insists on withdrawing without reasonable explanation;
- (10) The customer pays an obvious extra premium payable for the term and then requires the return of this excess almost immediately;
- (11) The insurance broker pays premiums on another’s behalf but fails to state the source of the funds;
- (12) The legal persons and other organisations insist on requiring the premiums to be returned in cash or transferred into a non-payment account without reasonable explanation;
- (13) The legal persons and other organisations pay the first period of premiums or single premiums from an account other than that of their entity or from their overseas bank account;
- (14) Payment of the premiums for an individual through a third party without reasonable explanation of the relationship between the third party and the policy holder, the insured and the beneficiary;
- (15) The business is related to a country and region with high money laundering risks;
- (16) The policy holder insists on using cash to insure, indemnify, pay premiums, in the withdrawal of premiums or for the surrender value of insurance policies, or to pay other funds large amounts and without proper explanation; and
- (17) The customer requires the insurance companies to remit the funds to a third party other than the insured and beneficiary when the insurance company indemnifies and pays premiums, or the customer requires the insurance companies to remit returned premiums and insurance policy value to persons other than the policy holder.

The reporting rules provide insurance companies with a series of suspicious activities, including applying for business outside the policy holder’s normal pattern of business, requesting an insurance product that has no discernible purpose for the investment or is inconsistent with the client’s insurance needs, conducting any transaction involving

an undisclosed party or with a person without any apparent connection with the policy holder, requesting the purchase of a large lump sum contract where the policy holder has usually made small, regular payments, applying for insurance business yet showing no concern for the performance of the policy but more interest in the terms for early cancellation of the contract, and applying for lump sum payments by a wire transfer or with foreign currency.

In addition, the reporting rules emphasise the vulnerability to ML of third-party payments and third-party involved transactions. Third-party payments refer to insurance policies funded by a third party, a person or entity other than the policy holder, and who has not been subject to the regular identification procedures when the insurance contract was entered into, and the identification of the source of funds and the relationship between the policy holder and the third party is unclear to the insurance company. A third party may be involved in insurance policies when there is early termination of a product and/or the refund cheque is to a third party, when the benefit of a product transfers to an apparently unrelated third party, or and when a customer attempts to use a third-party cheque to make a proposed purchase of a policy.

Generally, given the ML activities in the Chinese insurance market, four factors associated with the product's characteristics should be examined: 1) Is it convenient for insurance surrender?; 2) Does it have an investment or saving function?; 3) Does the business transaction involve large values of money?; and 4) Does the policy allow 'one off' payments? If any answers to these are 'yes', these insurance products should be regarded as high-risk products possibly involving ML. However, other more complex factors should also be taken into account, such as when multiple parties are involved in an insurance policy and associated involvement of parties over a geographical range.

In the insurance business, several parties can be involved in transactions that may

raise the possibility of ML: the insurer, the policy holder, the insured person and the beneficiary. The risks are assessed with respect to the duration, benefits, early surrender and designation of beneficiaries. Financial institutions should identify the beneficial owner when the beneficiary of a life insurance policy or trust contract is not the customer.³⁵³ When identifying the beneficial owner in practice, there are two difficulties. One is that it is difficult for financial institutions to know whether there is a so-called actual controller or beneficial owner, and the other difficulty is how to determine the scope of beneficial owner in the case where there are multiple beneficial owners involved in a policy and there are sophisticated structures between beneficial owners and the customer. Thus, counter staff of insurance companies should be alerted to any lack of information or any delay in the provision of information required to enable verification process to be completed, and any change in the designated beneficiaries. Situations where a business relationship could be used to establish bona fides prior to verification should be also paid special attention. These can occur in business involving group pension schemes, non ‘face to face’ business, premium payments made before the application has been processed, and the use of an insurance policy as collateral.

Furthermore, business in the insurance sector may be related to ML activities when it involves unusual geographical characteristics. This includes an application for a policy from a potential client in a distant place where a comparable policy could be provided closer to home, or contracts that are introduced by an agent/intermediary in an unregulated or loosely regulated jurisdiction or where organised criminal activities or corruption are prevalent, or when the transaction involves a cross-border payment where the first or single premium is paid from a bank account outside the country.³⁵⁴

Other international transactions requiring examination are the payment of premiums

³⁵³ ‘Beneficial owner’ refers to a person who enjoys the benefits of ownership though the title is in another name, and/or any individual or group of individuals that, either directly or indirectly, has the power to vote or influence the transaction decisions regarding a specific security. Introducing the concept of the beneficial owner to CDD is helpful for financial institutions to identify whether customers are doing transactions for someone else’s benefit, and to determine who is in charge of the final control and who is the ultimate beneficiary of the transaction.

³⁵⁴ Thanasegaran and Shanmugam, above n 343, 140.

from a foreign bank account or the payout of policies to a foreign jurisdiction, and complex transfers of money via bank accounts or cheques through different jurisdictions, as this complicates the control of the source of funds by the insurance company. Other transactions concern foreign customers and customers domiciled abroad who seek insurance policies via domestic or foreign intermediaries.

5.4.3 Vulnerabilities to Insurance Intermediaries and Rogue Employees

5.4.3.1 Insurance Intermediaries

The insurance industry has several ways to market its products. Some companies sell insurance directly to the customer and have their own agents, and some companies use intermediaries. These intermediaries could work exclusively for the company or sell products for more than one company. Intermediaries in insurance, independent or otherwise, are important direct links for distribution, underwriting and claims settlement between the policy holder and the insurance company. A person who wants to launder money may seek an insurance intermediary who is not aware of, or does not conform to, necessary procedures, or who fails to recognise or report information regarding possible cases of ML. Therefore intermediaries should play an important role in AML activities by carefully conducting appropriately thorough CDD measures. Alternatively, an intermediary could have been specifically set up to channel illegitimate funds to insurers.³⁵⁵ Sometimes insurance companies use other companies in the same group to market its products, for example, ‘over the counter’ sales at bank branches,³⁵⁶ and this is common in Chinese financial markets.

Indeed, collusive behaviour may take place either between the customer and the broker/intermediary or between the intermediary and the insurance company. The intermediaries involved accept illicit funds and transfer these in exchange for high commissions. Thus, it may be necessary to request intermediaries and third parties to perform the following CDD elements:

³⁵⁵ Ibid 138.

³⁵⁶ Joint Forum, *Initiatives to Combat ML and FT*, above n 323.

- identification and verification of customers, using reliable, independent source documents, data or information;
- identification of the beneficial owner, and taking reasonable measures to verify the identity of the beneficial owner, to the extent that the intermediary or third party is satisfied that they know who the beneficial owner is. This includes taking reasonable measures to understand the ownership and control structure of the customer, and
- obtaining information on the purpose and intended nature of the business relationship.

5.4.3.2 Rogue Employees and ‘Orphan’ Insurance Policies

High liquidity and lack of quality training of sales people in the Chinese insurance market increases the incidence of ‘orphan’ insurance policies, and the policy termination rate.³⁵⁷ In addition, casual sales staff’ working behaviour may create ML vulnerability as well, such as premium discounts and policy misrepresentation, and perhaps a failure to carefully follow CDD procedures.

‘Orphan’ insurance policies are policies where the agent who sold these policies has shifted to another company, and the person who bought these policies no longer has an agent or an intermediary, the person who would otherwise help service the policy. This is a common problem in the life insurance business in China, because an agent will frequently do anything to sell a policy. The agent receives a substantial commission when the insurance policy is sold, but if another company offers a better deal, the agent will leave straight away.³⁵⁸ Therefore, staff of insurance companies should be trained to a recognised qualified level of competence necessary for performing their duties.

Insurers should ascertain whether their appointed agents or intermediaries have the

³⁵⁷ 李薇 [Li Wei], 中国寿险业经营风险研究 [Research on Operational Risk in China’s Life Insurance Industry] (PhD Thesis, 辽宁大学 [Liaoning University], 2009). Note: ‘orphan’ policies refers to policies where the initial insurance company agent or intermediary involved in selling the policy to the client terminates his or her association with the insurer, and the policy holder (and their policy) has then has no active intermediary.

³⁵⁸ Ibid.

appropriate ability and integrity to conduct insurance activities in an ethical manner, taking into account potential conflicts of interest and other relevant factors. This may include an examination of the financial background of the employee.

In order to mitigate the vulnerability of the insurance industry to rogue employees and orphan insurance policies, insurance entities need to strengthen their screening and training of employees. More specifically, employees who deal with new business and the acceptance of new policyholders, claim settlement, and premium collection or the payment of claims need more specific training on AML procedures. Directors and senior management should also assume responsibility for supervising or managing staff, and for auditing the AML system in their respective insurance companies.

5.4.4 Vulnerability as a Result of Internal Controls in the Chinese Insurance Sector

As ML vulnerability in the insurance sector cannot be ignored, the duty of vigilance in deterring criminals from making use of insurance entities for illicit purposes consists of following elements: a) underwriting of cheques; b) verification of identity; c) recognition and reporting of suspicious customers/transactions; d) maintenance of records; and d) training. However, deficiencies in the internal controls of most small-and-medium sized Chinese life insurance companies present a series of weakness in combating ML. These include:

- (1) lack of explicit descriptions of self-regulation roles and inadequate systematic guidance, and, in some small companies, the lack of pre-event and between-event regulatory measures;
- (2) compliance functions that cannot be fully implemented because relevant compliance work is allocated to an internal auditing department or business law departments — most life insurance companies have no independent compliance regulatory systems; and
- (3) internal auditing — many life insurance companies are not independent enough and have little credibility, and emphasise post-event auditing and

financial supervision rather than pre-event risk analysis and between-event risk control.

Therefore, to guard against participation by insurers in ML, top priority should be given to formulating special departmental measures to ensure the implementation of AML systems in the insurance market. This is best done by establishing an office to take charge of AML work in an insurance company and to implement AML working procedures at different levels of the insurer's administration. This would include implementing reporting measures for suspicious transactions similar to those of the banking industry and ensuring that all doubtful policy transactions are brought to the regulator's attention. The next step is to establish an internet information platform and, for the purposes of AML, a policy analysis system in regard to large and suspicious transactions. The system should be capable of collecting information about suspicious policies and unusual transactions as well as about dealers, and then classifying and tracing those transactions. Standards that provide automatic alerts should be established in the systems with such alerts immediately logged to supervisory offices.

5.5 Money Laundering Vulnerabilities Associated with Mixed Business in the Chinese Financial Sectors

Since 1995, the Chinese financial industry has operated under separate business frameworks. However in recent years, with increased business cooperation and innovations among the banking, securities, and insurance sectors, the boundaries have been broken between what were separate markets.³⁵⁹ Mixed business in different financial sectors accelerated the funds movement between various areas. These included the capital market, the money market, the banking industry and the insurance industry, but this also increased cross sectoral ML risks.

Under the existing legal framework in China, there is some fee-based business between commercial banks and securities companies, including banking securities

³⁵⁹ 郭纹廷 [Guo Wentin], above n 156.

transfer services, the stock trading settlement services on commission, and trusteeship services. In terms of scope, the 'banking securities transfer services' refers to the service of mutual transfers between accounts of bank deposits and accounts of securities margins provided to clients through such methods as savings counters, telephone banking services and the EFTPOS system of the bank; while 'stock trading settlement services on commission' refers to receipts through the current account of a stock investor that is handled by the bank but the bank acts as an agent of the securities company when a stock transaction takes place. Banks can also undertake trusteeship services for securities companies, which mainly provide agency services for open-end funds.³⁶⁰

Business cooperation between commercial banks and insurance companies exists in the Chinese financial sector as well. This is called the 'bank insurance model' (BIM) and is also sometimes known as a 'bancassurance' service. A client may complete the whole range of insurance operations from effecting insurance and paying premiums to buying a policy and preservation at a savings outlet of a bank. It is the most prevalent means of banking-insurance cooperation. Under current financial regulations in China, an insurance company is allowed to conduct repurchase transactions in the inter-bank bond market. Apart from this, funds in the insurance sector can also be indirectly placed in the stock market through securities investment funds or directly integrated into the stock market.

Another question relevant to ML risks arises in relation to the cross-selling of products within mixed financial groups. The issue is whether simplified CDD would be acceptable in cases where one member of a group is approached by a customer from a different arm of the group. Indeed, the bancassurance service has been a very profitable channel for both commercial banks and insurance companies in recent years. It is reported that the original premiums in the first three quarters of 2010 reached CNY 826.3 billion, and more than 50 per cent of this business came from

³⁶⁰ Ibid.

bancassurance services.³⁶¹ Although commercial profit in the BIM is attractive, the improper selling activities of insurance products are an obvious risk as well. It has been demonstrated that some sales representatives of insurance products in banks assigned by insurance companies take advantage of the valuable customer resources of commercial banks, and the customers' trust in the commercial banks, to introduce and sell insurance products in an improper way, which results in serious damage to the image and reputation of commercial banks.

In this regard, the CBRC published the *Notice for Further Strengthening Compliant Selling and Risk Management of Insurance Agent Business in Commercial Banks* in 2010.³⁶² This notice aims to mitigate risks in bancassurance services that damage the customer's legal rights, and increase the service level of insurance products sold in commercial banks. According to the Notice, sales representatives assigned by insurance companies are no longer allowed to provide services in commercial banks, and all insurance products available for direct selling at commercial banks should be sold by banking staff with a certificate that qualifies them as able to do business as insurance agent. Besides, in principle, each bank outlet can only cooperate with no more than three insurance companies in their agent businesses. If the bank has more demands for insurance agent business, the bank should ensure their prudential operations and make reports to the local offices of the CBRC. The limited number of insurance companies forces banks to choose insurance companies with higher reputations, capacity, and competitiveness, and reduces the operational risks in bancassurance services.

One of the issues that should be highlighted is the need for supervisors to explore issues surrounding cross-sectoral risk transfer. Supervisors and firms should improve

³⁶¹ Ibid.

³⁶² 中国银行业监督管理委员会[China Banking Regulatory Commission], 《关于进一步加强商业银行代理保险业务合规销售与风险管理的通知》 [*Notice for Further Strengthening Compliant Selling and Risk Management of Insurance Agent Business in Commercial Banks*], Notice 90 [2010], 8 November 2010.

their understanding of the effectiveness of operational risk transfer mechanisms. Firms that take on risk should have in place adequate risk management and measurement systems. Supervisors should share information within and across sectors to most effectively keep pace with developments in the market involving operational risk transfer. In order to prevent cross-sectional risk transfer regarding ML (for example, when a bank introduces a customer to a financial institution from the securities sector), the securities institution could assume CDD has already been strictly done by the bank; however, customer identity and related business relationships should be rechecked.

CDD by members of cross-sector financial groups, for example, creates unique issues not present where a financial institution operates in a single sector or on a ‘stand alone’ basis.³⁶³ This means that the independent sector should combine to a certain degree, or establish a monitoring committee which has systems and processes in place to monitor the identity of customers of the entire group, and be alert to customers that use their services in different sectors. Indeed, a customer relationship issue that arises in one part of a financial group would risk the reputation of the whole group. Preventing mixed business from being abused through ML requires efficient coordination of information exchange, legislative regulation, and daily supervision and practice. Effective risk management in one sector, in return, will reduce the compliance cost associated with mixed business to another participating sector.

5.6 Comment and Conclusion

Capital movements rest on the payment and settlement services provided by financial systems, and financial institutions are favoured by money launderers as such institutions have a wealth of financial instruments available to be used for large-value funds transfer and there is also the capability for capital conversion by various means. ML activities are closely integrated with financial products and payment methods,

³⁶³ Joint Forum, *Initiatives to Combat ML and FT*, above n 323.

such as wire transfer services, forged commercial documents, bearer bonds, securities products, insurance policies, and new payment methods. With the growth of the socialist market economic system, there has been great development of diverse forms of ownership in China's economy. The organisational structures and ownership relationships of market players are becoming increasingly complicated. In the meantime, the constant development of financial markets and innovation in financial products provide greater choices for investment or speculative activities generating more attractive channels for money launderers. These changes include trust funds, trust management, asset management, and online banking businesses. In addition, when rogue employees from financial institutions are involved, specific ML activities will be conducted more professionally.

Indeed, according to the 2008 AML Annual Report published by the PBC, the statistical data for the distribution of predicate crimes for prosecuted ML cases shows that the crimes of disrupting the financial management order and financial fraud ranked first and second respectively. Those two types of predicate crimes together accounted for 44.4 per cent of the total number of ML cases prosecuted in 2008,³⁶⁴ which is apparently higher than for other predicate crimes. This proportion was reduced in the 2009 report, when they accounted for 36 per cent of the total number of prosecuted ML cases in 2009.³⁶⁵ The financial sectors have been the leading AML battlefield in China since 2002, yet the largest proportion of predicate crimes of ML is still directly related to financial institutions, financial services, and financial products. This data may suggest that laundering in relation to 'traditional' crimes (such as smuggling and drug trafficking) does not generate investigation of the associated ML. However, it also partially reflects the ineffectiveness of ML risk management in the Chinese financial sectors.³⁶⁶

³⁶⁴ 中国人民银行 [People's Bank of China], 《2008 年中国反洗钱报告》 [*Anti-Money Laundering Annual Report* (2008)], September 2009.

³⁶⁵ 中国人民银行 [People's Bank of China], *AML Annual Report* (2009), above n 250, 28.

³⁶⁶ Lishan Ai, John Broome and Hao Yan, 'Carrying out A Risk-Based Approach to AML in China: Partial or Full Implementation?' (2010) 13 *Journal of Money Laundering Control* 394, 397.

All financial entities that by the nature of their business are vulnerable to ML should have effective AML programs in place. This would enable them to (i) determine the true identity of existing and prospective customers and, where there are transactions involving an entity acting on behalf of another, to take steps to verify the identity of the underlying principal; (ii) recognise and report suspicious transactions to the law enforcement authorities and financial supervisors; (iii) ensure that compliance departments regularly monitor the implementation and operation of AML systems; (iv) ensure cooperation across different financial sectors; (v) prevent the ML risks from spreading from one sector to another; and (vi) develop practical AML approaches on the basis of risk consideration.

Chapter 6. MONEY LAUNDERING RISK-RATING SYSTEM AND ENTERPRISE-WIDE ANTI-MONEY LAUNDERING INFORMATION SOLUTION SYSTEM IN CHINESE FINANCIAL INSTITUTIONS

The Chinese AML regulatory body provides separate lists of suspicious transaction activities in the banking, securities, and insurance industries. The problem of using this approach is that, if action is entirely dependent on the financial institutions, it may encourage staff to largely focus on these particular transactions and thereby miss or overlook other problems. These listing-style monitoring systems are designed on the basis of regulatory rules that detect certain laundering behaviours rather than individual suspicious transactions, and so tend to produce a high number of false positive alerts.

This chapter attempts to explain the importance of developing combined functions of ML risk-rating systems and enterprise-wide AML information solution systems. In order to enhance the risk management capacity and efficiency concerning combating ML activities, financial institutions should carefully determine, analyse, and grade associated risks associated with customers and business operations. Taking particular national characteristics into consideration, relevant risks — even if they are not identified by international standards setters — should be examined if it is possible for them to be exploited by money launderers in a particular country. On the other hand, enterprise-wide AML information systems based on subjective assessments can facilitate the production of valuable results that can be further used by law enforcement agencies.

6.1 Synergistic Function of Money Laundering Risk Rating system and AML Information Solution

As presented in previous chapters, Chinese consumers have diversified their financial activities from traditional bank deposit and withdrawal services to investment, financing, professional financial management, and insurance businesses. Versatile financial activities conducted via different channels, especially high-tech methods,

will require a higher capacity for managing ML risks in financial institutions. Constant attention and maintenance at all levels are required as high risk activities and regulatory expectations have altered in the course of the modern economic environment. In order to insure appropriate procedures are in place to protect the financial institution from being used as a conduit for ML, financial institutions need to have processes and procedures in place for assessing the ML risk in providing designated services, customer identification and verification, ongoing CDD,³⁶⁷ and employee due diligence.³⁶⁸ They also should conduct training sessions on how to complete the risk rating procedures and how to better understand the risk rating process.

The PBC published the *Notice for the Purpose of Further Strengthening the Anti-Money Laundering Work in Chinese Financial Institutions* on 30 December 2008, which announced the implementation of a customer risk grading system in financial institutions. This required that:

- a) financial institutions shall complete, before the end of 2009, the risk grading of the customers with whom they established business relationships from 1 August 2007 to 1 January 2009;
- b) financial institutions shall complete, before the end of 2011, the risk grading of the customers with whom they had established business relationships before 1 August 2007, but established no new business relationships after 1 August 2007; and
- c) financial institutions shall, within ten working days after the establishment of business relationships, complete the classification of the clients with whom they establish business relationships after 1 January 2009.³⁶⁹

³⁶⁷ It refers to measures for checking the identity of customers and checking that their financial activity matches that identity.

³⁶⁸ It refers to measures for screening employees to ensure they do not expose your business to ML risk, for example, checking their identity and their background to ensure they are of good character, ensuring they are suitable.

³⁶⁹ 中国人民银行 [People's Bank of China], *Strengthening AML in Chinese Financial Institutions: Notice 391*, above n 2.

The notice also requires that ongoing CDD should be conducted to find out the natural persons who actually control the account, and the real beneficiaries of transactions. EDD on foreign politically PEPs is also required to be conducted. Both of these actions are responses to the ‘non-compliant (NC)’ classifications in relation to AML requirements on foreign PEPs and beneficial owners attributed by FATF to those operations in its mutual report in June 2007. In fact, however, as at the end of 2011, there is no evidence or announcement by the PBC that the designated goals of the 2008 PBC Notice have been achieved in practice.

Under the current situation, the key point to consider is how do supervisory and regulatory sectors maximise their guidance of financial institutions to effectively practise CDD rules on the basis of risk profiles, and ensure that the customer risk rating provisions are practically enforced rather than only existing ‘on paper’. Customer risk rating is just a part of what makes up a nation’s comprehensive ML risk identification system. More consideration of risks should be paid to business interface, products and services, and geographic jurisdictions as well. Indeed, a former IMF officer Mr. B commented that:

*[A] pillar of sound AML risk management is the ability to accurately identify, measure and categorise risk. Financial institutions need to assess risks associated with remittances, acceptance of deposits, brokers and dealers in securities, sellers of insurance products, issuer of credit cards, custodians of securities and transfer agent for mutual funds. They also need to analyse and categorize customers, correspondents, transactions, lines of business, products, and business locations to assess areas of vulnerability and to determine the best use of limited resources. This includes risk identification and categorisation of customers, correspondents, products and locations...*³⁷⁰

Thus, in order to make the financial sectors less vulnerable to ML abuse, it is plausible to adopt ML risk management mechanisms which acts against the likelihood of ML risks faced by individual financial institutions and involve financial services.

³⁷⁰ Interview with Mr. B, Former IMF Officer (Cambridge, Twenty-Eighth International Symposium on Economic Crime, 8 September 2010).

These mechanisms include enterprise-wide AML programs and financial entity regulation. The risk management mechanism contains two main components: the ML risk rating system, which measures the existing risk of ML in the financial institution under the regulation of the AML program, and the enterprise-wide AML information solution that measures the effects of an enterprise-wide AML program quality on the vulnerability of the financial institution to ML.

6.2 Index of Money Laundering Risk Rating System

6.2.1 Customer Risk Rating Index

To increase the institutions' attractiveness under the high pressure of market competition, financial institutions have enlarged their business scope and operational strategies to provide more versatile services according to changing consumer demands. For instance, Citibank US targets and categorises customers according to their age, gender, location, preferences, occupation, education level, income level, capital assets ownership and so on, and recommends the most suitable financial products and services pertinent to the needs of the individual customer.³⁷¹ Following this practice, if profit seeking activities can take advantage of profiling customers, why not use the same strategy in compliance operation in the form of developing a rating system to assess different levels of ML risk according to customer profiles?

To some extent, there is a 'win-win' result if customer profiles are created that can possibly be used for both profit seeking purposes and compliance. No further additional costs would be incurred if the customer has been profiled when opening their account or when establishing a business relationship with a financial institution, and when a standard verification on this customer is needed, the initial customer profiling should provide enough information for compliance purposes. However, it is

³⁷¹ 孙蓉, 彭雪梅, 胡秋明 [Sun Rong, Peng Xuemei and Hu Qiuming] 《中国保险业风险管理战略研究: 基于金融混业经营的视角》 [Strategic Research on Risk Management in the Chinese Insurance Industry: From the Perspective of Financial Mixed-Business] (中国金融出版社[China Financial Publishing House], 2006) 31.

only applicable for standard verification, and extra costs will definitely be incurred for checks relating to enhanced customer identity verification. In addition, the initial customer profile should be conducted carefully and include detailed customer information including location, occupation, education and income level, and capital asset ownership, and so on.

