



Political corruption and the assessment
of politically exposed persons

Table of Contents

1. Introduction	3
2. Politically Exposed Persons and the prevention of money laundersing and corruption	3
2.1 PEPs and the risk of money laundersing	4
2.2 Public officials as a corruption risk	5
2.3 Politically exposed persons - a central risk category	6
3. PEPs and political corruption	7
3.1 Red flags for high-risk countries	7
3.2 Mechanisms of political corruption	8
4. Four patterns of corrupt PEP-relationships	9
4.1 Influence markets	9
4.2 Elite cartels	9
4.3 Oligarchs and clans	10
4.4 Official moguls	10
5. Conclusion: Politically exposed persons and business partner due diligence	11

1. Introduction

Within the context of anti-money laundering, so-called politically exposed persons (PEPs) are classified as high risk among business clients and are therefore subject to increased due diligence by the relevant financial institutions. Companies trading in goods also fall under the pertinent requirements to examine their business associates with respect to fighting trade-based money laundering.

Against this background the question which needs to be addressed is; how carefully should companies examine foreign business partners that are either themselves PEPs, or who maintain close relationships with PEPs?

When assessing corruption risks in the context of business partner compliance, contacts with public officials and government officials mark a greater risk. Nevertheless, it becomes apparent that the category is too narrowly defined in order to determine to what extent overseas business transactions are exposed to the risk of political corruption.

In the following sections we will clarify the differences in terminology between the foreign public official and the politically exposed person. This differentiation is based on the definitions of the UN Convention Against Corruption (UNCAC), the FATF (Financial Action Task Force) and pertinent national and international anti-money laundering and anti-corruption laws. The links between anti-money laundering and anti-corruption are particularly important in this context, as corrupt practices such as bribery, fraud, or misappropriation are seen as offences predicate to money laundering.

Furthermore, the reasons why PEPs present a greater integrity risk need to be understood. Often it is not possible to do business in a country without encountering PEPs. For this reason, it is useful to inform oneself about political corruption in the country in question, in order to learn how high the risks of becoming associated with PEPs of a dubious integrity are.

The third and fourth sections will provide more detail about the nature of political corruption in a country. To this end, a helpful starting point for the assessments will be introduced. This approach differentiates four typical characteristics of political corruption: "influence markets", "elite cartels", "competition of oligarchs" and "official moguls" (M. Johnston 2005). These four "syndromes" of political corruption are actually closely linked to the specific relationship patterns that PEPs form amongst each other, and the interactions between the private and the public sector.

Finally, the conclusions which can be drawn if adequate business partner due diligence is performed, will be discussed.

2. Politically Exposed Persons and the prevention of money laundering and corruption

The United Nations Convention against Corruption (UNCAC) has been in force since 2005 and is the main internationally binding anti-corruption convention. In the definitions (Art. 2) the UN Convention clarifies that the term "public official" or "foreign public official" refers to any "appointed or elected" person holding a legislative, executive, administrative or judicial office and performs a public function, also for a public agency or a public enterprise.

The UN Convention does not actually use the term politically exposed person, but essentially describes its meaning. Such as is the case in Art. 52 on the prevention of money laundering from the proceeds of corruption. It refers to the identification and the screening of "persons who are or have been entrusted with prominent public functions and

their family members and close associates.” Here the circle of persons of interest is extended to persons holding important public functions, which can also apply to the leadership of political parties. Furthermore, persons who do not have a public function themselves, but who often play an important role when laundering money are included, i.e. relatives and business partners of the officials.

2.1 PEPs and the risk of money laundering

The Financial Action Task Force (FATF) defines individuals who have been entrusted with prominent public functions as “politically exposed persons” (PEPs). The FATF is the leading panel of experts and is located at the OECD in Paris. It sets the international standards for the fight against money laundering and terrorist financing. In 2012 it updated its recommendations and now not only includes foreign PEPs, but also domestic PEPs and important functionaries of international organisations. Notably, all requirements in dealing with PEPs should also apply to family members and close associates (see FATF Recommendations, International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation, February 2012, Recommendation 12).

The 4th EU Money Laundering Directive adopted by the European Union in June 2015, which still has to be implemented into member states’ national law, lists the following individual groups of PEPs.

[4th] Directive 2015/849 of the European Parliament and of the Council of 20 May 2015 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, Official Journal of the European Union, L141/73, 5.6.2015

Article 3 (definitions), section 9-11

(9) ‘politically exposed person’ means a natural person who is or who has been entrusted with prominent public functions and includes the following:

- (a) heads of State, heads of government, ministers and deputy or assistant ministers;
- (b) members of parliament or of similar legislative bodies;
- (c) members of the governing bodies of political parties;
- (d) members of supreme courts, of constitutional courts or of other high-level judicial bodies, the decisions of which are not subject to further appeal, except in exceptional circumstances;
- (e) members of courts of auditors or of the boards of central banks;
- (f) ambassadors, chargés d’affaires and high-ranking officers in the armed forces;
- (g) members of the administrative, management or supervisory bodies of state-owned enterprises;
- (h) directors, deputy directors and members of the board or equivalent function of an international organisation.

No public function referred to in points (a) to (h) shall be understood as covering middle-ranking or more junior officials;

(10) ‘family members’ include the following:

- (a) the spouse, or a person considered to be equivalent to a spouse, of a politically exposed person;
- (b) the children and their spouses, or persons considered to be equivalent to a spouse, of a politically exposed person;
- (c) the parents of a politically exposed person;

(11) ‘persons known to be close associates’ means:

- (a) natural persons who are known to have joint beneficial ownership of legal entities or legal arrangements, or any other close business relations, with a politically exposed person;
- (b) natural persons who have sole beneficial ownership of a legal entity or legal arrangement which is known to have been set up for the de facto benefit of a politically exposed person.

If customers, business partners or the beneficial owners on whose behalf they are acting are politically exposed persons, family members or close associates, according to the above definition, then this is deemed a greater risk from the point of view of anti-money laundering. All the regulators emphasise that the classification of a business partner as a PEP is not a prejudgment or does not criminalise them. However, the PEP status is associated with privileged decision-making powers, which enables them to enrich themselves through bribery, misappropriation of public resources or tax evasion and, possibly, even to conceal these crimes under the cover of public institutions. Therefore a more detailed assessment of the personal integrity as well as the business interests of the PEP is necessary. Consequently integrity screening serves as a preventative measure.

Financial institutions and certain other natural and legal entities have to identify the PEPs amongst their customers and business partners, and they must undertake enhanced due diligence in this context. This includes establishing the “source of wealth and source of funds that are involved in business relationships or transactions with such persons” (Art. 20 EU-Directive 2015/849) as well as the ongoing monitoring of those business relationships. These measures should ensure that the resources do not originate from shady channels.

2.2 Public officials and corruption risk

The link between anti-money laundering and anti-corruption is clear. However, the compliance requirements for companies with regard to the verification of the integrity of foreign business partners are governed by separate international conventions (the comprehensive UNCAC is an exception) and relevant national laws. Apart from UNCAC, these include in particular the important anti-bribery conventions of the OECD (Convention on bribery of foreign officials in the conduct of international business transactions) as well as the national laws of the United States and Great Britain, which also apply extraterritorially – the US