For example, when initially profiling a customer opening a new account there are three ways of considering risks. One is as ‘a new customer’, and one is as ‘a new customer who wants to carry out a large transaction’, and the other is as ‘a customer who can be persuaded that s/he needs more or different services’. This basic difference will affect future compliance work. Other examples of suitable profiling categories include ‘a customer or group of customers making lots of transactions to the same individual or group’, ‘a customer who has a business which involves large amounts of cash’, ‘a customer whose identification is difficult to check’, and ‘a customer who comes from jurisdictions with prevalent drug dealings’, and so on.

Conducting risk assessment based on customer profile may help the reporting entity to consider other factors relating to customers and take decisions regarding these customers’ risk ranking from an appropriate angle. According to the *AUSTRAC Guidance Note: Risk Management and AML/CTF Programs*, the reporting entity should consider whether³⁷²

- a) the customer is involved in a complex business ownership structure with no legitimate commercial rationale
- b) the non-individual customer (for example, a trust, company or partnership) has a complex business structure with little commercial justification, which obscures the identity of ultimate beneficiaries of the customer
- c) the customer is in a position which may expose them to the possibility of corruption
- d) the customer is based in, or conducting business through or in, a

³⁷² Australian Transaction Reports and Analysis Centre (AUSTRAC), *AUSTRAC Guidance Note: Risk Management and AML/CTF Programs*, September 2007, 11–13 [5.5].

- high-risk jurisdiction
- e) the customer is engaged in business which involves significant amounts of cash
- f) there is no clear commercial rationale for the customer seeking the designated service
- g) the customer is a PEP
- h) an undue level of secrecy is requested regarding a designated service
- i) the source of funds is difficult to verify
- j) the beneficial owners of a non-individual customer are difficult to identify and/or verify
- k) the beneficial owners of the non-individual customer are resident in a high-risk jurisdiction
- l) there is a one-off transaction in comparison with an ongoing business relationship or series of transactions
- m) a designated service can be used for money laundering;
- n) the customer makes or accepts payments (for example, electronic transfers) to or from accounts which have not been identified by the reporting entity
- o) the customer makes or accepts payments (for example, electronic transfers) to or from offshore accounts
- p) the customer makes withdrawal, transfer or drawdown instructions by phone or fax
- q) the customer has access to offshore funds (for example, cash withdrawal or electronic funds transfer)
- r) the customer when migrating from one designated service to another carries a different type and level of ML risk
- s) the customer has income which is not employment-based or from a regular known source
- t) the customer is new rather than having a long-term and active business relationship with the reporting entity
- u) the customer's business or provision of designated services is primarily of a money remittance service nature
- v) the customer's business is registered in a foreign jurisdiction with no local operations
- w) the customer's business is an unregistered charity, foundation or cultural association
- x) the designated services provided to the customer are primarily of a private banking and/or wealth management kind
- y) the customer is represented by another person.

Financial institutions may find it difficult to put in place a customised and robust system. Thus, client screening should be developed based as a 'step by step' approach and on a combination of factors directly related to their specific areas of risk.

6.2.1.1 Domestic Politically Exposed Persons (PEPs)

In order to comply with AML legislation and effectively protect themselves from risk, financial institutions are obliged to screen their existing and prospective customers to identify PEPs,³⁷³ together with their relatives and close associates. PEPs, by the nature of their position and authority, can access and move around substantial funds and, in some cases, may abuse this position for personal gain, or for that of their family or other close associates. Of course, the vast majority of PEPs are not corrupt officers, and they are potentially very valuable customers for financial institutions.

All FATF members show deficiencies in relation to dealing with PEPs. Recommendation 6 of the FATF *40 Recommendations* requires financial institutions to have in place the relevant risk management systems to identify PEPs. The explanatory note outlines how the definition of PEPs should also include those who hold prominent domestic positions, but does not make this a recommendation. However, according to the result of the FATF's mutual evaluation in 2008, low compliance levels would indicate that no country in the FATF has sufficient procedures in place.³⁷⁴ The virtual non-compliance with Recommendation 6 leaves plenty of room for those in positions of authority to take advantage of a global financial network to invest their funds wherever they choose.³⁷⁵

The FATF *Forty Recommendations* provides the following definition of PEPs:

- a) current or former senior official in the executive, legislative, administrative, military or judicial branch of a foreign government (elected or not);
- b) a senior official of a major foreign political party;
- c) a senior executive of a foreign government owned commercial enterprise, being a corporation, business, or other entity formed by or for the benefit of any such individual;

³⁷³ A politically exposed person is a term used by the Financial Action Task Force to refer to individuals who are or have been entrusted with prominent public functions in a foreign country. For example heads of state, senior politicians, senior government, judicial or military officers, senior executives of state-owned corporations, and important political party officials.

³⁷⁴ Johnson, 'In Pursuit of Dirty Money', above n 19, 16.

³⁷⁵ Johnson, 'Little Enthusiasm for Enhanced CDD', above n 40, 298.

- d) an immediate family member of such individual; meaning spouse, parents, siblings, children, and spouse's parents or siblings; and
- e) any individual publicly known (or actually known by the relevant financial institution) to be a close personal or professional associate.³⁷⁶

The Wolfsberg Group definition, on the other hand, has a broader definition for PEPs including:³⁷⁷

- * members of the ruling royal family;
- * senior and/or influential representatives of the religious organizations (if these functions are connected with judicial, military or administrative responsibilities);
- * senior judges;
- * senior party functionaries; and
- * senior and/or influential officials, functionaries, and military leaders and people with similar functions in international or supranational organizations.

Interviewee Mr. B commented that

*[T]he definition of politically exposed persons has presented implementation difficulties. Issues related to the definition problem include high level position, sufficient influence and control, lower ranking officials and petty corruption, or close associates...*³⁷⁸

Although there is great variation in the definitions of PEPs, regulators all agree that financial institutions should focus their efforts on monitoring senior PEPs and former PEPs. A real concern is whether PEP monitoring should be extended to domestic PEPs and other individuals exercising functions not normally considered prominent but having a political exposure comparable to that of those at a prominent level or with similar positions. In fact, if the AML and anti-corruption concerns are to be addressed it must be applied to domestic PEPs.

In general, PEP refers to an individual who is or has been entrusted with prominent public functions. The *Third EU Directive*, for example, stipulated that only those public functions exercised by a customer at a national level are regarded as

³⁷⁶ FATF, *Forty Recommendations*, above n 7.

³⁷⁷ Choo, 'PEPs: Risks and Mitigation', above n 41, 373.

³⁷⁸ Interview with Mr. B, above n 370.

‘prominent’. It is further stipulated that where the extent of political exposure at lower (that is, local) levels is comparable to similar positions at the national level, it is at the discretion of the reporting institutions to decide, depending on the level of risk, whether or not these individuals should be regarded as PEPs.³⁷⁹

Indeed, if the purpose of identifying PEPs is to become aware of the possibility that they may become involved in corrupt practices — that is, that they represent a laundering risk factor — it is not clear why middle ranking and junior officials are to be excluded from the PEP category. Perhaps it is assumed that the more central the role of the PEP in national politics, the larger the scope of potential corruption and reputational risk associated with the PEP’s role. This, however, is not necessarily always the case.

Among the top 10 political/administrative roles having the greatest perceived risk of involvement in ML, illicit payments, corruption and other illegal activity, as included on the Dow Jones Watchlist, are:

1. Heads & Deputies of State/National Government
2. Senior Members of the Armed Forces
3. National Government Ministers;
4. Senior Members of the Secret Services;
5. Heads & Deputy Heads of Regional Government;
6. Political Pressure and Labor Group Officials;
7. City Mayors
8. Political Party Officials
9. State Corporation Executives
10. Senior Members of the Police Services

Only city mayors were not considered PEPs in any of the PEP definitions currently available.³⁸⁰ The FATF definition is not intended to cover middle ranking or more

³⁷⁹ Liliya Gelemerova, ‘On the Frontline against Money-Laundering: The Regulatory Minefield’ (December 2008) *Crime, Law & Social Change*.

³⁸⁰ Kim-Kwang Raymond Choo, ‘Challenges in Dealing with Politically Exposed Persons’ Trends & Issues in Crime and Criminal Justice No 386, Australian Institute of Criminology, February 2010) 2. Dow Jones Watchlist – Top 10 High-Risk Roles are also available at http://www.solutions.dowjones.com/watchlist/highriskroles/?from=moneylaundrying_prbulletin22sep

junior individuals in the foregoing categories. However, the level of corruption of the middle ranking or more junior individuals in China is serious enough that it should not be ignored. The use of PEP profiles remains moderate in China, and the reason for this is, ironically, the incomplete information provided by the MPS, PBC or the social security department.³⁸¹

In regards to domestic customers with prominent public functions, relevant information gathered from other competent authorities, such as the property declaration system (PDS), could provide a useful reference. The PDS is a system that requires a specific group of people to truthfully declare their property and income in accordance with relevant laws and regulations in China. One such example is the *Chinese Civil Servant Law* implemented on 1 January 2006. Furthermore, the Central Office and State Council jointly released the *Rules on Personal Matters Reporting by the Leading Cadres* on 11 July 2010. The leading cadres include all cadres above deputy county level (including deputy county level) in the government and political agencies at all levels; all cadres' positions that are equivalent to or above deputy county level cadres in People's Organisations and public service units; and all members of leadership teams in large and extra large SOEs, state holding companies (including state-owned financial enterprises and state holding financial enterprises) and mid-level leaders of medium SOEs, state holding companies (including state-owned financial enterprises and state holding financial enterprises).³⁸²

The abovementioned leading cadres should report changes to their marriage status, immigration or residential status and that of their spouses and children, as well as the occupation and other details of their spouses and children. They also should report their property ownership, including their income, real estate, financial investment and

08&segment=PFA/compliance>.

³⁸¹ Asian Banker White Paper, *Identifying Anti-Money Laundering Issues in Chinese Banks* (2009) 10.

³⁸² 新华社, [Xinhua News Agency] 关于领导干部报告个人有关事项的规定 [*Rules on Personal Matters Reporting by the Leading Cadres*] (11 July 2010) at <<http://politics.people.com.cn/GB/1026/12111916.html>>.

other matters.

From a regulator's perspective, Mr. J stated:

*[I] believe that the focus should be on any high value and complex transaction, regardless of whether or not the transactor is a PEP, and whether or not it is an overseas or domestic person/entity.*³⁸³

While as a compliance officer from one of the biggest commercial bank in China, Mr.

W noted:

*[F]ATF recommendations do not mandatorily require financial institutions to conduct EDD against domestic PEPs, and since EDD will involve significant outlay of resources, it is therefore not commercially viable to engage in such activities.*³⁸⁴

In fact, only a very small number of FATF members have fully or partly complied with the domestic PEP requirement. These include Mauritius (fully compliant), Qatar (fully compliant), Hong Kong (partially compliant), Mexico (partially compliant), Indonesia (partially compliant), and Thailand (partially compliant) and so on.³⁸⁵ The low compliance level on domestic PEPs could create a favourable situation for criminals and corrupt PEPs who do not have to look far to infiltrate the global financial system. Whether to include domestic public office holders in existing PEP definitions is still a question without proper answer or response. However, it is necessary to understand that PEPs are potential targets for bribes due to their prominent position in public life since they have a higher risk of corruption due to their access to state accounts and funds.³⁸⁶

To combat ML risks posed by PEPs, there is a need for ongoing monitoring of risks

³⁸³ Interview with Mr. J, Former AML Regulator, Australia (Cambridge, the Twenty-Eighth International Symposium on Economic Crime, 9 September 2010).

³⁸⁴ Interview with Mr. W, AML Compliance Officer, Hong Kong (Shenzhen, 12 October 2010).

³⁸⁵ Choo, 'Challenges in Dealing with PEPs', above n 380, 5.

³⁸⁶ Ibid.

by regulated entities. Arguably, PEP monitoring should be extended to individuals holding prominent public functions in their own jurisdictions and individuals exercising functions not normally considered prominent but with political exposure comparable to that of similar positions at a prominent level.³⁸⁷

6.2.1.2 Financially Exposed Persons (FEPs)

Another question is whether to extend PEP monitoring to individuals holding important positions in the private sector, that is, FEPs. As a type of financial crimes that takes place on the threshold between the illegal and the legal economy, ML can be facilitated by using power. There are two dimensions of power related to this crime. To begin with, in order to speak of ML, the money needs to be ‘earned’ in the illegal economy by means of criminal acts, which often implies the use of violence or illegal pressure to acquire ‘power’ over funds. This power is subsequently transformed into ‘legal power by converting the money from illegal into seemingly legal revenues.’³⁸⁸

Enhancing and consolidating their position in the legal economy is crucial to money launderers. In order to create a beautiful mask for their illicit funds and avoid suspicion, money launderers need to explore the potential to gain influence in the world of legal corporations, investments and opportunities. As the growth of business requires new forms of business relationships — with lenders, co-investors, IPO underwriters and advisors — this inevitably leads to higher public exposure and function, and may be abused by possible money launderers, hence the need for more transparency.³⁸⁹ In Belgium, most wealthy people are suspected of ML,³⁹⁰ while in China, none of the most wealthy people dare to say his/her money is 100 per cent clean.

³⁸⁷ Choo, ‘PEPS: Risks and Mitigation’, above n 41.

³⁸⁸ Antoinette Verhage, ‘Power-Seeking Crime? The Professional Thief versus the Professional Launderer’ (2009) 51 *Crime, Law & Social Change* 399, 402.

³⁸⁹ Gelemerova, above n 379.

³⁹⁰ Verhage, ‘Power-Seeking Crime?’, above n 388, 411.

The magazine, the Hurun Report,³⁹¹ published the *Special Report of China Rich List* in August 2009, which pointed out that among all those 1330 names previously on the Hurun China Rich List from the decade 1999–2009, 49 of them have faced an ‘unforeseen event’, and 19 people had even been sent to prison or were under the process of criminal prosecution for their crimes.³⁹² Thus the Hurun List has also become known as the ‘Bad Luck Rich List’ After several occurrences of persons being prosecuted and convicted soon after their name appearing on this list, many of the most wealthy people in China prefer living a really low profile lifestyle in order to protect their real identity or avoid public attention in order to prevent the unwanted attention that accompanies being included on the list.

Indeed, in recent years, there has been an increasing concern about ML cases involving high net worth individuals who are or have been entrusted with prominent public functions and whose wealth is obtained by illegal means (for example, corruption).³⁹³ In one instance, a leading Chinese oil executive, Li Rongxing, was given the death sentence for embezzling more than USD 4 million and taking USD 620,000 in bribes.³⁹⁴ In addition, one of China’s wealthiest businessmen, Zhang Rongkun, was sentenced to 19 years in prison for his involvement in a social security fund scandal. Zhang received over USD 25 million that was embezzled from Shanghai’s social security fund. He was also convicted of bribing government officials with a total of over USD 4 million in bribes.³⁹⁵ Assuming that political and economic spheres have been infiltrated by criminal activities, and this may result in criminals gaining legitimate power, it may be argued that the monitoring on public figures should be extended to a wider range, such as the CEOs of listed companies, as these individuals are no less vulnerable to being corrupted.

³⁹¹ *Hurun Report*, founded by Rupert Hoogewerf in 1999, is a monthly magazine best-known for its ‘China Rich List’, a ranking of the wealthiest individuals in China.

³⁹² 广州日报, [Guangzhou Daily] 胡润中国富豪特别报告出炉 [*Hurun Special Report of China Rich Comes Out*] (29 August 2009) <http://news.163.com/09/0829/07/5HS8MAQ20001124J_2.html>.

³⁹³ Choo, ‘PEPs: Risks and Mitigation’, above n 41, 372.

³⁹⁴ Richard G Brody, and Robert Luo, ‘Fraud and White-Collar Crime: A Chinese Perspective’ (2009) 16(3) *Cross Cultural Management* 317, 322.

³⁹⁵ *Ibid* 323.

6.2.2 Operational Risk Rating Index

6.2.2.1 Customer's Business Operations

Apart from conducting a multi-tiered CIP from simple account opening, record keeping procedures and EDD for higher risk accounts, proactive account monitoring for suspicious activities should also be undertaken. Indeed, identification of customers with a high ML risk and investigating their associated operations, covering at the least non 'face to face' transactions, cross-frontier correspondent banking, and PEPs is necessary.³⁹⁶

Financial institutions are required to keep updating customer information collected under CDD processes and to undertake reviews of existing records of their customers, in particular those in higher risk categories of product/services, designated services, country/jurisdiction, and business delivery methods/channels. Lower risk customers are also categorised so that financial institutions can improve AML efficiency by taking simplified CDD procedures for these.

In the FATF methodology manual, non-resident customers, PEPs, private banking, and legal persons or arrangements that are personal assets holding vehicles, such as trusts, are recognised as having higher risk. On the other hand, examples of customers where the risk may be lower could include financial institutions under rigorous regulation, public companies, life insurance policies, and insurance policies for pension schemes. Financial institutions are advised to determine the risk level of a customer based on combined rating of all relevant customer information and account activities. Some examples of relevant high risk categories in relation to customers' business operation are provided in the table below.

Table 6.1: Examples of High Money Laundering Risk Categories³⁹⁷

Products and Services	Designated Services
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³⁹⁶ Handoll, above n 312, 158.

³⁹⁷ De Wit, above n 49, 163.

<ul style="list-style-type: none"> * private banking; * offshore activities; * deposit taking; * wire transfers an international activities; * transactions with undisclosed beneficiaries; * loan guarantee schemes; * traveller checks; * bank checks; * money orders; * foreign exchange transactions; * trade finance; * payable through accounts; and * pre-paid credit cards 	<ul style="list-style-type: none"> * opening an account; * accepting deposits or allowing withdrawals; * making a loan; * issuing a debit or credit card; * supplying goods through a finance lease; * supplying goods by way of hire purchase; * issuing traveller's cheques; * providing remittances services which transfer money or property; * certain superannuation-related transactions or services; * issuing or accepting liability under life insurance policies; * issuing or selling securities and derivatives; and * exchanging foreign currency
Country/Jurisdiction	Business Delivery Methods/Channels
<ul style="list-style-type: none"> * any country or particular region of a country in which you may do business; * any country subject to trade sanctions; and * any country known to be a tax haven, source of narcotics or other significant criminal activity 	<ul style="list-style-type: none"> * online/internet; * phone; * fax; * email; and * third-party agent or broker

6.2.2.2 Business Operations of Foreign Invested Enterprises (FIEs)

When talking about geographic risks relating to ML, normally this refers to the risk level pertaining to the geographic location of a customer's registered account. However, geographic risk can also be attached to transaction operations involving different types of currency. The *Chinese Anti-Money Laundering Law* requires financial institutions to report large and suspicious transactions that give warning signs ('red flags') to the CAMLMAC. Most of the suspicious reports are related to domestic individuals or legal entities and FIEs may not be heavily targeted as domestic enterprises in China. Hence, authorities should be particularly cautious (and suspicious) about FIE activities that appear legal but are unusual in certain aspects. These aspects may include, the following:

- i. when a FIE makes an equity investment in China with newly injected funds from foreign sources (instead of its locally-retained profits) and the investment is not consistent with the FIE's regular operational scale or needs;

- ii. after receipt of a capital investment from its foreign investor, an FIE transfers the capital fund overseas and the quick fund transfer is not in line with the FIE's normal operational scale or needs;
- iii. a foreign investor makes a capital investment in an FIE in an amount greater than the FIE's approved registered capital;
- iv. a foreign investor makes a capital investment in an FIE in an amount greater than the FIE's loan borrowed from a foreign lender;³⁹⁸ and
- v. a foreign investor gives capital contribution to an FIE and the capital originates in a country where the foreign investor has no affiliates.

The *Chinese Anti-money Laundering Law* was formulated to uphold the China's commitment to a fair financial market. By adhering to this new Law, foreign investors and FIEs will ultimately contribute to the benefit of everyone involved. Currently, most of non financial FIEs are still not under China's AML reporting system. However, foreign invested financial institutions, as a category of FIEs, are authorised reporting entities with full obligations to comply with China's AML legislation and regulation.

In recent years, the number of foreign bank subsidiaries in China has substantially increased. For these institutions, full compliance with local AML requirements is expected by Chinese authorities, and foreign bank subsidiaries are subjected to examination, just like any other bank. It is important therefore that they understand the local laws and regulations thoroughly, identify any differences from their home country requirements, and that they modify their group policies where necessary to accord with the Chinese AML requirements.

Business operations and the corresponding AML practices of foreign invested financial institutions are crucial to the general effectiveness of AML operations in China. For instance, there are numerous foreign banks and multinational banks

³⁹⁸ According to PRC laws, the amount of debt allowed for an FIE is based on, but usually greater than, the FIE's approved registered capital.

operating in China. In this situation, financial institutions may use the difference in regulation between the host country and their home country to not fully practise their AML compliance. Normally, AML regulations in the countries of origin of most Western foreign banks in China are stronger than the *Chinese AML Law*. These foreign banks may have capacity to act in a manner more highly compliant to AML goals, but they may prefer not to do so, and their home regulators turn a blind eye to the conduct. For one thing, Chinese law is relatively soft and has lots of loopholes. Moreover, the home regulators of these foreign banks probably may be less concerned about the local environment of another country in which it is operating. Thus, if these foreign banks compliance standards are less strict than in their home countries, or even in their Chinese operations act in breach of some of the home regulations, they may stay safely in China without any financial penalty or administrative punishment for their non-compliant activities.

In fact, the regulations on foreign branches and subsidiaries were not taken seriously by Chinese authorities. FATF made an evaluation of ‘non-compliant in relation to China’s effort of AML regulation of financial branches and subsidiaries. FATF pointed out that ‘there is no requirement for foreign branches and subsidiaries of Chinese-funded financial institutions to apply the higher standard where the AML requirements of China and the host country differ’, and that ‘there is no explicit requirement to inform the home country supervisor when a foreign branch or subsidiary is unable to observe appropriate AML measures’.³⁹⁹

Thus, the unusual business operations conducted by non-financial FIEs should be examined, and the regulations on foreign bank subsidiaries in China should definitely be enhanced. How these institutions comply with both local Chinese AML regulations and their home AML regulations should also be examined in a timely fashion by Chinese regulators.

³⁹⁹ FATF, *First Mutual Evaluation Report*, above n 53.

6.2.2.3 Rogue Employees' Law Breaking Activities

Operational risks may be generated inside financial institutions when rogue employees conduct secret law-breaking activities for illicit purposes. Two former employees of China Construction Bank, Zhou Limin and Liu Yibing, were executed for defrauding bank customers of approximately USD 50 million by offering bogus accounts which they said would earn higher interest rates. In another example, a corrupt banker, Yu Zhendong, was sentenced to 12 years in prison for embezzlement and ML involving over CNY 1 billion. Yu had fled to the US after committing his crimes and returned to China based on the promise that he would not be executed for his offences. Yu was the first corrupt Chinese official to be repatriated since China ratified the *United Nations Convention against Corruption*.⁴⁰⁰

Due to the existence of the shadow economy, there may be parallel operations within a financial institution: one operational area may be well-behaved, and the other may greedily seek laundered funds. In this regard, employees from all levels of a financial institution should be monitored via employee due diligence measures, and rogue employee risk should be considered as a part of the operational risk index. Suspicious indicators associated with rogue employees may include:⁴⁰¹

- a. The employee appears to be enjoying a lavish lifestyle inconsistent with his or her salary or position;
- b. The employee is reluctant to take a holiday or vacation;
- c. The employee is subject to intense job-related demands, such as sales or production goals, that may make him more willing to engage in or overlook behaviour that poses ML risks;
- d. The employee puts a high level of activity into one customer account even though the customer's account is relatively unimportant to the organisation;
- e. The employee is known to be experiencing a difficult personal situation, financial or other;
- f. The employee has the authority to arrange and process customer affairs without supervision or involvement of colleagues;

⁴⁰⁰ Richard and Luo, above n 394.

⁴⁰¹ Financial Action Task Force on Money Laundering (FATF), *Money Laundering and Terrorist Financing in the Securities Sector*, October 2009, 45.

- g. The management/reporting structure of the financial institution allows an employee to have a large amount of autonomy without direct control over his activities;
- h. The employee is located in a different country than his direct line of management, and supervision is only carried out remotely;
- i. A management culture within the financial institution focuses on financial reward over compliance with regulatory requirements;
- j. The employee's supporting documentation for customers' accounts or orders is incomplete or missing; and
- k. Business is experiencing a period of high staff turnover or is going through significant structural changes.

To conclude, ML risks faced by financial industries mainly comprise macro factors, systematic factors, and micro factors, including AML regulatory and legislative quality, the business scale of the financial institution, service and product variety, and internal factors affecting AML implementation in the financial institution. It is expected that financial institutions could use modern management strategies and information solutions to analyse, predict, access, and produce warnings of ML risks in financial sectors that better accord with national conditions. This will allow the conversion of post-event action to pre-event prevention through effective risk mitigation and control processes involving the monitoring stage, identification stage, and diagnosis stage.

6.3 Risk-Centred Approach for an Enterprise-Wide Anti-Money Laundering Information Solution System

The FATF *First Mutual Evaluation on Anti-Money Laundering and Combating the Financing of Terrorism* in June 2007 clearly points out that the reporting system appears to operate principally as a rules based unusual transactions regime. The majority of reported transactions can be reconciled quite simply with the customer's expected profile, but that reporting is still mandated.⁴⁰² The Report further suggests that the Chinese AML system should put significant emphasis on improving the overall effectiveness of the system. The Report also observed that the lack of

⁴⁰² Ibid 93.

subjective assessment by reporting institutions is obvious.⁴⁰³

Regarding the research and development of AML information system solutions, most of the previous work in Chinese focused on how to utilise data mining and business intelligence techniques to improve the deficiencies of the pre-established data filtering system. Jun Tang proposed to use the technique of behaviour module detection in AML applications, and Shenggang Yang and Chenghu Zhang looked into use of the data mining technique in ML detection.⁴⁰⁴

The IT industry is a facilitator and has proved to be a powerful engine for the development of AML practices. As a key part of an entire risk management mechanism, enterprise-wide AML information systems can assist financial institutions to identify, access, and control legal risks, operational risks, and reputational risks, and safeguard the soundness of financial institutions. For most Chinese financial institutions, data quality remains a challenge. Chinese banks have invested in information technology (IT) software and process modification when mandated by regulators. Generally most banks opt for cheap and basic ‘off the shelf’ systems which only satisfy the basic regulatory requirements and put the regulator at ease.⁴⁰⁵ However, these low-tech monitoring tools, which focus on detecting and flagging but not on the accuracy of these alerts, do not assure comprehensive suspicious transactions reporting, and where reports are made they are often useless because the underlying data is incorrect.

6.3.1 Development of an Enterprise-Wide AML Information Solution System

6.3.1.1 Defensive Filing in Suspicious Transaction Reports

‘STRs based on objective standards’ refers to a monitoring system utilising pre-established indicators for ML activities which automatically provides an alert

⁴⁰³ Ibid 97.

⁴⁰⁴ Lishan Ai and Jun Tang, ‘Risk-Based Approach for Designing Enterprise-Wide AML Information System Solution’ (2011) 18(3) *Journal of Financial Crime* 268, 269.

⁴⁰⁵ Asian Banker White Paper, above n 381, 9.

when those indicators are detected. In line with the principle of objective standards, regulatory departments are not interested in the dollar value of these flagged transactions in the STRs, but in the reporting result *per se*. That is, if when the regulator is conducting a regulatory examination of a financial institution, the regulator finds that the financial institution has failed to make a report involving an unusual indicator, a monetary fine or administrative penalty will be imposed on the financial institution. At the initial stages of Chinese AML practice there was a situation where staff of financial institutions universally lacked an awareness of reporting requirements and detection capacity in relation to suspicious ML activities. As a result the traditional monitoring system with pre-established indicators was introduced to improve these two shortcomings at that time. However, these pre-established indicators are public knowledge because they are listed in regulatory publications and AML legislation and so are possible to evade by money launderers. Previous experience demonstrated that the inevitable consequence of the traditional monitoring system based on objective standards is the prevalence of defensive filing. Faced with the sanctions from the regulatory authority for failure to report, financial institutions instinctively act in a self-protective way and choose the a course characterised by the following comments regarding reporting strategies — ‘make the report if the suspicious transaction is not assured’, ‘reporting is better than non-reporting’, and ‘the more reports the better’⁴⁰⁶ —directly subverting the original intention of creating an effective AML mechanism.

6.3.1.2 Monitoring Approach — from Objective Standard to Subjective Assessment

As rule-based AML approach and objective-standard monitoring principles have led to numerous practical problems, a significant tendency of regulatory reform to counterbalance those effects is to replace the objective-standard principle with a comprehensive risk-assessment process with consideration of the realities associated with the enterprise. Current AML legislation in the US only sets the objective

⁴⁰⁶ 高增安 [Gao Zengan], 《反洗钱: 可疑交易行为报告制度有效吗? 》[Anti-Money Laundering: Is Suspicious Reporting System Effective?] (2007) 4 证券市场导报 *Securities Market Guidance Paper*, 17–22.

thresholds for LVTRs. Instead of making any systematised financial transactional typologies or outlining a quantified determining criterion, the US AML authority hands the AML priorities of identifying, determining and dealing with suspicious transactions to individual financial institutions.⁴⁰⁷ It requests that the financial institution and its working staff perform their AML activities more pro-actively and with a greater sense of responsibility.

With regard to improving the law enforcement process and dealing with defensive filing, the Financial Crimes Enforcement Network (FinCEN) has worked with the FFIEC to publish and amend the *Bank Secrecy / Anti-Money Laundering Examination Manual* (hereafter the *BSA Manual*) in three consecutive years from 2005. The *BSA Manual* instructs examiners to focus on evaluating a bank's policies, procedures, and processes to identify and analyse suspicious activity, rather than on a bank's decision with respect to any individual case.⁴⁰⁸ Thus, banks should not be criticised for failure to file an STR unless the failure is significant or accompanied by evidence of intentional 'bad faith'. In addition, the UK — as the earliest country which applied STRs in 1986 — has gradually encouraged financial institutions in recent years to take any measures with a whole-hearted commitment to assist regulatory bodies tracing suspicious transaction activities.⁴⁰⁹

6.3.1.3 Principles for Designing a Risk Centred AML Solution

To reflect the shift in regulatory reform from objective standard principles to subjective assessment principles in designing information systems are changes in the traditional monitoring system with pre-established data filtering indicators in the transaction database being substituted by to an enterprise-wide AML risk assessment process. The new system utilises various risk analysis tools to meet the requirements of risk updating and risk removing activities, and assesses the risk level based on

⁴⁰⁷ 史秀芬, 邸志强 [Shi Xiufen and Di Zhiqiang], 《借鉴美国经验, 完善我国反洗钱体系》[Learning from American Experience: Improving Chinese AML System] (2004) 1 理论纵横 *Theoretical World* 11, 16–19.

⁴⁰⁸ Federal Financial Institutions Examination Council (FFIEC), *BSA/AML Examination Manual*, above n 236, 56.

⁴⁰⁹ Jason Kingdon, 'AI Fights Money Laundering' (2004) 5 *IEEE Intelligent System*, 87.

probability calculations. Risk analysis should penetrate every business's internal procedures, including CDD; the amount, flow, frequency of transactions; business background; and the associated individual or organisations of the transacted capital.

From the perspective of analysis granularity (a measure of web transactions or computer data on transactions), an accountable risk level score can only be eventually made according to a comprehensive analysis on behaviour patterns, which consist of individual and multiple transactions in temporal sequence, and the relationships among the transacted accounts, the transacted account holder, and the financial institutions of the transacted account holder. Apparently, designing the subjective principle information system is much more complex than designing the pre-established data filtering project. Via this reform of the objective standard principle to a RBA, a heavy burden of primary data analysis carried out by the FIUs is transferred to the institution with the best knowledge of the customer: the financial institutions themselves. In this way, high-quality information can be layered and filtered from financial institutions' massive reports and then submitted to the FIU for subsequent analysis and investigation, achieving practical effectiveness in the AML monitoring system.

In particular, principles for designing an enterprise-wide AML information system include:

- 1) Comprehensive Principle — enterprise-wide AML information systems should be based on KYC rules, and comprehensively consider and assess indicators and information of jurisdiction, industry, identification, transaction purpose, and transaction features of customers.
- 2) Qualitative and Quantitative Combination — as well as assessing qualitative indicators of a customer such as his/her nationality, industry, and occupation, quantitative factors of the customer should also be analysed; including transaction amount, transaction frequency, and transaction scale. The risk of money laundering

posed by a customer can only be properly assessed based on a combined analysis.

- 3) Dynamic Principle — due to the restrictions from political, economic, and market factors, criteria of risk ranking or risk categories should not be kept the same all the time. In order to ensure the establishment of concrete money laundering risk grading, financial institutions should conduct dynamic and ongoing management of risk analysis process.
- 4) Confidential Principle — risk indicators and risk scoring standards of an enterprise-wide AML information system should be regarded as ‘inside information’ for a financial institution, and should be strictly kept confidential.

6.3.2 Content of an Enterprise-Wide AML Information System

An enterprise-wide AML information system consists of all kinds of ML risk assessment systems, ranging from the ‘front end’ client reception to the background analysis.

6.3.2.1 Customer Due Diligence (CDD)

As the first step of the risk analysis process, customer reception in financial institutions is subject to strict examination by regulatory bodies, and it is the basic instrument in the implementation of KYC rules. The *BSA Manual* published by the FFIEC also emphasises the purpose of CDD. FFIEC states that:

[T]he objective of CDD should be to enable the bank to predict with relative certainty the types of transactions in which a customer is likely to engage, and these processes assist the bank in determining when transactions are potentially suspicious.⁴¹⁰

An effective AML compliance program includes due diligence around the account opening process. This must meet the requirements identified in the CIP, including

⁴¹⁰ Federal Financial Institutions Examination Council (FFIEC), *BSA/AML Examination Manual*, above n 236, 56.

customer identity verification, and determination of the actual beneficial owner and the actual account holder. Financial institutions should comply with due diligence legislation to verify the identification of the customer, and, if necessary, check the watch lists of high risk customers. Based on determining the nature and purpose of transactions, the CDD system should be able to anticipate account activity according to the amount transacted, the frequency of transactions, the objectives of capital flow, and the geographic factors. Apart from the basic compliance requirements in due diligence and account opening, this module should combine the enterprise's internal control, internal audit, and customer relationship management.

6.3.2.2 Watch List

A relevant watch list should be carefully checked both at the due diligence stage and the link analysis stage. It also represents an important reference for the case management module in the workflow tools. Watch lists are periodically released by law enforcement agencies or related international organisations. The primary functions of watch lists are:

- *Allowing organisations to monitor all transactions involving certain individuals, relationships, products, organisations, or countries;
- *Identifying and generating automatic reports on particularly risky entities, such as high-risk and non-cooperative jurisdictions determined by FATF, countries under international sanction, PEPs, and high-risk transaction activities performed by particular individuals or organisations which are under investigation or penalties from law enforcement agencies; and
- * Establishing “zero risk” or “no problem absolutely customers” — Since it is common to involve frequent transactions with large amount of funds for a large-scale enterprise, a “zero risk” or “no problem absolutely customers” list can exempt some big enterprises with high reputation from reporting during a certain time period. Enterprises on the zero risk list may be changed from time to time

according to their actual business behaviour.

6.3.2.3 Transaction Risks

Abnormal account transaction analysis is an analytical methodology based on in-depth experiences. This requires staff carrying out the analysis to have a sound knowledge of all kinds of normal trading behaviours, such as normal trading patterns in the real estate industry and the usual payment methods for senior managers of a corporate body. The idea is that the staff involved in analysis, would be more knowledgeable than counter staff, and would be immediately aware when abnormal behaviour occurs.

According to the determination criterion of STRs designed by the PBC, transaction risks can be summarised into the following three categories:

- (1)Fund-Related Behaviours — Transactions that are possibly involved with money-laundering activities or transactions that evidently disguise the origin of funds. For example, internal transfers between different accounts in the same enterprise, rapid fund movement, and the sudden activity of a previously dormant account need to be paid to enough attention as they may be used in ML.
- (2)Transaction-Related Behaviours — Behaviour where transaction value exceed specified limits, or there is an apparent structuring of large-value funds into small amounts of money (also known as ‘smurfing’) should be paid extra attention. This behaviour normally poses higher risks of ML activity, and are typically marked for further investigation; and
- (3)Miscellaneous Behaviours — Frequent changes to an account can often be regarded as a signal that ML is occurring. Activities that would fall into this category include the settlement and/or standing instructions of an account, the movement of funds without a corresponding business, and the indirect deposit in excess of a designated amount into an account. These types of offsetting trades can

increase the potential risk for ML.

There are numerous parameters used in the transaction risk assessment process, including transaction amounts, cash amounts in transaction, the number of transactions, the highest amount of a single transaction, transaction frequency coefficients, payment balance coefficients, dispersion coefficients of the transaction amount, the number of accounts, the number of branches in which an account is opened, the number of foreign currency accounts, the number of transaction counterparties, the number of accounts held by transaction counterparties, the number of transaction counterparties to the inflow/outflow of funds, the number of regions in the inflow/outflow of funds, and the number of foreign currencies involved.⁴¹¹ The pre-condition for the feasibility of this method is a sufficient understanding of local economic development, local industry distribution, transaction pattern in the specific industry, and counter staff awareness of the usual transaction behaviour of certain groups of customers.

6.3.2.4 Scenario Detection

This refers to traditional monitoring systems utilising a rules based approach to detect known patterns of ML behaviours. Scenario detection creates statistical data based on specific characteristics extracted from previous ML cases, and interpret these data via a set of regular indicators. If the upper limits of these regular indicators are triggered, the information system will determine as 'recurrence' of ML activity, resulting in an alert for the recurrence. Although scenario detection is still based on objective standards, it is a meaningful reference as well as an important component of the risk ranking process.

6.3.2.5 Behaviour Profiling

As traditional monitoring systems can only operate based on statistical profiles derived from previously known suspicious behaviour and customer activities across all lines of business, they can be evaded by money launderers. This has resulted in

⁴¹¹ 严立新, 张震 [Yan Lixin and Zhang Zhen], above n 71, 126.

behaviour profiling becoming a core module of second generation AML compliance systems at the international level. This module anticipates the customer's behaviour through behaviour profiling and generates continuous analysis. It has the ability to build and understand each individual customer's profile, compare activities with expectations, and provide alerts when profiles thresholds are exceeded. In detail, profile engine can automatically update behavioural profiles for every account that is maintained. The system is able to intelligently process every transaction and analyse behaviour in the context of the behavioural profiles, both on an individual basis, and against the defined peer group. When unusual or irregular activity is detected, alerts are triggered, signalling the need for investigation. Behaviour profiling provides further analysis and allows a financial institution to map previously unknown patterns of behaviour through a complete knowledge of a customer's activities, and can even detect suspicious links between seemingly unrelated accounts.

6.3.2.6 Link Analysis

Link analysis is a powerful tool for uncovering complex ML operations and is designed to identify hidden relationships between transactions, accounts, customers, and even associated organisations. An effective link analysis module is tightly connected to 'watch list modules', that conduct comprehensive analysis on the basis of notifications of suspicious behaviour provided by law enforcement agencies. When combating ML, a link analysis module can highlight high risk geographic locations, which represent a key element in the risk ranking process. In general, link analysis operates at three fundamental levels:

(1) Business Relationships

The system should be able to identify an actual beneficial owner, and defines unusual business relationships between underlying accounts, including relatives' relationships, relationships between affiliated companies, and special relationships involving risk sensitive persons. Under this category, there are three subsidiary

aspects, namely, funds link analysis,⁴¹² geographical link analysis,⁴¹³ and specific industry and occupation link analysis;⁴¹⁴

(2) Data Consistency

If money launderers attempt to disguise their behaviour by changing important details such as name, address, and reference details when opening an account, the system should be able to identify these data inconsistencies by checking other referencing data links, and generate alert reports; and

(3) Inter-Related Transactions:

The *modus operandi* for a sophisticated ML operation nearly always involves multiple financial institutions. The system should be capable of identifying possible associations between inter-related transaction patterns across accounts, both internal and external to the institution.

6.3.2.7 Risk Ranking

This is a module that collects all submitted risks from different risk assessment processes, and according to designated risk weighted values, gives a final risk ranking score for each transaction and its associated account, customer, and organisation, and produces a suspects list ranked by their risk scores. Along with the suspects list, the system also outlines reasonable grounds and explanations for each suspicious activity.

In a comprehensive database system, if the ML risk posed by a customer scores as medium level or high level in a number of sub-systems, the overall risk score of this customer should have a higher co-efficient as the final ranking. It is suggested by the

⁴¹² Funds link analysis is designed to use available data and information analysing the link between upstream and downstream sources of the funds and searching out the hidden relationship between seemingly superficial data.

⁴¹³ Geographical link analysis compares the funds flow situation with the local economic structure and development level and conducting statistical analysis on transaction data generated from geographic jurisdictions with high risk.

⁴¹⁴ Specific industry and occupation link analysis is used to extract indicators of business scale, business frequency, transaction time and settlement methods in specific industries and occupations with high reliance on data and to use these indicators to analyse abnormal business behaviours in individual cases.

author that risk rating codes could be classified as follows:

- * Extreme Risk (requires management approval) — this could include accounts for PEPs, such as diplomats from foreign countries; money service businesses owned by aliens; foreign correspondent accounts and so on
- * High Risk — non-resident aliens; accounts with high currency activity or high wire activity (particularly foreign wires);
- * Moderate Risk — limited private banking or trust services; established multi-faceted business that also provide limited money services businesses (MSB) services; new customer relationships with limited higher risk services (such as wires) or higher risk nature of business (such as cash intensive restaurant, jewellery store, pawnbroker, and so on.)
- * Low Risk — known customer; stable account activity such as cheque account; secured loans; few if any higher risk services.

6.3.2.8 Workflow Tools

An efficient workflow tools module is critical for the entire enterprise-wide AML solution. This process must be flexible, auditable, and have the ability to maintain, retrieve and report case management activities. It is the most important link and combines systems of the regulators and of other co-operating institutions, and integrates all business links within an enterprise as an automatic solution body. The main functions of workflow tools are:

- (1) Information Reporting and Investigation — Reporting systems should provide an ‘end to end’ AML SARs or STRs reporting process to the FIU, and guide the staff writing the filing reports in ‘wizards’ format, and encrypt the results during the automatic delivery process. Investigating tools assist the compliance staff to further investigate and verify the alerts submitted by the system before these

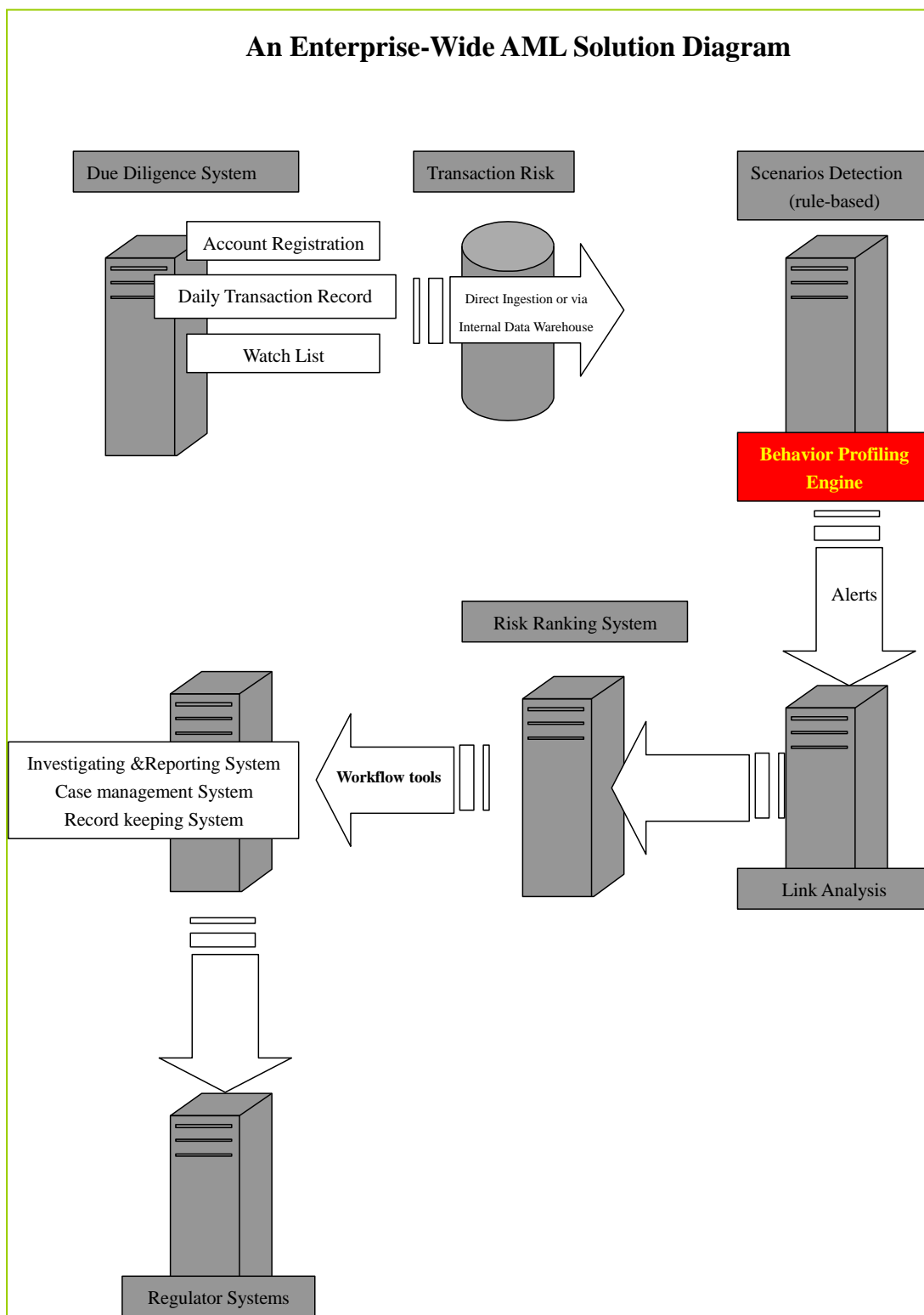
results are reported to the regulators. It also provides a summary of filing or reporting reasons, including account summaries, customer backgrounds, current status, and transaction history. If necessary, visual or graphic documents can be supported to investigate the hidden relationship between different accounts;

(2) Case Management — An effective case management system can reduce false positives and bring together the output from disparate systems. It allows for the staff keep adding false alert cases to the case library. Case management is helpful in allowing the system to learn new ML rules, and is also useful for training staff about working processes of enterprises.

(3) Record Keeping — This tool should meet key requirements of current international AML regulations, that is, all the transaction records generated over at least the previous five years should be kept as searchable data.

Generally, an enterprise-wide AML information solution system can be divided into two parts: risk analysis tools and compliance supplementary workflow tools. Data mining and business intelligence techniques are key components of risk analysis tools, while any other factors for tuning the accuracy of risk assessment should also be integrated into risk analysis. In particular, the risk analysis tools contain due diligence systems, transaction risk assessments and comprehensive risk analysis. Workflow tools, on the other hand, are designed for legislatively required AML management activities, for instance, data reporting and delivery, record keeping and searching, staff training, and case management.

Figure 6.1: Enterprise-Wide AML Solution Diagram



However, results produced by an enterprise-wide AML risk-assessment process are dynamic, which only provide an indication or possibility. Just like any human endeavour, technical data-mining models may make mistakes. A criminologist,

Interviewee Mr. S, commented that

[E]lectronic screening of transactions and software-based detection methods are only able to locate a small percentage of cases involving laundering, and, accordingly, human-based methods need to be used in conjunction with software to have an effective system of detection in place. Further research is needed to determine rates of false positives and false negatives in suspect matters reported to FIUs.⁴¹⁵

The real problem is that IT based solutions are not a real solution but a means to an end. Technology may create a false sense of security that leads the staff rely on the system to find possible ML. Further human analysis is also required on those transactions that have been identified by the systems. Indeed, two types of mistakes may be generated from the data mining model, namely false positives and true negatives. False positives refer to a data mining model that recognises a normal transaction as an ML activity, which in fact it is not, and the latter refers to data mining results that fail to identify a genuine ML activity and assesses it as a ‘normal transaction’. These two types of errors cannot be completely avoided in the data mining process;⁴¹⁶ thus, further checks of the technical results should be undertaken manually.

The solution diagram (above) explains key functions of an enterprise-wide AML information system solution, including CDD, watch lists, transaction risks, scenario detection, behaviour profiling, link analysis, risk ranking and workflow tools. However, in order to achieve greater success in combating ML, the enterprise-wide AML solution also needs supplementary support and assistance from the external environment, improvement of related regulatory guidance, maintenance of watch list databases, and the development of inter-relationships between different financial institutions. As an undertaking that provides more benefits to the public interest over

⁴¹⁵ Interview with Mr. S, Principal Criminologist, Australian Institute of Criminology (Cambridge, the Twenty-Eighth International Symposium on Economic Crime, 10 September 2010).

⁴¹⁶ 梅建明 [Mei Jianming] 《反恐情报与危机管理》 [Counterterrorism Intelligence and Crisis Management](群众出版社 [Qunzhong Press], 2007) 156.

private interests, AML activities cannot be successfully accomplished without any one of the above-mentioned elements.

6.4 Comment and Conclusion

AML compliance should be integrated into every business function within the financial institution. The basic step to achieve an enterprise-wide integration is the consolidation of AML into one compliance department and the integration of all systems on one technological platform.⁴¹⁷ Thus, it is of great importance to increase the synergistic capability of ML risk rating systems and AML information solutions in Chinese financial institutions.

On the one hand, the ML risk rating systems of a country should take particular national characteristics into consideration. For example, in China, it may be reasonable to extend enhanced customer diligence to including domestic PEPs and FEPs. Additionally, operational risks generated from business operations by foreign invested enterprises and rogue employees inside financial institutions should not be ignored. On the other hand, an enterprise-wide AML solution should use advanced analytics to provide adequate protection from increasingly skilful money launderers, reduce the number of false positives (those labelled as risky transactions without genuine ML risk), and develop the analysis of previously unknown behaviour patterns.

However, the automatic risk-assessment system is more feasible for large-scale financial enterprises, and in most cases, is centred in big cities, since greater resource capacity can be ensured, including software development, research and purchase, and associated staff training. Interviewee Mr. S noted that:

[T]he difficulty lies in the costs associated with providing such advice, particularly to small enterprises and low-risk entities. Often, it is

⁴¹⁷ Asian Banker White Paper, above n 374, 16.

*impossible to afford in-house AML compliance officers and expensive technological solutions, and external consultants are needed to enable businesses to become compliant.*⁴¹⁸

Mr. W also commented that *‘because of the significant number of transaction executed each day, AML automation is expensive and this will present a problem for smaller banks’*.⁴¹⁹

In fact, for many financial institutions in China, it is not only about the difficulty encountered in the application of IT support systems related to AML activities, but also the impossibility of implementing an advanced RBA of AML compliance. The question thus arises, what is a suitable approach for small and medium sized financial institutions located in areas of low income or middle income levels to adopt in order to achieve the high standards required by Chinese AML regulators — a rule-based approach, an RBA, or neither?

⁴¹⁸ Interview with Mr. S, above n 415.

⁴¹⁹ Interview with Mr. W, above n 384.

Chapter 7. 'RULE-BASED BUT RISK-ORIENTED' APPROACH FOR COMBATING MONEY LAUNDERING IN CHINESE FINANCIAL INSTITUTIONS

As we have seen, since they officially launched their AML actions in 2002, the Chinese AML authorities have been using a rule-based AML approach in every regulated entity to enforce the law and regulations and have paid insufficient consideration to ML risk management. In December 2008, China's Ministerial Joint Anti-Money Laundering System approved *China's 2008-2012 Anti-Money Laundering National Strategy*,⁴²⁰ and, one year later, the PBC published the national strategy with detailed descriptions which formally encourage the implementation of the RBA. However, a number of practical difficulties in implementing an RBA need to be addressed by Chinese AML authorities, and the policy dilemma between a rule-based approach and an RBA should be thoroughly considered as well.

Although China has made significant progress in combating ML, the practice of ML risk management in Chinese AML programs is still weak, and the pre-conditions for fully implementing an RBA in China are yet to be met. The main goal here, therefore, is to answer the question of whether the central bank's decision to implement a risk-based AML approach should be continued or be modified? A secondary question is how far has the implementation gone already? As early as the 1950s, Peter Drucker had already concluded that the decision making process can be divided into five crucial stages: 1) defining the situation; 2) determining what is relevant; 3) determining the scope and validity of factual knowledge; 4) developing all the alternative solutions; and 5) effectively putting the chosen solution into action.⁴²¹ Guided by this classical decision making logic, this chapter explains both the rule-based and risk-based AML approaches, examines the difficulties of adopting a full-blown RBA for AML compliance in the Chinese financial sectors, analyses the rationale for a transitional approach and finally concludes that the 'rule-based but

⁴²⁰ 中国人民银行 [People's Bank of China], *AML Strategic Development*, above n 221.

⁴²¹ Drucker, 'Long-Range Planning', above n 266.

risk-oriented' AML approach or partial RBA framework is the proper choice given China's AML realities.

7.1 Rule-Based and Risk-Based Approaches for Combating Money Laundering

The AML regime in China has been substantially upgraded during the past couple of years. However, previous Chinese achievements in implementing AML programs were mainly directed towards the development and implementation of AML laws and regulations under the rule-based approach, rather than taking sufficient consideration of ML risk management. Thus, balanced change or adaptation and new regulation should be developed on the basis of a right understanding and analysis of both the rule-based and risk-based approaches.⁴²²

7.1.1 Introduction of Rule-Based and Risk-Based AML approaches

The rule-based AML approach refers to a 'tick box' style approach applied by a regulated entity with the focus on meeting regulatory requirements.⁴²³ Under a rule-based approach, one has to comply with particular rules irrespective of the underlying degree of risk. Putting it differently, in a rule-based system, if something is prohibited (or required), then it should be prohibited (or required) in all contexts and all cases. For example, road traffic regulation is a rule-based system. Exceeding the specified speed limit is prohibited in all cases and all contexts. Neither the skill of the driver, the condition of the road, nor the safety attributes of the car have any bearing on compliance with this rule.⁴²⁴ Indeed, the FATF *Forty Recommendations* as promulgated in 1990 essentially lay the basis of a rule-based AML system. There are rules that specify that certain kinds of activity are prohibited, rules that require certain kinds of regulatory arrangements, and rules that require action by agencies with regulatory responsibility.

⁴²² 唐旭 [Tang Xu], above n 154, 7.

⁴²³ Ross and Hannan, above n 50, 106.

⁴²⁴ Ibid.

At the initial stage of a country's AML system, regulators are not supposed to assume that AML mechanisms and AML values can easily be universally accepted by the regulated entities. Under this condition, the rule-based approach is more direct and more efficient. On the one hand, regulators are obliged to provide referenced standards for financial institutions that lack AML motivation and the experience to establish sound AML programs. On the other hand, regulators need to strengthen compulsory measures to push financial institutions to actively play their preventive roles in AML activities. By stipulating regulatory documents and using laws, regulations, acts or administrative orders, AML regulatory bodies require financial institution to comply with the regulatory documents and conduct compulsory examinations on financial institutions' AML compliance. Rule-based AML regulation is a process that can be represented as follows

stipulating regulations → implementation examination → regulation adjustment → implementation re-examination.⁴²⁵

In fact, a rule-based AML regulatory approach in financial industries is universally adopted by countries at the initial AML stage.

Although analysis of 'risk' has been the fundamental element in financial industries for more than two decades, it is only since 2007 that concepts of risk, risk assessment and risk management have become central elements in the context of AML strategies. According to FATF, RBA can minimise burdens on customers, provide flexibility to approach AML obligations using specialist skills, and allow regulated entities of differing sizes, structures and practices to develop their own appropriate systems.⁴²⁶ The essence of RBA is that it is designed so that regulated entities can arrange and implement AML activities from the perspective of risk management, ensuring AML

⁴²⁵ 边维刚 [Bian Weigang] 《金融业反洗钱监管有效性研究》 [Research on Anti-Money Laundering Regulatory Effectiveness in Financial Industry] (中国金融出版社 [China Financial Publishing House], 2009) 83.

⁴²⁶ FATF, *ML and TF in the Securities Sector*, above n 401.

functions through risk identification, risk assessment and control, examination of workflows and measures for improvement, and managing risk within the scope of risk appetite and risk tolerance.⁴²⁷ To put it somewhat differently, the RBA for combating ML aims to provide control to the organisation itself so that it can design an AML program that best suits it, changing the approach from following ‘the letter of the law’ to an approach that embodies the practical management of risk. This transfer of control from regulatory body to the regulated entity provides flexibility but requires the organisations to be knowledgeable of the ML risks they face.

Risk-based AML principles in financial sectors include two core requirements: one is that an AML system must be able to fully reflect the ML risks of customers and associated financial businesses, and the other is that the AML system should consider the greater ML risks posed by non-contact transactions. Under a risk-based regulatory system, the regulated entity must be proactive in the mitigation of ML risk, and must be provided with the most appropriate regulatory strategies on specified risk.

7.1.2 Rationales of Transiting from a Rule-Based Approach to a Risk-Based Approach

It has been apparent for at least a decade that rule-based AML regulation resulted in defensive reporting by financial agencies which in turn gave rise to information overload for the regulatory agencies and resulted in reduced investigative capacity. There is a likelihood of ‘knee jerk’ reaction, for the reporters, with all large cash payments being deemed suspicious, and consequently the problem of reporting overload has been the basic weakness in rule-based regulatory models. Since the rule-based approach is a mandatory or prescriptive approach, it creates a comfort zone for regulated entities when there is no explicit distinction between suspicious and

⁴²⁷ ‘Risk appetite’ refers to the quantum of risk that the firm is willing to accept within its overall capacity. ‘Risk tolerance’ refers to the extent to which the firm is willing to accept more risk in exchange for the possibility of a higher return. Both risk appetite and risk tolerance set boundaries of risk that an entity is prepared to accept, but according to the Institute of Internal Auditors, risk appetite is a higher level statement that considers broadly the levels of risks that management deems acceptable while risk tolerances are narrower and set the acceptable level of variation around objectives. Also see, Institute of Internal Auditors, <<http://www.theiia.org/guidance/additional-resources/coso-related-resources/coso-framework-faq/?i=2>> 453.

non-suspicious indicators provided by authorities. Thus, deciding whether or not something constitutes ML requires an understanding of the processes and participants involved in the financial transaction and their particular circumstances. The large proportion of ‘false positives’ that occur in every AML system shows the AML systems are not as cost-effective as expected.

The move to an RBA by FATF and the other bodies involved in AML oversight (the World Bank, IMF, and the regional FATF style bodies) was driven in large part by the reporting entities who were concerned at the cost of the rule based approach and the apparent ineffectiveness of this approach at actually addressing ML. In addition, rule-based regulation is particularly vulnerable as a means of dealing with ML where one of the objectives of the launderer is to identify weak points in the regulatory system and exploit those weaknesses. Policy makers hope that RBA will help reduce the number of poor quality reports and improve the quality of intelligence provided to FIUs. Risk-based regulation provides a basis for reducing the flow of reports in a way that factors in those matters that are most likely to generate meaningful intelligence or a productive regulatory or law enforcement response.

The change in approach to AML regulation mirrors the adoption of risk-based strategies and tools across a range of regulatory domains, and is intended to address the problems inherent in rule-based regulatory approaches: over-regulation leading to excessive compliance costs, inflexibility and consequent poor regulatory performance, and a focus on legalism rather than regulatory effectiveness.⁴²⁸ A second advantage conferred by risk-based regulation is that it provides greater flexibility and sensitivity in responding to complex problems. Prescriptive regulatory systems are constrained by their rules and guidelines, and if mismatches arise between the regulations and the risky activity then the compliance framework will become ineffective. The third part of the rationale for RBA is that it transfers responsibility from regulatory institutions to financial institutions. Regulated entities must now be pro-active agents in the

⁴²⁸ Hutter, above n 4.

mitigation of ML risk.

An important consequence of transferring regulatory responsibility to financial institutions is that they already have considerable experience in the management of risk, since misunderstanding of these risks may be interpreted as non-compliance by AML regulatory authorities. The rationale of implementing RBA looks sound; however, the practical application of an RBA requires resources to gather and interpret information on risk, develop AML procedures and systems, as well as well-trained personnel with a sound understanding of the risk and who are capable of making sound judgements. These conditions are not readily found in either government or private sectors in many developing economies, and even some of developed countries. That is also true for regulated entities in China.

7.2 Feasibility of Full Implementation of RBA in the Chinese Financial Sectors

It is quite unrealistic to expect that a business could operate in a completely risk-free environment in terms of ML. Financial institutions should identify the ML risk they face, and then work out the best way to reduce and manage that risk, while balancing the costs to their business and customers against the risk of the business being used for ML. Indeed, regulated entities would face legal sanctions if the authorities detect the presence of illegal or highly suspicious transactions through means other than the reporting of such transactions by the institution involved in the transaction. Financial institutions, therefore, should minimise the risks of penalties for non-performance of the AML task, both as a matter of good governance and to meet their legal obligations under AML laws. Indeed, the fear of legal action should not be the only reason that institutions need to take AML programs seriously. However, proactive approaches to combating ML in regulated entities are difficult to foster.

Fixed rules can be applied to militate against certain extreme behaviours and to enforce defined regulations. However, embedding static rule-based systems into

electronic transaction environments does not provide adequate safeguards to combat ML. RBA, on the other hand, is considered as effective method, and KPMG has even suggested that RBA is the only way to identify potential ML transactions.⁴²⁹ However, a deficient RBA will result in the risk of non-compliance with AML regulations as well as exposing financial institutions to too much risk. Although RBA seems attractive in theory, it poses some challenges in practice, due to both the internal and external environment.

7.2.1 Practical Arguments regarding Implementing a Risk-Based approach

Even in those jurisdictions that have already adopted RBA for AML, there are a series of practical problems which are attracting academic discussion. Since RBA was first introduced by FATF in 2007, various scholars have been critical of the how RBA could be implemented effectively.⁴³⁰ Killick and Parody, for example, highlighted the need for regulators to fall in line with the RBA and return responsibility for the implementation of systems of control which are appropriate and proportionate to senior management.⁴³¹ But most of the current systems of control in AML are not capable of identifying and understanding the risks facing financial entities. Jos de Wit outlined the controversy present between financial institutions and regulators in the approach to AML, and found that regulators and financial institutions need to co-operate so that AML standards can be set within an RBA and be implemented in the best way to avoid ML taking place.⁴³²

Practising risk-based AML strategies involves significant elements of uncertainty and these factors were addressed by Ross and Hannan.⁴³³ The authors argued that the move to RBA presents a number of theoretical and practical issues that must be

⁴²⁹ Shijia Gao, Dongming Xu, Huaqing Wang and Peter Green, 'Knowledge-Based Anti-Money Laundering: A Software Agent Bank Application' (2009) 13 *Journal of Money Laundering Control* 63, 65.

⁴³⁰ FATF, *ML and TF in the Securities Sector*, above n 401.

⁴³¹ Killick and Parody, above n 48.

⁴³² De Wit, above n 49.

⁴³³ Ross and Hannan, above n 48.

resolved if risk-based strategies are to work effectively. The study concluded that risk assessment systems should move towards a regulatory approach that is based on risks rather than compliance with rules. There also is a need for fundamental changes in the relationship between the regulators and the regulated. Those responsible for developing and refining risk-based decision models must have access to knowledge about the outcomes of assessments. In many developing economies there is poor development of the necessary relationships between the regulators and the regulated entities to allow such shared knowledge. The regulatory models are typically command models and there is little if any dialogue.

Moreover, an RBA *per se* is relatively risky both for the regulatory body and the regulated entities. In order to reduce the heavy duties of and costs to regulated entities in their conduct of rule-based approaches, the regulatory bodies shift the strategy to an RBA, and require the regulated to be the decision maker. However, when the regulated entities begin putting in place an RBA, the financial institutions start to realise that it is not easy to put the theory into practice. If they do things right, it is what they are supposed to do. If they do not, the only one who is blamed will be the financial institution itself.

Three of the most important conditions in RBA implementation are:⁴³⁴

- i) There has to be agreement about the basis on which risk is determined or what the risks are.
- ii) There must be an explicit, agreed model of the attributes what will contribute to the assessment of risk.
- iii) There must be a model of accessing to knowledge about the outcomes of assessments in order to develop and refine a risk-based decision.

Interviewee Mr. N commented that

[A] symptom of uncertain content of the obligation is the recurrent use (in regulations, guidelines etc) of the term “appropriate” or equivalent: there is always one step further to be accomplished, in order to achieve and

⁴³⁴ Ibid 110.

*verify such “appropriateness”. The guiding function, which is currently mainly exerted by issuing precepts, might be usefully complemented by also helping the institution to which precepts are addressed to deal with difficulty of application. Additional feedback required, also in terms of interpretation. Guidance should be given in such a way as to provide operational indications...*⁴³⁵

Furthermore, the drastic shift to the RBA approach which was hoped to lead to regulatory cost reductions might actually lead to increased costs, and a higher risk of failure. This not only means a breakdown in the effectiveness of the regulatory system but exposes the institution to regulatory risk and costs (such as penalties for non compliance). In any event, it is by no means clear that the shift to RBA — even when applied well — will lead to lower regulatory costs for the reporting institutions. Whether RBA is a cost-effective approach in AML is still to be proved. It might act as ‘the emperor’s new clothes’, causing the regulator and the practitioner to disguise the truth from the outside world.

In fact, the cost consideration is a genuine and real issue for every participant in the AML system. However, while there are constant claims about the ‘high input costs’ and of the ‘tremendous cost’ of combating ML, it is interesting to examine whether all of these ‘costs’ are actually and properly attributed to AML. Are many of these resources poured into other infrastructure in financial institutions but deliberately and falsely attributed to AML activities? How many computer system upgrades have been attributed to AML requirements when in fact they were always going to be needed to update old and increasingly ineffective IT systems? Where such systems allow for greater knowledge of customer profiles and business activities, they also provide important marketing tools which can often defray their capital investment. It might well be that both the benefits of using RBA and the compliance costs of AML programs are over-estimated.

7.2.2 Challenges of RBA Implementation in the Chinese Financial Sectors

⁴³⁵ Interview with Mr. N, AML Regulator, Italy (Cambridge, Twenty-Eighth International Symposium on Economic Crime, 7 September 2010).

Since 2007, FATF has issued a series of guidelines concerning the application of the RBA to combating ML in various sectors.⁴³⁶ However, any RBA needs to be adapted to different countries in accordance with their own national priorities. FATF states that countries will need to make their own determinations on whether or how to apply a RBA. When deciding to carry out the risk-based AML approach as an AML national strategy, Chinese authorities should carefully evaluate whether the preconditions for conducting a full implementation of the RBA are in place.⁴³⁷ Not only are there the issues of adequate resources and sound staff training, but there is also a need for efficient information sharing systems and cooperative arrangements among AML shareholders. Adequate internal control systems and comprehensive legal framework are also demanded.

Vulnerabilities to ML are hidden or obscured in all aspects — the customer, transaction interface, payment instruments, financial services and products, and so on. These emerging challenges and potential ML risks require financial sectors to be continually vigilant and constantly reviewing previous AML arrangements, identifying weaknesses and loopholes, and proposing revised approaches. Following this trend, the latest AML countermeasures must be factored into risk reducing plans, supported by customer risk rating, ML risk management, and a rigorous application of the RBA. This requires resources, skills, application and a thorough approach. There are no short cuts.

At the very least, a well prepared AML regime applying the RBA requires the following minimum requirements in all financial institutions:

- a) skills in identifying risk;
- b) skills in developing risk reduction strategies;
- c) implementation of a thorough RBA;

⁴³⁶ FATF published several typologies reports since 2009, providing guidance for applying a risk-based approach to the securities sector, the life insurance sector, and free trade zone.

⁴³⁷ 中国人民银行 [The People's Bank of China], *AML Strategic Development*, above 221.

- d) a system of internal controls to ensure ongoing compliance;
- e) independent testing of AML compliance;
- f) designation of an individual or individuals responsible for managing AML compliance (ML compliance officer); and
- g) adequate, accurate, and complete training for appropriate personnel.⁴³⁸

Indeed, an overarching theme affecting implementation at the country level relates to human and financial resources. Insufficient regulatory resources and, in some instances, an acute shortage of the required skills within a country often impede the adoption of best practice and the achievement of the regulatory objectives. Insufficient numbers and quality of staff often affect not only the capacity to apply the rules as intended, but also operational issues.⁴³⁹

There are several challenges in RBA implementation due to the internal environment of financial institutions. First, financial institutions are not well equipped with the appropriate analytical skills regarding specific RBA methodologies. Also transitioning from the traditional practice of a check list basis to RBA requires training personnel with the responsibility to make critical judgements and decisions. For example, these include judgements about customers by front-line personnel such as tellers, or, decisions regarding case management by AML officers. In addition, it is not easy to check the output of risk-based AML control systems. The information provided by the AML authorities necessary for the implementation of an RBA strategy in financial institutions is insufficient. Also, regulatory expectations are unclear, making it difficult for financial institutions to determine the appropriate level of measures to be taken. This obscurity may be generated from regulatory bodies' risk aversion, that is, self-protection by AML regulators in avoiding taking full responsibility for defining clearly what should be done. For a really long time, the focus has been

⁴³⁸ Federal Financial Institutions Examination Council (FFIEC), *'BSA/AML Examination Manual'*, above n 236, 59.

⁴³⁹ International Monetary Fund (IMF), 'Accountability Arrangements for Financial Sector Regulators' (2006) No 39 *Economic Issues*, 22.

overwhelmingly put on those that are regulated; however, how the regulators behave is of equal importance in AML implementation.

In addition, RBA implementation would need to ensure that appropriate software is installed within its IT systems to enable it to identify unusual transactions. It is vital to tackle the problem using an RBA, as well as the technology that is adaptable, so that systems can be dynamic in the way that they respond to changes in the patterns of ML. Although Chinese AML programs have made such improvements, the capacity and readiness of reporting institutions to fully implement RBA in the short term is still doubtful.

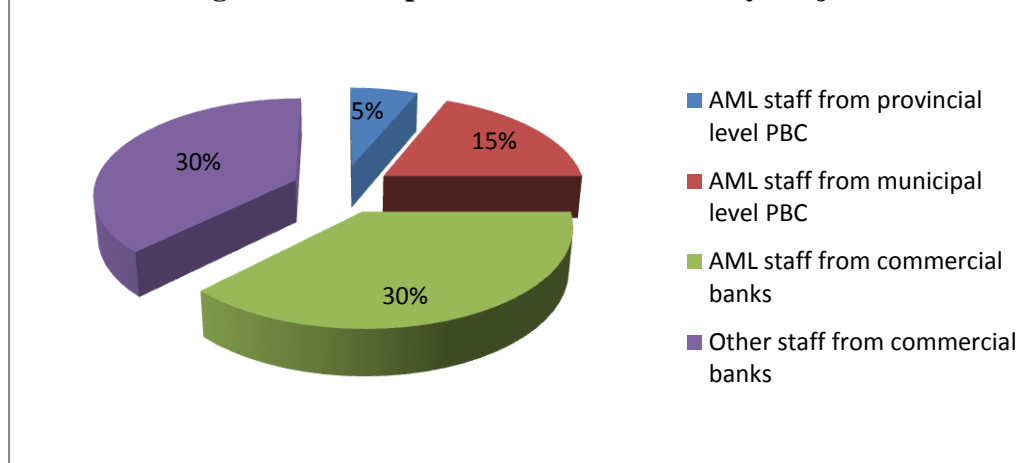
7.2.3 The Oversupply of RBA Implementation from Chinese AML Regulator

The survey project conducted by Anti-Money Laundering Bureau of PBC in 2008 based upon around 9000 questionnaires (see 4.1.2.4) revealed a number of interesting concerns about RBA implementation. The respondents came from the PBC, commercial banks, and credit cooperatives, including staff at headquarters, branches and outlets. Of those questioned, AML staff from provincial level PBCs accounted for 5 per cent of respondents, and those at the municipal level PBC accounted for 15 per cent; AML personnel at commercial banks accounted for 30 per cent; and other types of personnel working at outlets of commercial banks accounted for another 30 per cent.⁴⁴⁰

Only respondents from the banking sector were chosen to participate in the project because AML activities has long been undertaken in the banking sector and non-bank financial institutions still could not meet the conditions required for a comprehensive assessment.

⁴⁴⁰ 唐旭, 师永彦, 曹作义 [Tang Xu, Shi Yongyan, and Cao Zuoyi], above n 243, 3.

Figures-7.1: Respondents of PBC's Survey Project



When answering the question ‘How do you think financial institutions should identify suspicious transactions?’, 55.77 per cent of respondents thought that suspicious transactions should be automatically identified and reported strictly on the basis of objective standards provided by AML authorities, while 53.01 per cent of respondents thought that financial institutions should analyse and make judgments on their own according to guidance and references provided by authorities. Only 20.39 per cent of respondents thought that authorities should no longer formulate objective standards and guidance, and that financial institutions should do all the analysis and make judgements primarily on their own. It is quite ironic that after being cultivated and trained for so many years, more than half of respondents still expect to fully rely on a ‘tick the box’ approach in AML procedures. To some degree, this proportion implies that AML education in past years has not been satisfactory.

Answers from different respondents varied greatly: PBC personnel (63.75 per cent) hope that financial institutions make their own analyses and judgements in reference to the objective standards provided by AML authorities. On the other hand, most banking staff (59.12 per cent) think that financial institutions should automatically identify and report suspicious transactions strictly following the objective standards provided by AML authorities.⁴⁴¹ Interestingly, this is consistent with traditional

⁴⁴¹ Ibid.

cultural modes such as Confucianism, and this may impact on the effectiveness of AML in China (see 3.4). Regulated entities are still used to the ‘command and follow’ model, and following the decisions made by higher authorities. If the situation were to change and required entities to play a more active role in decision making, the regulated entities may want this transformation to be carried out gradually. However, cultural elements should be considered in designing the approach transition.

Indeed, these figures show that China’s financial institutions are not taking strong initiatives in identifying suspicious transactions on their own. However, the RBA promoted by Chinese AML authorities takes the subjective assessment of suspicious transactions made by financial institutions as the primary standard since different views exist between the regulators and the regulated and it is still too early to conclude that RBA will be able to be successfully implemented in the Chinese financial sectors. Indeed, the expectation by AML authorities of a change from a rule-based approach to an RBA is clearly there, but the desire for regulatory change from financial institutions is not obvious. Transformation from the current approach to another regulatory arrangement is a procedure requiring time and resources. Excessive costs in transforming the approach will seriously impact the outcome of regulatory reform in some regions.⁴⁴² Only when demand equals supply, and regulatory change achieves equilibrium, is it the best time to make the changes.

In fact, when the preconditions for implementing an RBA are not yet fully in place in a country, determination of suspicious activities should not be overwhelmingly dependent upon automatic information systems. While these systems can be useful in identifying transactions for further scrutiny they are not fail safe systems. Having skilled staff is an essential part of the process. Proper guidance is needed to ensure that systematic deviations due to possibly unsound indicator systems do not drive the reporting outcomes. Additionally, the fact that significant flexibility is being allowed

⁴⁴² 叶莉, 陈立文 [Ye Li and Chen Liwen], above n 107, 113.

to the financial institutions implies that the regulators cannot provide substantial guidance in dealing with the RBA. Under the risk-based system, prescriptive rules are no longer the primary requirement, but if risk identification falls into a bureaucratic standard, the RBA will again become a de facto ‘tick the box’ approach. Therefore, it is important to develop AML systems that meet the specific needs of a country, together with consideration of the domestic AML resources.

7.3 Rule-Based but Risk-Oriented Approach of Chinese AML Practice

Under the new environment, regulators should be the drivers behind the adoption of customised solutions that mitigate the real risks facing a firm, by giving back to senior management the responsibility for their design and implementation while at the same time as holding them accountable for this.⁴⁴³ More importantly, both the regulators and the regulated should determine the most applicable way to implement risk management strategies for every step of AML programs.

It is apparent that the internal and external conditions required to fully apply an RBA are far from being met currently in China, and that China needs to develop its AML systems before it can effectively apply a full RBA in China. The ‘Theory of the Second Best’ implies that if one optimality condition in an economic model cannot be satisfied, it is possible that the next best solution involves changing other variables away from the ones that are usually assumed to be optimal.⁴⁴⁴ Therefore, the argument is, whether the RBA should be fully implemented in Chinese financial institutions when pre-conditions are not being met. Is a ‘rule-based but risk-oriented’ approach, or a partially implemented RBA, the ‘second best’ option for China?

7.3.1 Specific Issues to be Addressed for Full RBA Implementation in China

7.3.1.1 Enforceability of RBA in Chinese Small and Medium Sized Institutions

Regulatory innovation should be applicable to the objective requirements of the

⁴⁴³ Killick and Parody, above n 48, 215.

⁴⁴⁴ 严立新, 张震 [Yan Lixin and Zhang Zhen], above n 71, 211.

regulated bodies, and at the same time, consistent with the development stage of the society. For different financial institutions subject to different advantages and disadvantages, regulatory innovation may not be suitable for all of them. Nevertheless, large organisations are in a better position than smaller organisations. Still, major banks are finding it difficult to comprehend legislative expectations and meet compliance costs.⁴⁴⁵ Thus, it would be fair to say that small businesses who are new to the AML regime would find it even more difficult to achieve compliance. Interviewee Mr. S stated that:

*[A] difficulty exists for small to medium-sized enterprises (SMEs) in these sectors which may find the costs of compliance heavy in comparison with larger entities. The AML regulator needs to ensure that appropriate procedures are in place to assist organisations of all sizes in complying with their obligations, not just the large banks. SMEs have limited resources and a risk-based approach which expects reporting entities to have comprehensive understanding of ML risks may be onerous...*⁴⁴⁶

On the other hand, although some big banks also have weaknesses in their AML internal control systems and may lack adequate AML experience, small scale financial institutions will still provide a greater attraction for money launderers. In fact, opportunistic behaviour and operations outside compliance guidelines in small companies are often more common than in large enterprises. Regulatory bodies, thus, should emphasise monitoring activities for AML implementation in the small and medium size financial institutions. This would apply, for example, to those financial institutions at the local level.

For large scale financial enterprises, the availability of regular business operations can satisfy the financial institution's appetite for profit, and correspondingly, the attraction of getting profit from irregular business such as ML activities will be less apparent. In addition, enterprise expansion means significantly more to large financial groups,

⁴⁴⁵ Juni Gurung, Marcell Wijaya, and Asha Rao, 'AMLCTF Compliance and SMEs in Australia: A Case Study of the Prepaid Card Industry' (2010) 13(3) *Journal of Money Laundering Control* 184, 190.

⁴⁴⁶ Interview with Mr. S, above n 415.

especially to open a wider overseas market. In this regard, large scale financial institutions with relatively prominent market positions will be more concerned with keeping and increasing the social reputation of the enterprise, thus providing higher opportunity costs to the potential criminals wanting to launder money. However, it does not mean that large scale enterprises fully comply with AML legislation and regulation, but that they have a different perspective. With greater financial power, large scale enterprises may not worry about law enforcement and regulatory oversight, since enforcement action may be at a heavy cost to regulators. It is noted by Interviewee Mr. A that

[S]ome financial institutions have been deemed by their governments too big to fail, and been given millions or billions in bailout funds. Under those conditions, law enforcement is hard put to seek criminal charges against a large FI, except some type of deferred or non prosecution agreement, in which case the FI can negotiate its way out of a prosecution, perhaps with taxpayer (bailout) funds. Consequently, I wonder whether FIs worry about law enforcement, and if law enforcement provides a sufficient deterrent⁴⁴⁷ ...

The level of financial development is a factor resulting in uneven AML implementation. Regions with very limited resources face a particularly difficult challenge in addressing competing priorities and may not know how to build the requisite institutional and regulatory infrastructure. Moreover, given the size and depth of the market, certain components of the standards may have little relevance to a region's circumstances. Both of these factors lower the overall implementation rate.⁴⁴⁸ Also, regulators in such systems face very different challenges from those in well-developed financial systems.

While large scale financial institutions, such as Standard Chartered, HSBC and Citigroup, in developed economies can provide substantial in-house training resources devoted to AML issues, the same cannot be said of many other parts of the world.

⁴⁴⁷ Interview with Mr. A, AML Regulator, USA (Cambridge, the Twenty-Eighth International Symposium on Economic Crime, 05 September 2010).

⁴⁴⁸ International Monetary Fund (IMF), *Accountability Arrangements*, above n 439, 20.

Much of such training is then provided through online systems and other computer-based training products.⁴⁴⁹ For much smaller institutions in China, these high quality resources are not available in many financial institutions at local level. It was also found by the Australian Transaction Reports and Analysis Centre (AUSTRAC) that there are considerable disadvantages in designing and implementing an RBA for SMEs.⁴⁵⁰ Therefore, to some degree, a prescriptive or rule-based approach is realistic for resource constrained businesses.

7.3.1.2 New Relationship between Regulators and the Regulated in a Full RBA

The idea behind the risk-based AML compliance procedure is that organisations are more aware of their business risks and are in a better position to address them effectively. Organisations themselves need to define the ‘risks’ pertinent to their business — this can be misleading. The precision of a risk assessment process is important as the entire RBA becomes faulty without an accurate identification of risks.⁴⁵¹ Thus, without both a reactive and a proactive risk management strategy, AML compliance will become merely a regulatory risk avoidance tactic for organisations thereby undermining the legislation’s primary objective to control ML activities.

Reporting institutions also need to be better informed in order to understand the rationale behind certain official requirements if they are to effectively apply a RBA. As John Broome stated in his book,

[I]t may be a ‘war’, but although reporting institutions find themselves on the frontline of this war, they do not necessarily make good soldiers, especially when they have to fight in the fog.⁴⁵²

Consequently, an RBA for ML regulation would require greater feedback from government entities, including more precise parameters regarding what is being

⁴⁴⁹ Broome, above n 17.

⁴⁵⁰ Gurung, Wijsys, and Rao, above n 445, 186.

⁴⁵¹ Ibid, 194.

⁴⁵² Broome, above n 17.

sought and who are the high-risk targets.⁴⁵³ In short, RBA involves new concepts and new roles. While these issues are now well understood in major international institutions and have attracted a great deal of government attention, they are still novel concepts in many parts of the world. These approaches are relatively new and there is a vast knowledge gap in parts of the Chinese financial sector.

7.3.2 Choosing a Suitable AML Approach for Chinese Financial Sectors

Successful RBA implementation depends on the understanding of threats and vulnerabilities. Also, regulatory authorities should assist the private sector by providing information about the vulnerabilities of the financial system as well as offering advice which takes into account any related risks. Furthermore, it is important to make sure that risk-based requirements correspond to risk-based examination. In order to avoid any misunderstanding between regulators and financial institutions regarding which AML measures are required for a specific financial institution, there must be a clear, shared understanding of what RBA is needed for the risks that each financial institution faces. Institutions must understand their own risk level. Initially, external consultants may be utilised; however, in the long run financial institutions must be able to manage risks and controls by themselves. Finally, RBA requires significant deployment of resources. It is difficult to gather and coordinate all these elements from the beginning, therefore, a ‘spiral up’ approach to gradually increased control levels is recommended.

It should be pointed out that the implementation of RBA in China could strengthen the monitoring of management financial performance and corporate reporting and auditing processes, but it may take time for the new approach to function effectively given the present level of sophistication and destruction of and penetration by AML systems in China. Nonetheless, it is important to understand that a simple transplantation of RBA as used in developed countries, without adaptation, to AML

⁴⁵³ James F Gilsinan, James Millar, Neil Seitz, James Fisher, Ellen Harshman, Muhanmad Islam, and Fred Yeager, ‘The Role of Private Sector Organizations in the Control and Policing of Serious Financial Crime and Abuse’ (2008) 15(2) *Journal of Financial Crime* 111, 114..

practices under varied operational environments may not necessarily produce a desirable outcome. The long-range objective of flexibility in RBA implementation also requires stability within the system. At the very least they require that instability be confined to a pre-determined range. This, however, raises the problem of how much flexibility is required to make stability possible, and where to place the burden of flexibility. Integrating the entire process means finding and establishing a balance between stability and flexibility.

In fact, we can see that two different AML implementation approaches co-exist in Chinese financial sectors. The ‘siloes’ approach, the first approach, is a logical first step for financial institutions, which are forced to quickly adapt to new regulations, without a deeper awareness of the complexities and seriousness of the matter. That is, financial institutions organise their compliance in ‘silos’ with more or less coordination from a central compliance department. This is common in emerging markets like China, where the banks began implementation of AML operations due to external pressure by regulators, and were provided with ‘fuzzy’ standards and definitions.⁴⁵⁴ That is, the standards and definitions lacked clarity and were inexact, were difficult to comprehend, open to interpretation and so on. On the other hand, the integrated approach is mainly found in advanced financial institutions, such as a few large local banks in China, and international banks like Standard Chartered. As these systems usually work enterprise-wide, these banks also take the ‘know how’ to their subsidiaries across Asia, including China, and operational risks are managed by one department throughout the whole bank across all countries.⁴⁵⁵

A drastic shift from a rule-based approach to an RBA may bring practical failures, which could seriously harm the effectiveness of the entire AML program in China. Thus, in order to solve the contradiction between keeping an unchanged rule-based approach in Chinese financial institutions and applying a uniform RBA in China, a

⁴⁵⁴ Asian Banker White Paper, above n 381, 12.

⁴⁵⁵ Ibid.

partial RBA approach incorporating risk considerations might be developed to meet the specific Chinese environment. This could combine the merits of both rule-based and risk-based approaches.

7.3.3 Combined Solution: Rule-Based but Risk-Oriented Approach or Partial Risk-Based Approach

This kind of a partial RBA, which could be described as a ‘rule-based but risk-oriented’ approach, would enable institutions to put ML risk considerations into a rule-based compliance system.⁴⁵⁶ This would enable a transitional approach from a rule-based approach to an RBA that suits Chinese AML realities. As the Chinese AML systems mature, moves could then be made towards fully implementing an RBA to AML in China.

Mr. J believes that there must be a balance between both approaches,⁴⁵⁷ and Kun Wang also agreed with the dual approach. She said:

*[C]ontents under an AML operations framework should be managed by a rule-based approach, for example, the AML internal control system. AML activities should fully consider the industry features and institutions’ reality, and combining both rule-and risk-based approach will be a practical and scientific strategy.*⁴⁵⁸

Indeed, promotion and application of an RBA does not mean that we ignore or even destroy the old rule-based approach. However, we need to encourage regulated entities to develop their own AML internal control systems that accord with their business characteristics, while continuing to meet the minimum standards in their AML program. The minimum requirements include having a CDD system, transaction monitoring and LVTR, record-keeping system, and so on. The entities are given more flexibility to design their own internal control system, but they must still meet minimum standards. Explicit rules for regulating low-risk ML activities would still be

⁴⁵⁶ Ai, Broome, and Yan, above n 366, 402.

⁴⁵⁷ Interview with Mr. J, above n 383.

⁴⁵⁸ Interview with Kun Wang, Compliance Officer, Anti-Money Laundering Department, China Securities Regulatory Commission, (Beijing, 10 November 2010).

necessary for the regulated. These rules should be developed and published by the regulatory bodies, and the rule-based approach should be retained for assessing the minimum standard of AML compliance, which may, for example, be a ‘tick the box’ approach.

7.4 Rule-Based but Risk-Oriented AML Approach or Partial RBA Framework

Regulatory reform from rule-based approach directly to RBA may generate new uncertainty. For example, regulatory legislation can be swiftly changed, but behaviour, custom and ideological understanding cannot be cultivated in a short time.⁴⁵⁹ That is, moving to a full RBA needs to have robust requirements which ensure resource stability.

On the other hand, taking into account the different vulnerabilities faced by different Chinese financial institutions over a number of regions, the CDD requirements of the partial RBA then needs to be tailored according to specific conditions. That is to say, risk management does not have to be exactly the same across the entire banking, securities and insurance sectors, and in all geographical areas. Indicators of suspicious transactions vary in different departments or industries so the indicators used to determine suspicious transactions should be developed with a certain degree of flexibility.

7.4.1 Proposal for a Rule-Based but Risk-Oriented Approach in China

Similar to Basel II,⁴⁶⁰ the proposed rule-based but risk-oriented framework provides different options for implementing AML practices to allow financial institutions to select approaches that are most appropriate for their operations. As Interviewee Ms. G stated,

⁴⁵⁹ 叶莉, 陈立文 [Ye Li and Chen Liwen], above n 107.

⁴⁶⁰ See, Basel Committee on Banking Supervision (BCBS), *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version*, June 2006. Basel II provides a range of options for the member countries to deal with credit risk, operational risk, and market risk, including the standardised approach, basic indicator approach, and advanced measurement approach (AMA). Besides, Basel II also recognises that banks may apply partial use of standardised and advanced approaches if the requirements are immature.

*[L]ow capacity entities in financial sector have little chance of implementing proper responses to the RBA requirements. There should be standard and advanced approaches, rather than the risk based approach.*⁴⁶¹

Indeed, the proposed framework contains two parallel AML implementation routines. A rule-based implementation would be compulsory for all Chinese financial institutions, while a risk-oriented assessment performance would be expected from all well-equipped financial institutions, with the less well resourced financial institutions implementing this when ready.

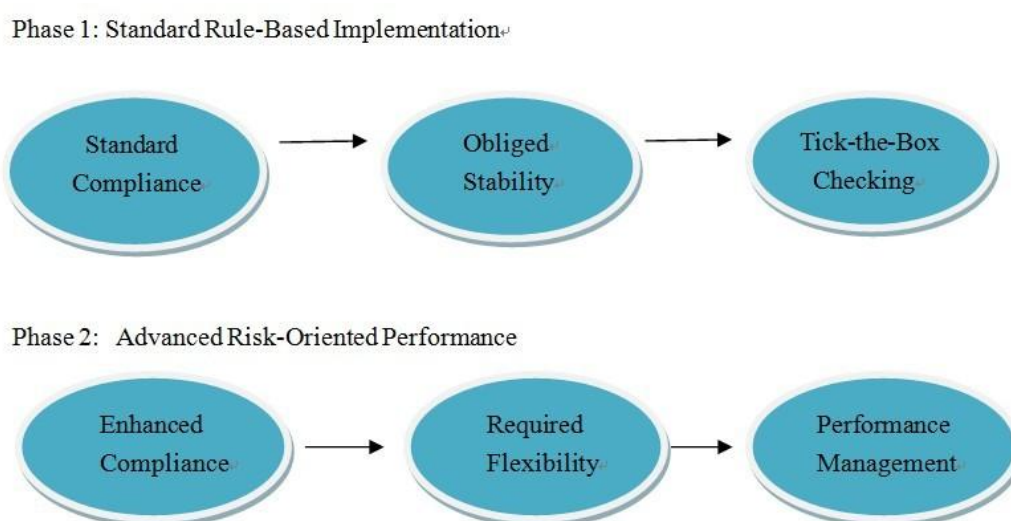
It is also expected different regions would move forward with the appropriate adoption procedures. Institutional supervisors (the board of directors and senior management) should consider carefully the benefits of the transition approach from Phase 1 to Phase 2 (Figure 7.2) in the context of its own AML system when developing a timetable and approach to the implementation. The supervisors of each financial institution should develop a set of review procedures for ensuring that AML systems and controls are adequate to serve as the basis for the transition approach. Supervisors will need to exercise sound judgement when determining an institution's state of readiness, particularly during this implementation process. Supervisors need to focus on compliance with the minimum requirements used as a means of ensuring the overall stability of an institution's ability to provide prudential controls to prevent ML.

Financial institutions are encouraged to move along the spectrum of available approaches as they develop more sophisticated measurement systems and practices. Internationally active financial institutions and financial institutions with good AML resources are expected to use an approach that is more sophisticated than the standard rule-based approach (Phase 1) and that is appropriate for the risk profile of the

⁴⁶¹ Interview with Ms. G, AML Managing Director, Australia (Cambridge, the Twenty-Eighth International Symposium on Economic Crime, 06 September 2010).

institution. A financial institution will be permitted to use the standard rule-based approach for some parts of its operations and an advanced risk-oriented approach (Phase 2) for others, provided certain minimum criteria are met. The financial institution should provide institutional supervisors and AML regulators with a plan specifying the timetable to progress to Phase 2. The plan should be driven by the practicality and feasibility of moving to the Phase 2 over time, and not for any other reasons.

Figure 7.2: Mapping out the Rule-Based but Risk-Oriented Approach



A financial institution will not be allowed to revert to a simpler approach once it has been approved for a more advanced approach without obtaining supervisory approval. However, if a supervisor determines that a financial institution using a risk-oriented approach (Phase 2) no longer meets the qualifying criteria for this approach, it may require the financial institution to revert to a rule-based approach (Phase 1) for some or all of its operations. It would follow this approach until it meets the conditions specified by the supervisor for returning to the more advanced approach.

No matter what approach a financial institution chooses, in order to ensure the AML compliance qualifies for using the selected approach, this financial institution must

satisfy its supervisor that, at a minimum:⁴⁶²

- (a) Its board of directors and senior management, as appropriate, are actively involved in the oversight of ML risk management framework;
- (b) It has an ML risk management system that is conceptually sound and is implemented with integrity; and
- (c) It has sufficient resources allocated to the selected approach in the major business lines as well as the control and audit areas.

7.4.1.1 Basic Obligations of Rule-Based but Risk-Oriented Approach (Phase 1)

Compared to the traditional AML program at the initial stage, the basic required elements of the current AML preventive measures should be widened to ensure AML compliance feasibility include KYC, employee due diligence, employee training, ongoing CDD, the reporting of suspicious transactions, record keeping, the presence of an AML compliance officer, and with each AML procedure to be carried out at a higher standard.

Financial institutions must understand who their customers are and what business they do throughout their relationship with them. KYC in a rule-based but risk-oriented approach requires or recommends developing a keen understanding, through appropriate due diligence, of who the true beneficial owners and parties to transactions are, the source and intended use of funds and the appropriateness and reasonableness of the business activity and the expected patterns of transactions in the context of business.⁴⁶³ Reporting institutions should have clear directions and criteria on deciding which customers are ‘high risk’. The most important thing to remember is that the reporting institutions should know precisely whom they are dealing with and, depending on the level of risk, decide the scope of due diligence for themselves.

Apart from CDD, employee due diligence requires monitoring of employees capable of facilitating ML. The process allows the determination of job positions that pose a

⁴⁶² Basel Committee on Banking Supervision (BCBS), *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version*, June 2006, 148.

⁴⁶³ Gao, Xu, Wang, and Green, above n 429, 65.

ML risk and therefore should be under constant supervision. Both existing employees and prospective ones need to be screened via employees' identity and background checks. Employee due diligence is an important requirement to ensure that employees are not the weakest link in the business.⁴⁶⁴ In particular, employee screening programs should pay special attention to abnormal conditions related to staff or agents, such as 1) significant and sudden improvement of marketing performance, especially increased sales of products with high ML risk, 2) obvious increase of consumption level, and 3) use their own business mailing address to send or receive letters for customers.⁴⁶⁵

The emphasis on compliance in recent years has also resulted in the staff now being well informed, educated and trained in operational control and AML. In other words, professionalism within financial institutions is enhanced through the introduction of compliance in financial institutions.⁴⁶⁶ Consequently, the monitoring process in the current rule-based but risk-oriented approach should be enhanced, enabling employees to recognise and detect atypical transactions. Training should be aimed at raising questions when seemingly unusual transactions are noticed. After detection of an atypical transaction, employees are supposed to report these transactions to their AML compliance officers.

Within their AML tasks and because of their monitoring and reporting role, compliance officers act as gatekeepers for the AML chain, deciding on whether or not to report transactions to the FIU. This implies that they provide the potential starting point for ML investigations.⁴⁶⁷ In addition, AML compliance officers should be actively involved in the discussion of new products and services before the specific nature of the product or services has been finally determined. Their role is therefore crucial in the entire preventative approach to AML, and compliance officers must see

⁴⁶⁴ Gurung, Wijaya, and Rao, above n 445, 191.

⁴⁶⁵ 熊海帆 [Xiong Haifan], above n 86, 262.

⁴⁶⁶ Verhage, 'Compliance and AML in Belgium', above n 284, 118.

⁴⁶⁷ Ibid, 119.

their role as an integral part of the financial institution's business plan.⁴⁶⁸

Financial institutions should draft an operating manual or codes for staff, or add relevant AML responsibility to the existing codes according to AML legislation or existing internal principles. Detailed operating guides should consider the type of business or the unique field in which staff work, and all staff should be required to follow the manual in their daily practice. As a part of AML information and activities, most financial institutions in China have made their own AML operation manuals available within the institutions. For example, the Postal Savings Bank of China, which was established in March 2007, published its AML working manual in March 2009. It widely circulated the AML information and compliance requirements within all branches and at all levels. This included full descriptions of important AML legislation and financial sector guidance, general knowledge regarding the nature and consequences of ML, the AML obligations of financial institutions, the CDD and STR rules as well as five selected case studies. Eighty per cent of the content of the working manual, apart from copies of the AML legislation, focussed on answering the question of 'what it is', rather than 'how can it be done'.⁴⁶⁹ If this was an AML information brochure provided for the use of common people or non-professional individuals to disseminate the significance of ML prevention, there would be no problem. However, as an institutional publication which is to guide professional practitioners from all departments at all level, it is of very limited value.

In fact, almost all Chinese banks have more or less successfully implemented basic AML regulations, but understanding the necessity of AML is challenging and often not a major priority. This impedes the quality of AML efforts, as banks usually do not supervise and robustly audit the successful implementation of AML.⁴⁷⁰ In addition, when approving the establishment of new financial institutions, it is necessary to

⁴⁶⁸ Broome, above n 17.

⁴⁶⁹ 中国邮政储蓄银行 [Postal Savings Bank of China], 《反洗钱工作手册》 [Anti-Money Laundering Working Manual], March 2009.

⁴⁷⁰ Asian Banker White Paper, above n 381, 8.

check whether the entity has a sound AML internal control system, employs appropriate AML staff, and is equipped with AML supporting techniques.

7.4.1.2 Enhanced Requirements of a Rule-Based but Risk-Oriented Approach (Phase 2)

As China is a large and heterogeneous country, AML requirements vary from financial institution to financial institution and from region to region. In China, regions differ greatly in ML practices and therefore require a refinement of their regional ‘high risk’ profiles and an increased vigilance of particular practices and target groups as part of their due diligence.⁴⁷¹ Where the institution operates in a number of different regions, it is particularly important that senior compliance staff have a full understanding of the entire range and scope of the institution’s operations. Regular visits to each region and the development of close contact with local compliance staff are all essential to effective compliance work.⁴⁷²

Higher requirements for CDD should focus on the recognition of particular behaviour patterns instead of on particular background knowledge, as knowing how people behave is the best way to identify risks. Achieving higher criteria of KYC in the financial service industry would be based on:⁴⁷³

- * KTYC — *know the transactions of your customers*. Beyond KYC, understand the transactions of the customer and have systems in place to spot any irregularities or suspicious activity.
- * KCYC — *know the customers of the customer*. This extra level of understanding of the customers activities allows for an extra level of KYC process.
- * KYBP — *know your business partners*. Understanding partner institutions’ work to avoid involvement in unwanted activities.

A risk-oriented approach in Phase 2 requires financial institutions to develop the practical means to allocate appropriate resources for risk management. Consideration

⁴⁷¹ Ibid, 15.

⁴⁷² Broome, above n 17.

⁴⁷³ De Wit, above n 49, 156.

should be given to personnel, skills, experience and competence; resources needed for each step of the risk management process; documented processes and procedures; and information and knowledge management systems. Risk management is the process of recognising risk and developing methods to both minimise and manage this risk. This requires the development of a method to identify, prioritise, treat (deal with), control and monitor risk exposures.⁴⁷⁴ In the risk management framework, reporting entities are encouraged to include procedures for updating and reassessing risks and identifying new and significant changes to risks, which may assist business decisions regarding the mitigation and management of risks. For each identified risk, the reporting entity should: (a) assess the likelihood and impact of the risk; (b) assess the level of the risk identified; and (c) identify risk mitigation and control procedures relevant to the level of risk identified.⁴⁷⁵

The most critical point of an STR is the accurate identification of suspicious transactions. Thus, each suspicious transaction reported should cover all related information about the transaction, with an attached analysis and explanation made by the reported entity. A suspicious transaction should not be reported simply because the transaction is inconsistent with the descriptions of AML regulations. Phase 2 of the ‘rule-based but risk-oriented’ approach implies the use of ML risk rating system and an enterprise-wide AML information solution system. The automatic systems should serve as a second level detection mechanism, when Phase 1 implementation is not able or is not in the position to detect a suspicious transaction. Such a monitoring system should be installed and include detailed and tailor-made criteria, allowing for a consistent check of all transactions passing through the financial institutions’ systems. This implies that each financial institution should develop their own criteria and triggers for alerts, considering their customers, services and products.⁴⁷⁶ In addition, localisation efforts and plans should focus on enhancing local systems to be based on quasi-automated transaction monitoring, and developing a group of AML analysts for

⁴⁷⁴ Australian Transaction Reports and Analysis Centre (AUSTRAC), *Risk Management*, above n 290.

⁴⁷⁵ Australian Transaction Reports and Analysis Centre (AUSTRAC), *Guidance Note*, above n 372.

⁴⁷⁶ Verhage, ‘Compliance and AML in Belgium’, above n 284, 118.

each region, and leveraging off local systems for data mining.

Furthermore, the audit committee of a financial institution has a significant role in relation to the internal control of the financial institutions. Non-audit practitioners should be required to participate in the governance of the system for public oversight of the auditors, and the audit committee must monitor the effectiveness of the institution's internal control, internal audit and risk management systems.⁴⁷⁷ If the financial institution has long term problems with AML procedures, specific auditing reports should be made, and suggestions on the FI's risk management and internal control should be provided.⁴⁷⁸

7.4.2 Rule-Based but Risk-Oriented AML Audit Function

Accompanied by the transformation from a rule-based approach to RBA, AML regulation is no longer only focusing on external control but also on the combination of internal and external regulation, that is, independent audits of financial institutions by an internal audit function or external auditor is necessary.

Rule-based but risk-oriented AML auditing requires the auditor gather the information needed to identify the risks of ML in the financial institution that can be exploited by criminals, assess these risks after taking into account an evaluation of the entity's AML programs and controls, and provide suggestions as a result of this.

Where audits of account opening procedures are undertaken and deficiencies identified, it is important these are dealt with quickly and adequately. The causes of the problems must be identified, additional training provided if necessary and staff should be encouraged to meet their obligations. Where they confront difficulties with customers, staff should be encouraged to seek the assistance of more senior staff. If non-compliance continues, appropriate action targeting relevant staff needs to be taken by the institution to ensure that the financial institution's obligations are being

⁴⁷⁷ Michael Levi, and Nicolas Dorn, 'Regulation and Corporate Crime: Managers and Auditors' (2006) 12 *European Journal of Criminal Policy Research* 229, 245.

⁴⁷⁸ 边维刚 [Bian Weigang], above n 425, 93.

satisfied. Remediation plans should be established and maintained for issues identified by the audit. Employees in an internal auditing department cannot be appointed or supervised by the compliance department. For those small regulated entities in Phase 1 where internal auditing and compliance functions are often conducted by management staff, different functions should be implemented by different individuals.

Regulatory bodies should also allow financial institutions to employ external auditors to provide periodic auditing reports on a financial institutions' AML compliance. For a financial institution conducting an internal AML audit or resorting to external auditors to monitor AML compliance, the following auditing categories should be covered in both Phase 1 and Phase 2 of the rule-based but risk-oriented approach:

- 1) *KYC, CDD and Risk Rating Process* — Reviewing, developing, and assisting in the implementation of customer 'on boarding' and KYC procedures in accordance with risks of the institution and business lines under construction; customers being given a risk ranking in accordance with customer type, product, geography, transaction types, and other relevant factors; analysing, testing, and enhancing existing customer risk rankings; and conducting customer EDD and investigations into high risk customers.
- 2) *Risk Identification and Assessment* — Analysing the ML risks applicable to a particular institution, business line, product offering, or customer base, according to legal and regulatory requirements, regulatory guidance, and leading industry practice; developing and/or enhancing an institution's risk assessment methodology, working with existing tools and creating a program for on-going risk assessment; and conducting detailed risk analyses to assist in formulating a list of priorities for program enhancements where needed.

- 3) *Transaction Monitoring and Suspicious Activity Reporting* — Assessing, testing, and assisting in the development of automated transaction monitoring system; selecting AML transaction monitoring software providers and seeking advice on AML systems implementation; implementing AML monitoring systems, including the development and implementation of business rules, scenarios, and typologies for identifying suspicious transactions; identifying ML ‘red flags’ applicable to individual business and service lines; and implementing case management, investigative due diligence, and escalation protocols for suspicious activity reporting.
- 4) *Investigations and Due Diligence* — Assisting in the implementation of FIU, including procedures for information sharing and other enterprise-wide investigations; assisting in conducting broad and complex AML investigations, including asset tracing; and assisting in merger and acquisition-related due diligence of AML systems and controls
- 5) *Training and Awareness* — ensuring the adequacy of training program and materials; developing and/or enhancing enterprise-wide and business line specific AML training programs and/or materials; and delivering live training sessions covering key ML risks, identification and detection of suspicious and red flags as well as aspects of an AML compliance program.
- 6) *Gap Analyses* — Assessing gaps in current programs against legal and regulatory requirements, regulatory expectations, and leading industry practices; assessing gaps at institutional, business line, product, or customer level with respect to all aspects of program requirements or individual program requirements; and issuing recommendations to address gaps, keeping in line with industry standards.
- 7) *Policies and procedures* — Designing and implementing appropriate AML policies and procedures, as well as the internal audit testing programs for those policies and

procedures, including those relating to compliance, governance, KYC standards, monitoring, detection, investigation and reporting of suspicious activity, recordkeeping, and other AML requirements; accessing technical advice and interpretation of global and local regulatory standards; adopting risk management procedures based on business lines and products offered, in addition to customer base and relative geographies; and utilising geography and customer risk scoring methodologies.

Additionally, for a financial institution conducting internal AML audit or resorting to external auditors to monitor AML compliance, the following auditing categories should be further covered in Phase 2 of the transition to a rule-based but risk-oriented approach:

- a) *Sanctions/Undesirables Lists* — Utilising risk of enterprise, business lines, customers, geographies, transactions, and delivery channels to identify areas of risk and vulnerability; and analysing customer and vendor databases for compliance with sanctions lists and lists of undesirables, helping to ensure effective recognition of any prohibited entities and false positives after further scrutiny.
- b) *Introducing Broker/Dealer Due Diligence* — Analysing various international regulatory AML environments; determining regulatory risk exposure for potential introducing brokers/dealers relationships; and developing robust practices in risk mitigation in introducing brokers/dealers relationships.
- c) *Remediation and valuation* — Scoping, planning, and implementing AML remedial work to meet regulatory requirements; complying with all aspects of regulatory enforcement actions; utilising data extraction and normalisation of transaction analysis; conducting transaction ‘look backs’ and preparing materials for remedial suspicious activity reporting; validating of remediation efforts; conducting quality assurance reviews; and designing, operating, populating, and scrubbing remediation

databases

- d) *Independent Testing* — Assessing existing AML compliance programs for compliance with legal and regulatory requirements, as well as regulatory expectations and leading practices; conducting internal audit testing of appropriate AML policies and procedures as part of the annual independent testing function; and testing of AML systems and controls to evaluate design and operating effectiveness.

7.4.3 Standardised ‘Tick the Box’ Checking and Advanced Performance Management

The rationale for proposing the ‘rule-based but risk-oriented approach’ is to create a buffer zone during the full implementation of RBA. The ultimate goal of partial RBA is to remove the immature parts of AML compliance within a designated time period having regard to the operational reality of each financial institution. However, the focus on the formal existence of regulatory arrangements, rather than on implementation, poses a challenge to the evaluation of the effectiveness of regulatory systems.⁴⁷⁹ Scientific measurement methods should be devised on the basis of and be consistent with the different phases of a rule-based but risk-oriented approach.

A senior officer from the China Anti-Money Bureau of the PBC commented that risk based assessment of AML regulation in China should focus on CDD on new and existing customers, customer risk classification, the financial institution’s manual analysis and subjective judgement of STR, the AML offsite supervision, the AML onsite inspection, and dialogue with the private sector.⁴⁸⁰ As can be seen, some of the elements are the basic obligations and some of them are enhanced requirements of a partial RBA. It is expected that a ‘tick the box’ method will be used to check standard AML criteria, and apply performance management (PM) method to measure advanced

⁴⁷⁹ International Monetary Fund (IMF), *Accountability Arrangements*, above n 432, 23.

⁴⁸⁰ Yongyan Shi, *Understanding and Complying with AML Regulations in the Asia Pacific Region*, August 2010. This is a presentation at the 2nd Annual ACAMS Anti-Money Laundering & Counter-Terrorism Financing Conference held in Shanghai.

AML indicators.⁴⁸¹

Financial institutions and AML regulators can determine whether an institution is ready to implement a full RBA through positive performance indicators, for example, the above-mentioned AML auditing categories. If the auditing result of all categories is largely compliant, that is to say, the audited entity's AML program is mature enough to commence RBA practice. Conversely, the readiness of RBA practice can also be assessed from negative performance indicators, such as AML failures categories.

Indeed, a reporting entity's AML compliance may alert the entity to any potential failures including but not limited to:⁴⁸²

- (a) failure to include all mandatory legislative components;
- (b) failure to gain board and/or executive approval of the AML program;
- (c) insufficient or inappropriate employee due diligence;
- (d) frequency and level of risk awareness training not aligned with potential exposure to ML risk;
- (e) changes in business functions which are not reflected in the AML program;
- (f) failure to consider feedback from the FIU;
- (g) failure to undertake independent review of the content and application of the AML program;
- (h) legislation incorrectly interpreted and applied in relation to a customer identification procedure;
- (i) customer identification and monitoring systems, policies and procedures that fail to confirm the information's adequacy, quality and accuracy;
- (j) lack of access to information sources to assist in identifying higher risk customers, such as PEPs, terrorists and traffickers of illicit drugs;

⁴⁸¹ Frank H Verbeeten, 'Performance Management Practices in Public Sector Organizations: Impact on Performance' (2008) 21(3) *Accounting, Auditing & Accountability Journal* 430. Performance management (PM) can be defined as the process of defining goals, selecting strategies to achieve those goals, allocating decision rights, and measuring and rewarding performance.

⁴⁸² Australian Transaction Reports and Analysis Centre (AUSTRAC), *Guidance Note*, above n 372.

- (k) lack of ability to consistently and correctly train staff and/or third parties;
- (l) acceptance of documentation that may not be readily verifiable.

In fact, key performance indicators (KPIs) are commonly used in industry as a measure of performance. KPIs are commonly used by an organisation to evaluate the success of a particular activity in which it is engaged. Accordingly, choosing the correct KPIs relies upon having a good understanding of what is the important AML focus for an organisation. Organisations often focus on results expressed as numbers; however, what they really need to look at is the activities and processes. A small number of core indicators, and normally no more than 10 indicators, are enough to be the KPIs to serve as performance assessment indicators for an entire organisation.⁴⁸³ These assessments of indicators often lead to the identification of potential improvements, and, as a consequence, performance indicators are routinely associated with performance improvement initiatives.⁴⁸⁴

Using KPIs in AML performance management is to allow periodical assessment of the AML performances of organisations, AML business units, and their division, departments and employees. The PM process can follow the SMART (Specific, Measureable, Attainable, Relevant, and Timely) criteria. This means the AML performance measure has a specific purpose for AML practice. It is utilised to determine a value of the KPI, and the defined norms have to be attainable. The improvement of a KPI has to be correlated with the success of AML practice in the organisation, and finally it must be 'time phased', which means the value or outcomes are shown for a predefined and relevant period.

KPIs can be applied both for organisations in a rule-based but risk-oriented approach Phase 1 or Phase 2, or both for small and medium sized financial institutions and larger enterprises, since different organisations select their own KPIs that reflect the

⁴⁸³ See, David Parmenter, <<http://davidparmenter.com/books/key-performance-indicators/>>.

⁴⁸⁴ David Parmenter, *Key Performance Indicators* (John Wiley & Sons, 2007).

organisation's AML goals. When an organisation completes its progress from Phase 1 to Phase 2, the goals for AML KPIs should change as the organisation's AML requirement and goals change, or as it gets closer to achieving full RBA practice.

A properly developed system of KPIs should provide all staff, including counter staff, compliance officer, suspicious transaction analysts, internal auditors, and senior managers, and so on, with clear AML goals and objectives, coupled with an understanding of how they relate to the overall success of the AML practice in the organisation. As introduced by David Parmenter, KPIs are a special instrument which can link daily activities of the staff in an organisation to the general direction of strategies. Parmenter also suggested organisations from government departments through to private sectors and financial institutions should implement KPIs in their PM.⁴⁸⁵

It should be borne in mind that PM results should be interpreted as guidance, not answers. The use of PM practices should also be accompanied by conduct guidelines such as ethical codes and codes of behaviour.⁴⁸⁶ A successful AML compliance transition in a rule-based but risk-oriented approach, both from operational capacity and ethical perspective, will, in the future, definitely provide a robust foundation for full RBA practice in the Chinese financial sector.

7.5 Comment and Conclusion

Indeed, with the transition of the financial institutions' autonomous strategy of risk management, regulation is a time when greater attention should be paid to financial institution's behaviour. However, we should not neglect where the regulator stands in the approach to transition. A lax or light system of regulation will reduce the financial institutions' commitment to AML with a correspondingly increase ethical risk. Over-stringent regulation, on the other hand, will add to compliance cost for financial

⁴⁸⁵ Parmenter, above n 483.

⁴⁸⁶ Verbeeten, above n 481, 443.

institutions, and correspondingly impede financial innovation.⁴⁸⁷ In order to find a balance point between stability and flexibility in achieving AML effectiveness in the Chinese financial sectors, this chapter concludes that the proper approach to AML compliance in China is a combined solution as rule-based but risk-oriented approach or partial RBA. This will retain the benefits of simplicity and certainty, enhancing the effectiveness of AML compliance.

Given different business sizes and a varied regional financial environment, financial institutions in China may stand either in Phase 1 or Phase 2 of the rule-based but risk-oriented AML approach. Each phase is provided with associated measurement methods, and all financial institutions initially in Phase 1 will converted to Phase 2 within a designated time period. This dual approach system is not only consistent with the Chinese financial institutions' reality, but also has cultural underpinning which means the necessary associated behavioural changes are acceptable.

As the ultimate goal for the regulated entities is to make them ready for the implementation of a full RBA, all financial institutions in China must spare no effort in meeting the following criteria to combat ML:

- (a) The financial institution must have an AML system with clear responsibilities assigned and that will develop strategies to identify, assess, monitor and control/mitigate ML risks, codify institution-wide AML policies and procedures, design and implement an STR system and introduce the institution's AML assessment methodology.
- (b) The AML assessment system must be closely integrated into the risk management processes of the financial institution. Its output must be an integral part of the process of monitoring and controlling the institution's risk profile.

⁴⁸⁷ 边维刚 [Bian Weigang], above n 425, 109.

- (c) There must be regular reporting of financial institution's performance in complying with AML legislation and regulations.
- (d) The financial institution must have a routine in place for ensuring AML compliance with a documented set of internal policies, controls, and procedures, which must include policies for the treatment of non-compliance issues.
- (e) The financial institution's AML processes system must be subject to validation and regular independent review by internal and/or external auditors.

Chapter 8. CONCLUSION

8.1 Summary and Final Remarks

The purpose of this research was to explore (i) why the existing AML system lacks effectiveness in the Chinese financial sectors; (ii) what the ML vulnerabilities in the Chinese financial sectors are; and (iii) what the most suitable approach for AML compliance in the Chinese financial sectors is. To achieve these goals, this thesis examined current AML regulation and compliance in the Chinese financial sectors based on an objective analysis of the internal and external environment. It also considered comprehensive risk considerations and proposed necessary measurements to ensure an effective AML process in the Chinese financial sectors.

8.1.1 Criminal Offence of Money Laundering and Anti-Money Laundering in China

In Chapter 2, this thesis examined the background of criminalisation of ML stipulated in Chinese legislation, features of ML methodologies in China, and Chinese AML institutional structure. The thesis found that ML activities are mainly conducted through financial institutions, recirculation in legitimate businesses and commodity markets, the underground banking system and private loans. In addition, local policies for AML in loosely regulated jurisdictions are also taken advantage of by money launderers.

Within these ML activities, there are close relationships to corruption, international hot money, and privatised economic activity. Indeed, Asia continues to dominate illicit flows from developing countries, and China continues to be the top exporter of illicit capital according to statistics of cumulative outflows of illicit capital from developing countries in the period 2000–2008.⁴⁸⁸ Moreover, the British Broadcasting Corporation (BBC) reported that thousands of corrupt Chinese government officials have stolen more than totalling CNY 800 billion (USD 120 billion or GBP 74 billion) and fled overseas, mainly to the US, and between 16,000 and 18,000 officials and

⁴⁸⁸ Dev Kar and Karly Curcio, 'Illicit Financial Flows from Developing Countries: 2000-2009' (January 2011) *Global Financial Integrity*, 16.

employees of state-owned companies left China with funds from the mid 1990s up until 2008.⁴⁸⁹ Due to the strict requirements for borrowing money from formal banks, local SMEs have to resort to private loans to meet their financing needs. It provides a fruitful environment for ML activities. It is obvious that there is a strong correlation between ML and those critical issues, and AML has a correspondingly significant role in dealing with social and financial problems in China. Indeed, the more attractive the underground economy is for legitimate transactions, the more available that market is for illicit transactions.⁴⁹⁰ As a result, these alternative or underground financial systems become a ready conduit for illegitimate transactions that are undetectable to governmental authorities and in turn undermine AML efforts and the integrity of the financial system.

Although a series of successes and landmarks in China's AML legislation from the 1990s until 2010, the AML institutional structure and AML arrangements in Chinese financial sectors has been developed and improved. Chapter 2 identified regulatory weaknesses and practical loopholes faced by both AML regulators and regulated entities that consequently undermine the effectiveness of AML compliance in Chinese financial institutions at all levels.

8.1.2 The Economic, Political, Legal, and Cultural Factors of Anti-Money Laundering Effectiveness

Apart from establishing a fully-fledged AML structure and comprehensive AML arrangements, effective AML implementation depends on a country's domestic reality. Chapter 3 discussed inherent limitations and practical difficulties in China's AML implementation from economic, political, legal, and cultural perspectives.

During the last 30 years, China's financial structure has been reformed from a planned

⁴⁸⁹ BBC, Chinese Officials Stolen \$120 Billion, Fled Mainly to US (17 June 2011) <<http://www.bbc.co.uk/news/world-asia-pacific-13813688>>. The author of that report noted that it was based on a study posted on the People's Bank of China website the week of publication but that it had since been removed.

⁴⁹⁰ Financial Action Task Force on Money Laundering (FATF), *Anti-Money Laundering and Terrorist Financing Measures and Financial Inclusion*, June 2011, 15.

economy to a socialist market economy, and in this process, the economic distance between different regions in China, is large and growing, especially between East China and West China. Income distribution has correspondingly changed drastically, and the income gap between urban residents and rural residents is continually widening. Due to the huge differences in the scope of business, operational capacity, customer type, and the understanding of risk management, it is self-evident that universal performance of effective AML compliance at all levels in China is hard to achieve.

Huaping Kang noted that

*[A]t present, the regulatory model in Chinese financial sectors is functional regulation. Under this regulatory structure, uniform minimum standards for regulatory compliance is set up for similar work at the same level, and the progress rate will be included in the assessment criteria. However, financial institutions execute AML compliance to different degrees due to geographic factors and capacity factors. It would be more reasonable for regulators, at next stage, to consider the East-West economic differences in accordance with local conditions when assessing a financial institution's AML compliance at different levels...*⁴⁹¹

This thesis found that driven by widespread establishment of sub-branches, increasing scale and market share, and national and global expansion, Chinese financial markets are facing uncontrolled competition. Problems hidden by this growth are weak internal controls and risk management within financial institutions, and uncontrolled competition may lead to ignorance of professional and ethical issues. In addition, local implementation may be inconsistent with centralised law making since local government has its own preferences or interests. A Special Report on China's commercial banking undertaken by Business Monitor International (BMI) pointed out that from a political perspective 'provincial governments often fail to enforce central government directives', and the country has faced growing corruption, widening inequalities and increasing rural poverty in recent years.⁴⁹²

⁴⁹¹ Interview with Huaping Kang, Deputy Chief, Human Resource Department, China Banking Regulatory Commission (Beijing, 4 November 2010).

⁴⁹² Business Monitor International (BMI), *China Commercial Banking Report Q3 2011: Including*

In Chapter 3, this thesis also looked at inherent limitations and practical issues concerning the effectiveness of AML performance. In particular, China shares some common features with most transition countries in AML practices such as the conscious strategy of adopt but not enforce'. In some cases, AML is used as political or diplomatic game chips, and international AML cooperation between China and other international organisations has been obstructed due to political issues. Apart from the external environment, there are also problems inside the AML system *per se*. Domestically, when the PBC (the central bank), implements its guiding role in the entire Chinese AML regime, it faces inherent dilemmas arising from the institutional conflicts with the CBRC, the CSRC and CIRC, which in turn affects the effectiveness of AML actions. Under the financial reform of 'separate operation, separate supervision', the relevant regulator for an individual sector is responsible for regulating all types of business activities other than AML related work. When it comes to dealing with AML work, the three sector regulators hand back the supervising power and responsibility to the central bank. Similar institutional conflict exists within the PBC itself as well. In fact, the recent reforms have left the role of the central bank unclear. Is it to function as a regulator of banks and other financial sector elements (in relation to AML for example) or to function as a provider of financial services?⁴⁹³ The blurred function impedes the effectiveness of AML supervision of the entire financial sectors.

Huaping Kang continued,

[I]t is fairly to say that information sharing among banking, securities, and insurance sectors is not quite effective nor is the information exchange between individual sectors and the central bank. Although the CBRC, CSRC, and CIRC have separated from the PBC in order to ensure effective supervision of each financial sector, these three sectoral regulators are not 100 per cent independent from the central bank. In fact, there are always competing interests among these four leading regulators.

5-Year Industry Forecasts to 2015, May 2011, 8.

⁴⁹³ 边维刚 [Bian Weigang], above n 425, 208.

*Besides, although punishment of violations of law in financial sectors has been intensified, for most of Chinese banks, reputational risk is still not an area worthy of being paid great attention...*⁴⁹⁴

Kun Wang pointed out the AML institutional problem as well as she said,

*[T]he PBC should play the role of coordinator in AML regulation, and allocate the duty of AML front-line supervision to individual sectoral regulators daily supervisory obligation. That is, AML front-line examination and punishment should be done by the CBRC, CSRC, and CIRC, rather than PBC per se. Instead, the PBC should put its efforts on further development of the entire Chinese AML framework*⁴⁹⁵

Chapter 3 finally found that AML performance is also negated by unproductive criminalisation of ML crime due to ineffective confiscation systems, and low penalties that provide little deterrence. It also examined the nexus between Chinese culture reflected in concepts such as the ‘Three Cardinal Guides’, the ‘Doctrine of Mean’, and ‘Face Culture’, and AML effectiveness. With a society built on Confucian ‘Cardinal Relationships’, Chinese people are socially oriented and situation-centered and more likely to follow orders of or adhere to doctrine from their leaders.⁴⁹⁶ The thesis revealed that Chinese traditional culture encourages ‘command and follow’ behavioural models and a reserved manner of AML practice. With such traditional mores, implementation of an RBA poses significant challenges for Chinese financial institutions.

8.1.3 Implementing Factors Affecting AML Effectiveness

AML performance is partly influenced by external factors; however, a number of shortcomings in AML enforceability can be found within the regulated institutions *per se*, resulting in gaps between the enactment of legislation and practical AML implementation. In Chapter 4, this thesis examined the main weaknesses within the AML programs of Chinese financial institutions. These included account-opening CDD, social environmental support of customer ID identification, customer

⁴⁹⁴ Interview with Huaping Kang, above n 491.

⁴⁹⁵ Interview with Kun Wang, above n 458.

⁴⁹⁶ Brody and Luo, above n 394, 320.

identification in non ‘face to face’ transactions, and CDD by a third party. Due to the unsound implementation of AML programs, as well as the lack of both professional AML training and adequate technical support, large-value or suspicious transaction reports made by most regulated entities are of limited value, and transactions are often repeatedly reported. When determining a suspect transaction, more work should be done on automatic analysis and manual examination in order to reduce the FPR. However, this thesis found that limited investment has been made in AML resources and employee training in Chinese financial institutions. For one thing, the priority for financial institutions is to survive the global financial crisis and its recovery period, and thus, there is no strong incentive for them to add further AML costs. In addition, the AML culture within Chinese financial institutions is immature so that internal control is inadequate in the following respects: staff-screening, monitoring of AML compliance outcomes, external and internal AML assessment, the role and functions of compliance officers and the professionalism of the AML team.

8.1.3.1 Building Incentive Mechanisms in the Chinese AML System

Financial institutions have long had the motivation of avoiding finding their names linked with undesirable elements enforced by existing criminal legislation. However, evidence suggests that compliance is seen as sanction avoiding rather than viewed as good business practice.⁴⁹⁷ Worried by the risk of losing a share of customers’ money, bankers and other financial institution practitioners are reluctant to ask customers pertinent questions. The same level of compliance cannot be assured among different banks, for example. If every bank asks the same questions during their customer identification process about the origin of funds and the purpose of their transactions, the problem of poor compliance would recede. AML compliance would cease to be a competition issue. Implementation of AML programs and CDD, however, is easier said than done; that is, a gap may exist between documented regulations and practical compliance. But the question must be asked, ‘Why does the gap exist?’ Concerns

⁴⁹⁷ Jackie Harvey, and Siu Fung Lau, ‘Crime-Money, Reputation and Reporting’ (2009) 52 *Crime Law Social Change Cultural* 57, 58.

about implementation costs may be one of the answers, hence incentive mechanisms and lower cost compliance options (such as sharing training costs and the production of material between a number of institutions) may be needed to help fight ML.

For AML program non compliance, effective, proportionate and dissuasive criminal, civil or administrative sanctions should be available in relation not only in relation to the legal persons that are financial institutions or businesses, but also to their directors and senior management. These might include written warnings, fines for non compliance, and restrictions on the managers' power, and so on. The standard for determining whether a financial institutions is found 'guilty' of non compliance by the regulator is for that regulator to examine whether the financial institutions has, in the regulator's view, effective systems and controls to provide reasonable assurance that the institution can avoid aiding or abetting money launderers and financial criminals. It is not even necessary for any ML to have actually taken place. The financial institutions and the directors of the institutions should be subject to substantial fines and personal liability for defective or ineffective implementation of the AML system. According to PBC statistics, in 2005 600 financial institutions received administrative penalties and were ordered to pay fines of CNY 56.26 million in total because of non compliance with AML regulations.⁴⁹⁸ Apart from the administrative penalties, the *Chinese Criminal Law* also imposes the following penalties on those found guilty of ML: a) fines of up to 20 per cent of the money laundered and/or up to 10 years of imprisonment for individuals; and b) fines of up to 20 per cent of the money laundered and/or up to 5 years of imprisonment for chief officers, executives or other personnel with direct responsibility for institutions.⁴⁹⁹

Reporting entities must establish procedures for managing employees who fail to comply with their employer's AML policies, procedures or processes. Some considerations in assessing non compliance include: seriousness of non compliance,

⁴⁹⁸ 中国人民银行 [People's Bank of China], 《2005 年中国反洗钱报告》 [*Anti-Money Laundering Annual Report (2005)*], 24 August 2006.

⁴⁹⁹ 《中华人民共和国刑法修正案（六）》 [Criminal Law of the People's Republic of China (VI)].

reason for non compliance (for example, whether it is deliberate or inadvertent), and the frequency of non compliance. The corresponding responses may include: additional training, an adverse effect on an employee's performance assessment, disciplinary action, dismissal, and reporting the actions of the employee to AML regulatory authority.⁵⁰⁰

Indeed, the whole international community emphasises the need for 'sticks' to be available to deal with non compliance by financial institutions but few 'carrots' are offered to encourage compliance. However, does the 'one way' non compliance punishment use make AML compliance more effective, and does the 'no carrot and lots of sticks' game in relation to Chinese AML programs really produce results? This is worthy of discussion. Economists would like to bring incentive mechanisms into AML systems, and this is not a bad or impossible idea. It is suggested that incentives created by an AML regime may guide the regulated entities toward the desired conduct. Supervisors and regulators should foster the kinds of AML regulations that incur not only costs but also benefits for financial institutions, so that their conduct will be as effective as possible in regard to AML, without reducing their efficiency in performing normal duties.

In order to improve the average level of AML compliance in financial sectors, relevant incentives should be rewarded to those financial institutions with outstanding performance on combating ML. The incentives can be derived from confiscated illicit funds that have been facilitated by financial institutions and tax return from government. Proposed economic compensation systems may include:

- (1) A suspicious reporting fund — which aims to assist with a financial institution's expense of investigation concerns about key suspicious customers, and associated reporting costs.
- (2) A result incentive fund — which aims to reward law enforcement agencies,

⁵⁰⁰ Alison Dietz and John Buttle, *Anti-Money Laundering Handbook* (Thomson Lawbook, 2008) 171.

financial institutions, and individuals that have made obvious achievements in combating ML.

In addition, according to the AML performance grading of individual financial institutions, AML authorities should formally publish special recognition of AML achievement through the national mainstream media. With regards to those financial institutions earning higher grades in performance assessment should be publicly acknowledged so as to supply social recognition of their achievements and to enhance such an institution's reputation. By doing so, a positive norm of AML can be cultivated in the public, and it will contribute to establishing AML awareness across the entire society. In addition, the central bank should consider linking AML achievements to financial incentives, such as refinancing services. The higher the level of AML performance ranking the financial institution achieves, the more preferential policies the financial institution enjoys.

8.1.3.2 Strengthening Chinese AML Loss Prevention Mechanism

Under the AML regime, building a loss prevention mechanism is also important for combating ML. Under an effective loss prevention strategy regarding AML, loss can be reduced or prevented by putting in place, adequate preventive steps or early detection methodologies. Losses may also be recovered in an unencumbered manner based on previous detection.⁵⁰¹ All the possibilities and endeavours in a loss prevention strategy have a uniform theme: 'crime does not pay'. In particular, the strategy for loss prevention has to be proactive. Based on an intelligence oriented approach, there may be forewarnings of possible damage and timely and effective steps can be taken to prevent or reduce the losses. With regard to the importance of loss prevention under the AML regime, it may be a good strategy for regulatory bodies in China to have a view to building effective strategies and also take the necessary steps to develop early warning systems and emergency response mechanisms for ML offences.

⁵⁰¹ Tyoti Trehan, *Crime and Money Laundering: The Indian Perspective* (Kluwer Law International, 2004) 167.

8.1.3.3 Further Developing AML Corporate Culture

The predominant feedback from commercial banks in China was that they regard AML mainly as a means of risk management, as a waste of time and resources, or as a major cost driver. Some even perceive it as negatively affecting profits as it frightens away customers with its more complicated and comprehensive KYC procedures, and because clients are afraid of a weakening of bank secrecy. Moreover, rigid AML specifications have the potential to limit business opportunities. It is even directly claimed that ‘AML remains a non-issue for most Chinese banks, unless they go international’.⁵⁰²

Senior managers of financial institutions should recognise that being seen as a good corporate citizen is a valuable positioning and reputational strategy that enhances consumer trust; but, unfortunately, crime prevention is rarely one of the priority areas listed by corporations in their portfolio of corporate social responsibility (CSR) activities.⁵⁰³ Thus, cultural change is required in the private sector to ensure that the necessary development occurs. Secondly, cultural change without structural change in organisations will be insufficient.⁵⁰⁴ IN accordance with AML strategy, the Board of Directors should approve the AML policy and any subsequent significant change to the policy. The internal AML system should include provisions that ensure compliance with applicable laws and regulations, appoint a designated AML officer, provide for periodic training, and provide for independent audits to ensure compliance with the policy. As a matter of good governance, the Board should review the AML policy and the underlying components on a regular basis.

8.1.3.4 Enhancing AML Staff Training

There is a continuing need for AML training throughout a firm. Training initiatives

⁵⁰² Asian Banker White Paper, above n 381, 11.

⁵⁰³ Jeffrey Avina, ‘Public-Private Partnerships in the Fight against Crime: An Emerging Frontier in Corporate Social Responsibility’ (2011) 18(3) *Journal of Financial Crime* 282, 283.

⁵⁰⁴ R E Bell, ‘The Confiscation, Forfeiture, and Disruption of Terrorist Finances’ (Autumn 2003) 7 (2) *Journal of Money Laundering Control* 105, 118.

should be developed to ensure consistency in content, delivery methodology, testing and tracking. The primary content of training series should include:

- (1) AML basic knowledge training — including definitions, features, methodologies, and evolving trends of ML and AML; the strategic aims and systematic framework of the AML program; and the AML roles and obligations of financial institutions and other AML-related departments.
- (2) AML legislation training — conduct thorough research on AML legislation; have a sound understanding of all reporting criteria of large-value transactions and suspicious transactions; update study of and training regarding newly published AML regulations and policies.
- (3) AML operation training — combine the latest AML trend and international AML cases to analyse domestic ML methodologies, introduce AML experiences and techniques, demonstrate systematic operation of AML business, steadily enhance financial professionals' AML awareness and AML skills, and particularly strengthen their capacity of determining suspicious transactions.
- (4) Other AML-related training — In order to deal with increasingly complex money-laundering activities which involve cross-border or international transaction and high-tech transactions, AML staff should have comprehensive training on legislation, finance, accounting, auditing, computing, and English, and so on.

Mr. W noted that

“...each financial institution in Hong Kong is expected to have a dedicated AML team in place to tackle AML related matters. These AML teams will be responsible for CDD/EDD, AML risk assessment, transaction monitoring and account exit policies. AML training is mandatory for all new and existing staffs of FIs in Hong Kong. Such training will include CDD/EDD, use of AML system, identification of typical money laundering patterns, requirements to file suspicious

*transaction reports, etc*⁵⁰⁵

According to Australian experience, AML risk awareness training program must be:⁵⁰⁶

- based on an assessment of gaps in employee knowledge and competence;
- ongoing from the time of induction;
- aligned to the corporate training system;
- practical and readily understood by employees;
- relevant to the 'day to day' work of employees and illustrative of the industry, organisation or sector concerned;
- sufficiently flexible to account for a range of techniques to accommodate the differing needs of organisations and employees;
- assessed for effectiveness;
- updated as required;
- recorded.

8.1.4 Money Laundering Vulnerabilities in the Chinese Financial Sectors

Financial institutions, as the most popular venue for financial activities, may be abused as an instrumentality for laundering money. In order to implement functional risk management on ML, an organisation should first understand its processes and avenues of likely exposure to ML. In Chapter 5, this thesis examined key elements for Chinese financial institutions to develop earlier detection of threats or vulnerabilities of ML, and introduced reporting standards for suspicious RMB payment transactions in Chinese banking, securities, and insurance industries.

This thesis found that Chinese financial institutions should increase their understanding of operational risk and reputational risk related to ML compliance, even though the fact is there is no actual risk of bankruptcy or collapse faced by these institutions. Reputational damage and fines are still not seen as a serious concern by most Chinese banks, but things are slowly changing, and reputational risk is gaining

⁵⁰⁵ Interview with Mr. W, above n 384.

⁵⁰⁶ Dietz and Buttle, above n 500, 155.

in importance. AML management relies on a good environment of public opinion, however, the news media rarely pays attention to ML risks faced by financial institutions. There are governmental notices and regulations which can be found in news media; however, the public still do not have a basic understanding of ML, as well as their own associated responsibility to assist financial institutions to fight against ML.

The use of publicity should be seen as a valuable and appropriate means of achieving compliance. News media is the main channel from which the members of the public gather information, and the media should perform their role in a responsible manner. Apart from reporting government regulations, critical and objective comments should be made regarding ML related cases. In some particular cases, prosecuted money launderers are people who have no idea that the nature of their behaviours is actually criminal. From this perspective, news media should bear a part of responsibility in AML education, and play a positive role in fostering the informal AML system in China. For those financial institutions involved in ML cases, the names of financial institutions and associated persons prosecuted and related prosecutions should be publicly released. In this way, financial institutions linked to criminal activity will be condemned by the public, and correspondingly actually sustain a loss to their reputation. On the other hand, the names of financial institutions that have made obvious achievements in fighting against ML activities should also be acknowledged by the news media.⁵⁰⁷ Instead of blindly following the international standards, regulators and practitioners should thoroughly analyse the nature of the Chinese financial sectors as well as the nature of predicate offences for ML linked to these sectors to determine areas of high risk according to actual national realities.

In this regard, this thesis examined a numbers of ML vulnerabilities particular in the Chinese banking, securities, and insurance sectors. Overall, these three sectors need to

⁵⁰⁷ Karin S Helgesson, 'Public-Private Partners against Crime: Governance, Surveillance and the Limits of Corporate Accountability' (2011) 8(4) *Surveillance & Society* 471, 475.

increase their capacity to determine and verify customer identification, developing internal audit and self-assessment systems. Close attention should be paid to monitoring the ML risk associated with non ‘face to face’ transactions in Chinese banking institutions, especially in regard to the electronic payment system and related bank services. Regarding a correspondent bank, the first financial institution must carry out a due diligence assessment on the second financial institution in regard to the following aspects: the nature of business (including its product and customer base), country of residence and its parent company, adequacy of control and internal compliance practices, ownership and management structures, financial position, reputation and history, and whether second financial institution has been subject of investigation or proceedings.⁵⁰⁸ As the Chinese securities sector is full of speculative activities performed in irregular ways, high levels of ML vulnerabilities are more likely related to insider trading, market manipulation, transactions involving multiple jurisdictions, reciprocal trades, and rogue employees. In the Chinese insurance sector, apart from common ML vulnerabilities in the unusual purchase or surrender of insurance policies, the content of insurance policies, third party payments, and unusual geographical involvement, greater attention should also be paid to insurance intermediaries, orphan insurance policies, and underground insurance policies purchased from Hong Kong or Macao.

This thesis also found that mixed (or cross sector) businesses — such as is involved in the cross-selling of products, the stock trading settlements service on commission, and bancassurance services — in the Chinese financial sectors are vulnerable to ML activities. Since reforming and opening, China’s financial market has gradually shown a tendency towards mixed-sector business and even integrated business. It is inevitable that financial services from different sectors will cross-integrate with each other; however, under the current financial regulatory system, there is both duplication of regulation and a vacuum of regulatory activity across the banking,

⁵⁰⁸ Dietz and Buttle, above n 500.

securities and insurance sectors.⁵⁰⁹ These circumstances make the complicated mixed-sector business more vulnerable to ML risks, and make the supervision on mixed-sector business even harder.

Granted, the unique features of ML via financial sectors and transaction flows are more likely to be apparent to financial sector professionals than AML regulators. However, different financial institutions may practice AML at different levels and this presents challenges to regulators to achieve equal standards of compliance, especially during the global financial crisis's slow recovery stage. In this regard, self-regulatory associations constituted by financial institutions can, to the largest extent, control ML risks without affecting their normal businesses.

Domestically, China developed its own self-regulation association in each individual sector, namely the China Banking Association (CBA), the Securities Association of China (SAC), and the Insurance Association of China (IAC), aiming to encourage self-regulation and communication among members, regulate operation and management of its members, protect the legal rights of members, and promote the healthy development of the banking sector, securities sector, and insurance sector.⁵¹⁰ However, so far there are only very few examples of AML activity that can be detected on the CBA, SAC and IAC websites, and all of them are PBC regulatory announcements dated from August 2006 to September 2008.⁵¹¹ Valuable lessons can be learned from Wolfsberg Group in enhancing the role of AML self-regulation. All members of domestic self-regulation associations should strictly follow their association's AML agreement. Certain sanctions or consequences should be imposed with regard to agreement violation, such as public criticism, naming on blacklists, and cancellation of association membership. External professionals including independent accountants, independent auditors, and AML researchers should be able to join these

⁵⁰⁹ 孙蓉, 彭雪梅, 胡秋明 [Sun Rong, Peng Xuemei and Hu Qiuming], above n 371, 298.

⁵¹⁰ Business Monitor International (BMI), above n 492, 36.

⁵¹¹ See, <www.china-cba.net>; <<http://www.iachina.cn/>>; <<http://www.sac.net.cn/>>.

self-regulation associations. External professionals should work with the executive body of self-regulation associations to ensure the technical and fair assessment of AML performance practised by all association members.

8.1.5 Money Laundering Risk-Rating System and AML Information Solution

In order to increase the capacity for risk management, Chinese financial institutions should recognise the importance of combining functions for ML risk rating systems and enterprise-wide AML information solution systems. In Chapter 6, this thesis examined an index of ML risk-rating system and proposes the design of a risk centred AML information solution system, which would assist financial institutions to produce valuable reports based on adequate risk identification, measurement, and categorisation.

Chapter 6 encouraged Chinese financial institutions to grade the ML risks associated with customers by creating customer profiles, and taking the Chinese reality into consideration, customer monitoring should be also conscientiously and seriously conducted on domestic PEPs and FEPs. In addition, this thesis concluded that ML risk monitoring, identification, and diagnosis should be applied according to risk categories of products and services, designated services, country or jurisdiction, and business delivery methods, and types of customers. ML risks attached to business provided by FIEs and those risks hidden in law breaking activities of rogue employees in Chinese financial institutions should also not be neglected.

Financial institutions normally collect data internally and externally. External data is usually retrieved in the form of open data from ML watchdog agencies, national government, and other authorities.⁵¹² On the other hand, internal data collecting from an enterprise-wide system enables financial institution to check its own data quality and control defensive report-filing. In particular, the ML information solution system covers customer profile assessment, transaction risk measurement, and further

⁵¹² Gao, Xu, Wang, and Green, above n 429, 71.

behaviour diagnosis and reporting. Developing effective suspicious activity detection methods has become an increasingly critical problem for governments and financial institutions in their efforts to fight ML. The second part of Chapter 6 proposed the development from the traditional fixed-rule-based solution based on pre-established indicators to a risk centred solution based on subjective assessment, since the fixed-rule-based systems cannot learn or generalise new patterns and they can only match patterns that they have already identified.

This thesis designed an enterprise-wide AML information solution system which contains seven sub-systems, namely, CDD, watch lists, transaction risks, scenario detection, behaviour profiling, link analysis, risk rating, and workflow tools. The system examines ML risks in all business lines within the financial institution from the front counter client reception personnel to back-office analytics. By comparing query sequences with historical information it is possible to detect suspicious activity according to its own transaction trend or temporal pattern rather than by simply picking out those transaction points exceeding human-set thresholds. The designed system has a number of features, including:⁵¹³

- * extracting information from the source database of the reporting entity;
- * analysing data using a range of analytical methods;
- * generating auto-alerts when unusual transactions/activity is detected;
- * transaction profiling to check at account level and customer level against transactions of the customer and his or her peers;
- * adaptive learning to incorporate new information based on emerging ML typologies;
- * case management to track the investigation and resolution of flagged transactions and any suspicious matter reports given; and
- * automatic generation of a suspicious matter report.

However, it should be bear in mind that manual assessment has to be conducted over

⁵¹³ Dietz and Buttle, above n 500, 178.

and above any software-based system.

ML enforcement operations have developed into a combination of informant information and other intelligence. The volume of electronic records and the complexity of the relationships call for innovative techniques aiding financial investigators in generating timely, accurate leads.⁵¹⁴ However, the problem is that new computerised systems for customer surveillance require additional costs associated with assigning personnel to work with implementation, information, education, and with various kinds of surveillance activities,⁵¹⁵ and it is definitely a challenge for most of small and medium sized financial institutions in China. At the end of Chapter 6, this thesis raised the question of the most reasonable approach for China's universal AML compliance at all levels.

8.1.6 Rule-Based but Risk-Oriented or Partial Risk-Based AML approach

Theoretically, the effectiveness of AML legislation should be measured by reference to a reduction in predicate crime as well as by a reduction in opportunity for ML to occur. This difficulty with measurement is clear, and regulatory authorities inadvertently promoted the 'tick box' culture.⁵¹⁶ Indeed, the 'rule based' or 'tick the box' approach is feasible at the initial stages of AML activities as it enables government authorities to universally spread the requirement for AML implementation at all levels within a country. However, with FATF's recent shift from the traditional rule-based system to an RBA in regard to ML, the AML architecture encourages a framework to identify ML risks and vulnerabilities that can facilitate the design of appropriate AML system ensuring more effective compliance.

Chapter 7 of this thesis compared the differences between the rule-based approach

⁵¹⁴ Petter Gottschalk and Hans Solli-Saether, 'Computer Information Systems in Financial Crime Investigations' (Spring 2010) 50(3) *The Journal of Computer Information Systems* 41, 44.

⁵¹⁵ Helgesson, above n 507, 479.

⁵¹⁶ Jackie Harvey, 'Just How Effective Is Money Laundering Legislation?' (2008) 21 *Security Journal* 189, 190.

and RBA, explained the rationales of adopting an approach to suit a transition from rule-based to risk-based assessment, demonstrated the practical challenges of universally implementing full RBA in Chinese financial institutions, and creatively proposed a rule-based but risk-oriented AML approach or partial RBA that fits the reality of Chinese financial institution's reality and is underpinned by Chinese culture.

RBA allows financial institutions to associate risk levels with customers and products and produce an appropriate system, one that suits their own risk profiles. There is flexibility and sensitivity in the implementation of RBA; however, RBA must be reflected in company philosophy and embedded through its various policies and procedures.⁵¹⁷ RBA is expected to reduce the high compliance cost and apparent ineffectiveness of a rule-based approach, and increase the quality of suspicious transactions, but the feasibility of full implementation of a RBA in Chinese financial institutions is questioned. In addition, it is risky for financial institutions if the RBA is deficiently practised or performed hastily. This thesis encouraged an organisation to readily adapt to the changing environment. In particular, Chapter 7 found that capacity constraint is an issue for directly transplanting the RBA performed by developed countries to Chinese financial institutions. This constraint has two dimensions. First is the level of human resources employed at government bodies and private sector entities. Second is the level of technical expertise of such human resources as compared with their counterparts in developed countries.⁵¹⁸

Mr. W commented that

*[L]ack of AML experience and expertise of banking staff will be the biggest challenge for FIs adopting risk-based approach to AML preventive measures. To this end, more industry guidance and AML training will be needed to address this problem. Regulators play a major role in AML. They should provide clearly drafted AML requirements as well as AML guidance notes to help staff of FIs to adopt the risk-based approach...*⁵¹⁹

⁵¹⁷ Dietz and Buttle, above n 500, 83.

⁵¹⁸ Neil Jensen and Cheong-Ann Png, 'Implementation of the FATF 40+9 Recommendations: A Prospective from Developing Countries' (2011) 14(2) *Journal of Money Laundering Control* 110, 115.

⁵¹⁹ Interview with Mr. W, above n 384.

Wei Geng stated that the RBA announced and adopted by the PBC in March 2010 should enhance the future usefulness of STRs.⁵²⁰ However, the shift to the RBA further increases compliance challenges, as staff require further training to develop their skills and knowledge to evaluate and analyse data effectively.⁵²¹ Indeed, both AML regulators and the regulated entities in China still lack the capacity to identify and understand ML risks. Efficient information solution systems are lacking in Chinese financial institutions as well, especially in small and medium sized institutions.

In addition, Chapter 7 revealed that the uncertainty of RBA requires a fundamental change in the relationship between the regulators and the regulated. The effectiveness of AML system certainly rests on the interactions and communications among financial institutions, law enforcement agencies, FIU, and other stakeholders. Communication within the system of AML becomes critical, as it implies communication of ‘code’,⁵²² and details of what is suspicious/non-suspicious. Under the rule-based approach, the regulation and compliance seem to be under a ‘relative rest’ frame without much communication, that is, neither regulatory bodies nor regulated entities want to do more in combating ML. However, an efficient AML system needs mutual promotion among shareholders. Financial institutions are expected to carefully conduct examination on suspicious ML activities, and, in the meantime, regulatory bodies need to provide standard setting and upgrading, compliance assessment, and reporting feedback. Indeed, financial institutions learn either directly from their own experience or indirectly through public sector guidance about indicators of illegal or unusual conduct and which factors make those indicators more or less likely to occur. Public sector supervisory authorities cannot realistically assess the private sector’s implementation of an AML approach to combating ML

⁵²⁰ 耿伟 [Geng Wei], above n 257.

⁵²¹ Association of Certified Anti-Money Laundering Specialists (ACAMS), ‘Aspects of Asia: Development of AML/CTF in Mainland China’ (June-August 2011) 10(3) *ACAMS Today* 50, 52.

⁵²² According to the *Merriam Webster Dictionary*, the ‘code’ here refers to ‘a system of symbols (as in secret communication) with special meanings’. To be more specific, it stands for the system of symbols to standardise the ML suspicious/non-suspicious distinction.

without first themselves understanding the underlying risks and necessary safeguards.⁵²³ Thus, under an efficient AML system, different stakeholders should foster co-evolution for increasing the AML quality.

Considering the reality of different levels of development and associated uneven AML compliance in Chinese financial institutions, this thesis argued the possibility of internal and external pre-conditions to fully implement an RBA, and a proposed rule-based but risk-oriented AML approach as the ‘second best’ solution for Chinese practice. As flexible AML processes also require a maximum of stability, it is proposed to apply a ‘spiral up’ approach combining prescriptive rules together with subjective assessments. A combined approach relying on both rules and risks will avoid the possibility that a RBA moves the system from one which is more state-focused towards one with greater non-state influence.⁵²⁴ Yan Zhang, a senior officer of the PBC believes that effective AML requires a tiered approach, with different levels tailored to varying degrees of experience and knowledge required by different industry participants.⁵²⁵ The rule-based but risk-oriented approach proposed in Chapter 7 provides a layered implementation for Chinese financial institutions with different levels of compliance requirements. Standard rule-based implementation (Phase 1) ensures the minimum AML standards have to be met by all Chinese financial institutions, while advanced risk-oriented performance (Phase 2) is required for well-equipped financial institutions and all less-equipped entities as soon as they are ready for the upper phase. Having regard to practicality and feasibility, the entire transition should be developed within the time-period designed by individual financial institutions. This partial RBA in fact requires the organisation working with past, current (yesterday and today’s activity) and future (scheduled dates to do key tasks)

⁵²³ Financial Action Task Force on Money Laundering (FATF), *Money Laundering & Terrorist Financing Risk Assessment Strategies*, 18 June 2008.

⁵²⁴ Navin Beekarry, ‘The International Anti-Money Laundering and Combating the Financing of Terrorism Regulatory Strategy: A Critical Analysis of Compliance Determinants in International Law’ (Winter 2011) 31(1) *Northwestern Journal of International Law & Business* 137, 164.

⁵²⁵ Association of Certified Anti-Money Laundering Specialists (ACAMS), above n 521, 52. Yan Zhang is the Director of the General Office, Anti-Money Laundering Bureau, the People’s Bank of China.

orientated measures, and needs to determine the right ‘timing’ to ensure resources will be freed up to complete upgrading task.⁵²⁶

The rule-based but risk-oriented approach in Chapter 7 provides different options to financial institutions considering their own circumstances, and correspondingly different assessment methods are presented as well. Minimum AML standards in Phase 1 can be assessed by a ‘tick the box’ approach, and advanced AML performance should be periodically checked by using KPIs. By using KPIs to assess the organisation’s AML management, large financial institutions and the SMEs will be able to convey more clearly to staff the AML strategy it is applying, and staff will know ‘which direction they should be travelling in’.⁵²⁷ AML performance can be examined from senior management levels down to all related divisions, departments, and employees. Regarding the transition from Phase 1 to Phase 2, financial institution should modify and change some of their KPIs as priorities change during their journey of process improvement; however, some KPIs should always be maintained relating to customer focus and corporate culture.

8.2 Suggestions for Future Development

From October 2009 to June 2011, the FATF plenary agreed on a list of issues to be considered in preparation for the 4th Round of Mutual Evaluations, including the RBA, CDD relating to legal persons and beneficial owners, life insurance, PEPs, reliance on third parties and reliance within financial groups, wire transfers or electronic funds transfers, and the role and functions of FIU.⁵²⁸ This thesis has covered all the issues on the FATF list which indicates that the proposals are consistent with international AML trends.

Critical elements of a robust AML program include ‘real time’ monitoring, capture

⁵²⁶ David Parmenter, Implementing Winning KPIs in a Small-to-Medium Enterprise <www.DavidParmenter.Com>.

⁵²⁷ Ibid.

⁵²⁸ Financial Action Task Force on Money Laundering (FATF), *The Review of the Standards — Preparation for the 4th Round of Mutual Evaluation*, June 2011, 4.

and monitoring of client information and transactions, international cooperation, enterprise-wide risk management culture, leveraging best practice AML technology, and well defined AML regulatory guidelines.⁵²⁹ It is clear that both public and private sectors should enhance certain functions within their own duties. Thus, with regard to the effective implementation of AML program, the multiple stakeholders involved and diversity of interests require greater cooperation between public and private institutions. The sound policy and operating environment required for effective regulation, however, is not always present.⁵³⁰ This thesis suggests that further development should be focused on increasing the function of the compliance industry in the private sector, developing a sound regulatory culture in the public sector, and ensuring the practicality of the public-private partnerships (PPPs) on combating ML.

8.2.1 AML Compliance Industry

For the private sector, there are a number of areas of particular concern, including partial compliance or non compliance with AML requirements pertaining to CDD, monitoring of unusual or suspicious transactions, transactions involving high risk jurisdictions, as well as the level of resources and capacity.⁵³¹ It is common that many financial institutions are not confident to handle all of these functions by themselves and, to this end, the involvement of the compliance industry in the AML battle is to be encouraged.

The compliance industry represents the entrepreneurial approach to AML and compliance. This supply side of the market of compliance officers involves: software providers to enable in-depth transaction monitoring, databases of high risk individuals to enable thorough checks of potential individual clients, and also the provision of training and education for staff or for compliance officers themselves.⁵³² Canada's largest accounting firms are quite mature, and staff recruitment for these firms covers

⁵²⁹ Asian Banker White Paper, above n 381, 17.

⁵³⁰ International Monetary Fund (IMF), *Financial Sector Regulation: Issues and Gaps*, 4 August 2004, 18.

⁵³¹ Jensen and Png, above n 518, 113.

⁵³² Verhage, 'Between the Hammer and the Anvil?', above n 284.

police officers, criminologists, security specialists, intelligence analysts, MBAs and computer specialists to complement their accounting resources, with the goal of providing a number of investigative, risk management and consulting services to the public and private sectors.⁵³³

AML professional services include full-service accounting firms that combine their core accounting function with risk management and investigative services to provide a wide array of AML services, such as the ‘Big Four’ accounting firms (Deloitte Touche Tomatsu, Ernst & Young, KPMG, and PricewaterhouseCoopers), and also include smaller firms that specialise in forensic accounting and other related financial investigative, security and risk management services, and that provide AML consulting services to the private sector, primarily to help ensure compliance with transaction reporting legislation.

The AML services of Deloitte focus on ‘three readiness areas: Compliance, KYC, and Training and Awareness’. The service

will ensure sound compliance controls and protect your organization from becoming a victim of illegal activity on an ongoing basis by identifying suspicious transactions while protecting your relationship with “honest” customers” and preparing “your employees to act as the “first line of defence”.⁵³⁴

Ernst & Young’s approach to risk management enhancement includes:⁵³⁵

- recognising ‘red flags’ or warning signs associated with parallel payment systems;
- conducting an internal review to assess current ML prevention and detection strengths and weaknesses;

⁵³³ Stephen Schneider, ‘Privatizing Economic Crime Enforcement: Exploring the Role of Private Sector Investigative Agencies in Combating Money Laundering’ (2006) 16(3) *Policing and Society* 285, 294.

⁵³⁴ Ibid 297.

⁵³⁵ Brian P Joyce, ‘E-Diligence: Money Laundering Risks in the Electronic Arena’ (Autumn 2001) 5 (2) *Journal of Money Laundering Control* 146, 148.

- creation and implementation of an enhanced KYC process;
- developing an internal investigation and notification policy for unusual and suspicious activity;
- educating and training staff and clients; and
- constant re-evaluation of program application and effectiveness.

KPMG's AML services are meant to help clients 'achieve compliance with money laundering rules and regulations, build money laundering prevention awareness', and 'include general and targeted training to management and staff' that 'helps clients evaluate the effectiveness of their AML, compliance and ethics programs'.⁵³⁶ In addition, KPMG's approach involves an innovative online AML website called 'MLRO-net', which assists monitoring trade-related payment systems and offshore financial institutions, and in turn mitigates the risk in areas of ML and fraudulent activity.⁵³⁷

Till late 2011, KPMG China has 13 offices (including KPMG Advisory (China) Limited) in Beijing, Shenyang, Qingdao, Shanghai, Nanjing, Chengdu, Hangzhou, Guangzhou, Fuzhou, Shenzhen, Xiamen, Hong Kong SAR and Macau SAR, with more than 9000 professionals. KPMG has extended its advisory services to AML in the Chinese market, and AML services provided to local banks in China include: a) gap analysis of policies and procedures of Chinese AML legislation, regulations and rules in regard to international best practice; b) examination of effectiveness of bank AML compliance program at branch level; c) observation of and recommendations for program remediation; and d) comprehensive, institution-wide training programs on AML compliance.⁵³⁸ In regard to AML compliance examination in particular, based on leading international practices, tempered with jurisdictional and legislative requirements, KPMG designs an AML program which can be referred to by financial

⁵³⁶ Schneider, above n 533, 298.

⁵³⁷ Joyce, above n 535, 148.

⁵³⁸ KPMG, Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) Services — China and Hong Kong (2009) <<http://www.kpmg.com.cn/>>.

institutions in China in their assessment of their practical compliance as per the content of the following table.

Table 8.1: KPMG’s AML Program in China

Governance and strategy	<ul style="list-style-type: none"> • leadership and governance • policies and procedures • risk based approach
Specific AML control areas	<ul style="list-style-type: none"> • know your customer • sanctions compliance • transaction monitoring • regulatory reporting • sharing information
Demonstrating and monitoring compliance	<ul style="list-style-type: none"> • record keeping • compliance monitoring
Underlying people controls	<ul style="list-style-type: none"> • accountability • training and awareness

Deficiencies in internal security and controls within private sector companies place financial institutions in a vulnerable position in relation to ML activities. There is, therefore, a demand for specialised accounting expertise to support ML prevention due to a combination of increased scope of the problem and limited resources. A comprehensive package of AML services provided to clients usually begin with a risk assessment, which is meant to identify aspects of a company’s business practices that make it vulnerable to ML, including assessing a company’s exposure to illegal funds, assessing current control measures and identifying high risk areas.⁵³⁹ Granted, as compliance and AML have become a market as well as a marketing product, how Chinese financial institutions perceive this development is still an unanswered question. Thus, if there is no actual willingness to get the compliance industry involved in their own AML business, financial institutions should develop more interactions with regulators in order to ‘play safe’ (that is, demonstrate adequate compliance) in the application of partial or full RBA.

8.2.2 AML Regulatory Culture

⁵³⁹ Schneider, above n 533.

When assessing the effectiveness of AML implementation, financial institutions are normally the object of assessment, while how regulators implement their roles in AML combat is rarely examined. However, in order to ensure the AML performance of a country, not only should the AML corporate culture in the private sector be fostered, but also the AML regulatory culture in the public sector should be enhanced. For example, in Sweden's experience, as regards the roles of the public and private sectors, what was in a role only changes for the private actors, while for the public agencies, their ascribed roles remained basically the same — with or without risk-based AML.⁵⁴⁰ This is definitely not right. Indeed, on February 2012, FATF announced revisions to the 40 Recommendations after more than two years of debate by member countries, and one of the key changes to the standards is that revised recommendations set out new recommendation on powers and responsibilities of competent authorities, including AML supervisors, FIUs, law enforcement and investigative authorities, and self-regulatory body. The recommendation clearly requires the competent authorities should maintain comprehensive statistics on matters relevant to the AML effectiveness and efficiency, and provide feedback to assist financial institutions and designated non-financial businesses and professions in detecting and reporting suspicious transactions.⁵⁴¹

At the very least, regulatory and supervisory agencies (RSAs) should ensure that the designed mandate or policy change is appropriate, and determine whether the powers delegated to financial regulators are exercised effectively and are suitable for achieving the intended objectives.⁵⁴² That is, Chinese AML authorities should examine whether the national AML strategy will be able to be successfully implemented. Especially, for the partial or full RBA to work properly, the authorities and the FIU must provide reporting institutions with regular feedback so that the

⁵⁴⁰ Helgesson, above n 507, 482.

⁵⁴¹ Financial Action Task Force on Money Laundering (FATF), *International Standards on Combating Money Laundering and the Financing & Proliferation - The FATF Recommendations*, February 2012, 26.

⁵⁴² International Monetary Fund (IMF), *Accountability Arrangements*, above n 439, 7.

reporting entities can learn how to better assist the FIUs, and this should not be only in the form of advice about general patterns or trends.⁵⁴³

Contemporary AML arrangements emphasise the need for private business actors to be more actively engaged in crime prevention, notably as it is expressed by the RBA. According to Interviewee Mr. S,

*[T]he government should have a larger role to play in providing effective compliance solutions for the entire regulated sector at no cost or minimal cost, rather than requiring regulated businesses to seek out their own solutions amongst the compliance industry.*⁵⁴⁴

However, risk-based practice in AUSTRAC implies that some reporting entities have indicated that they really want some prescription in the regulations and/or rules.⁵⁴⁵ In fact, Jensen believes that ‘*AML programs require a “partnership” between the government and private sector entities*’.⁵⁴⁶ Thus, to develop the public-private partnerships, law enforcement agencies need to have clear, shared mutual understandings with private sector, and support private sector to address own perceptions, both positive and negative related to being associated with crime prevention.

Mr. N stated that:

*[P]erhaps time is ripe for starting a reviewing effort that may bring increased efficiency and more attuned regulation to the overall system and its different components, and in this regard stricter partnership between regulators and regulated entities may perhaps ensure appropriate focus.*⁵⁴⁷

⁵⁴³ Ross and Hannan, above n 50, 113.

⁵⁴⁴ Interview with Mr. S, above n 415.

⁵⁴⁵ David Chaikin (ed), *Money Laundering, Tax Evasion & Tax Havens* (Australian Scholarly Publishing, 2009) 53.

⁵⁴⁶ Interview with Mr. J, above n 383.

⁵⁴⁷ Interview with Mr. N, above n 435.

Private sector involvement in crime prevention has also been an important hallmark of success. PPPs between corporations and crime fighting bodies to devise and employ solutions to stymie criminal activities have been uniquely effective; however, the challenge for many law enforcement groups is to learn how to effectively promote and sustain PPPs with the private sector as law enforcement agencies lack experience in engaging corporations.⁵⁴⁸ Indeed, the PPPs require a sustained four step cycle to be effective:⁵⁴⁹

- 1) Dialogue — AML authorities need to reach out to the private sector where mutual interest is present.
- 2) Demand — Dialogue content needs to be clearly target the problems the AML authorities currently face and why a financial institution's specific core competencies tend toward a public-private partnership.
- 3) Design — Once the demand is clear and interest of the private sector partner is established, an iterative process of solution development can occur.
- 4) Dissemination — Once solutions are developed, sustained campaigns are required to put these into practice.

In short, an effective regulatory governance regime should explain to the public how it is pursuing its mandate, and allow the public to express their views about its policies. Collaborative relationship between the public and private sector can be enhanced via regulatory agencies' transparency, consultation, participation, and representation in interaction with supervised institutions on the appropriateness and practicality of proposed AML policies and rules.⁵⁵⁰

8.2.3 Leveraging AML Program into Anti-Corruption Compliance

Corruption not only produces, but as well protects, money laundering. Inadequate oversight, transparency and accountability may all have certain impacts on AML

⁵⁴⁸ Avina, above n 503, 283.

⁵⁴⁹ Ibid.

⁵⁵⁰ International Monetary Fund (IMF), 'Accountability Arrangements', above n 439, 10.

effectiveness. On the other hand, it would appear that all stages of the money laundering process - placement, layering and integration - are present in the laundering of proceeds regardless of the manner of corruption.

In appreciation of the importance to combat money laundering and corruption, several global, regional and national legislative and enforcement initiatives have merged since the 1980s to combat corruption and money laundering e.g. the various U.N. legal instruments; the Transparency International (TI); Global Index; the FATF and its network of Regional Style Bodies (FSRBs). More recently there is a growing realization that, rather than representing separate problems, money laundering and corruption may be linked. It is assumed that the strategies in place to combat one kind of crime may be effective in reducing the other. The Asia/Pacific Group on Money Laundering (APG) began examining the linkages between corruption and money laundering in 2003, and related research has been conducted by the World Bank, Asian Development Bank (ADB), Eastern and Southern Africa Anti-Money Laundering Group (ESAAM), and Inter-Governmental Action Group against Money Laundering in West Africa (GIABA). In 2009, Global Witness criticized FATF saying that there has been too limited focus from FATF on combating the laundering of corrupt funds, compared with the focus on combating terrorist finance.⁵⁵¹ Two years later, in 2011, FATF published a typology report focusing on laundering the proceeds of corruption.

Indeed, AML systems should be potentially a highly effective tool for reducing corruption since the law enforcement agencies in many countries and jurisdictions specify corruption as the main underlying offence generating illegal funds to be laundered. However, the tremendous potential of AML regimes in fighting corruption is currently under-deployed.

⁵⁵¹ Global Witness, *Undue Diligence: How Banks Do Business with Corrupt Regimes*, March 2009, 106.

A loophole in the approach to corruption is that there is limited clarification of the distinction between private and public corruption in the AML literature. Indeed, while the designated category of predicate offences for money laundering includes “corruption and bribery”. It is not always seen as necessarily extending to commercial corruption offences. The degree of corruption in China has been critically worsened during the past 10 years, while the AML system has, so far, never played its proper role in anti-corruption practice in China during this period of time. In order to explore the linkage of AML and anti-corruption, an enhanced monitoring on PEPs and FEPs may be a good start. Granted, PEPs including foreign and domestic have been considered as key elements involved in controlling the laundering of proceeds of corruption for many years. However, to date, corruption cases detected via this way are normally those involving public corruption, and private corruption cases are rarely found out. Thus, the proposed monitoring measure on FEPs will be a potential tool to prevent private and commercial corruption conducted by companies, especially in those industries particularly prone to corruption.

Under current global AML programs, financial institutions already have capacity to identify the natural person behind the funds, investigate the source of funds, and refuse the customer if they present a corruption risk. As there is a very large degree of overlap in meeting international standards in AML and anti-corruption treaties, it may be a cost-effective strategy to use existing AML tools to fight corruption. AML regulators and practitioner should treat the prevention of corrupt money flows as a priority, and these should be undertaken by the governments of the world’s major economies.

8.3 Limitations

One limitation of this research was data collection on AML compliance. In particular, information for this research largely depended on official data produced by governmental authorities and related international organisations, and data gathered from interviews with both Chinese and international AML researchers, officers, and

experts. However, given the sensitive nature of this research *per se*, official information is relatively limited. In addition, information about AML compliance, for most of financial institutions, is confidential as a part of their internal control system. Although some valuable data was obtained via interviews (with 21 participating interviewees from law enforcement agencies, AML regulatory authorities, large banks, and academics), the interviews failed to cover AML officers from Chinese securities companies and Chinese insurance companies. Besides, two participants were not finally interviewed due to the difficulty in arranging mutual acceptable interview time and place. Data in this research was mainly descriptive information, thus this current research could be complemented by statistical data.

Another limitation of this thesis was the research scope. In examining the effectiveness of the Chinese AML system in its financial sectors, the research was limited to arguments surrounding AML preventive measures, AML regulation and compliance, ML risks identification, and the AML approach in financial sectors in China. However, as China has been involved in the second stage of implementing its AML strategic approach with great focus on implementing RBA in China, more complicated work will be allocated to each financial sector, and, in the meantime, China's AML work will keep extending to other non-financial industries. Any institution with the potential to serve as a channel for ML would fall in the formal AML regulation. By then, whether the PBC can handle all the regulation, assessment, reporting gathering and analysis, and policy making of both financial and non-financial is seriously doubted. Thus, future research concerning ML and AML can be extended in various fields apart from the financial sectors.

8.4 Future Research: The RBA Puzzle

According to *China's Anti-Money Laundering Strategic Development Guidelines*

(2008-2012),⁵⁵² Chinese AML authorities aim to apply an RBA to further combating ML in the financial sectors as well as in designated non-financial business and professions (DNFBP). Currently, however, the necessary conditions for implementing RBA within the Chinese AML architecture are seriously underdeveloped. This thesis has fully examined the practical challenges and deficient conditions for implementing RBA in the Chinese financial sectors. The AML situation in DNFBP in China is even worse. As early as 2007, FATF had pointed out that there were no requirements for any category of DNFBP to apply any of specific AML obligations, there were no requirements for dealing with PEPs, no need to address problems arising from new technologies, non ‘face to face’ transactions and third party introducers, and no requirements to deal with unusual transactions.⁵⁵³ Although China’s AML strategies announced the objective of establishing AML programs in DNFBP, no detailed guidance or rules have been generated by AML authorities so far.

This thesis commented that a hasty application of RBA or attempts to simply copy RBA approaches from developed countries, without consideration of China’s AML reality, may backfire and undermine the effectiveness of all aspects of the Chinese AML systems. Thus, these self-evident problems and the apparent blind adoption of the RBA pose a puzzle: Why did the Chinese government favour an RBA to combat ML if the implementation problems are so obvious? China does not have a history of taking any major initiative without careful consideration of its implications and consequences, both domestic and international.

There are three possible reasons. The first assumption is that it is reasonable and sensible to enhance the awareness of risk management in all areas related to financial activities. Given that the date of announcing the national AML strategy was just after the occurrence of the 2007–2008 global financial crisis, it is logical to regard the

⁵⁵² 中国人民银行 [People’s Bank of China], *AML Strategic Development*, above n 221.

⁵⁵³ Financial Action Task Force on Money Laundering (FATF), *First Mutual Evaluation Report*, above n 53.

application of RBA in Chinese AML programs as a reflection of a greater emphasis on controlling risks in the financial industry and a desire by the Chinese government to enhance its risk management of its own financial sector. Practising RBA to determine, monitor, and reduce potential ML risks in relation to all kinds of financial products, services, transactions, and businesses will definitely contribute significantly to efforts to safeguard the soundness of entire financial industry. To this end, Chinese government has no reason to refuse RBA.

Secondly, as Chinese financial institutions are experiencing dynamic development with the country's economic growth, the large-scale financial institutions, especially the 'big four' banks which want to play a more active role at the international level, have been incessantly expanding their global markets. Applying RBA to these Chinese financial groups will enable them to present themselves as being in line with advanced international AML standards, and, as a result, enhance their reputation as well-equipped financial institutions on the global stage. A sound AML program is without question an important prerequisite for entry into foreign markets as this is an essential requirement designated by all economically developed host countries.

The third rationale may stem from the strategy of 'adopt but not enforce (see 3.2.1.1) exploited by many transition countries and developing countries. That is, rather than seriously examining the applicability and feasibility of implementing RBA while considering China's local conditions, Chinese authorities adopted RBA practices in its national AML strategy to present the country as being an active member of the international AML team. According to Sharman and Chaikin, AML reform is often instituted in developing countries to maintain a good reputation among outsiders rather than from a genuine interest in substantive policy effectiveness.⁵⁵⁴ Indeed, the 2008–2012 China national AML strategy enthusiastically responded to the trend of applying RBA to AML programs, encouraged by international organisations such as

⁵⁵⁴ J C Sharman and David Chaikin, 'Corruption and Anti-Money-Laundering Systems: Putting a Luxury Good to Work' (January 2009) 22(1) *Governance: An International Journal of Policy, Administration, and Institutions* 27, 28.

FATF and the Wolfsberg Group and developed countries. However, as this four year national strategy is to expire in the coming year, all of the expressed objectives to be met by the end of 2012 will be found wanting since most of the goals have not, in fact, been put into practice.

Behind the above-mentioned possibilities, what was the real rationale of making the RBA announcement in the China's 2008–2012 national AML strategy? This is an interesting area for future research.

While this thesis has argued that the tiered rule-based but risk-oriented approach' is suited to local conditions in the financial markets, a further question in need of research will be the extent to which even a tiered approach will work in the DNFBP sector given China's political, social and economic realities.

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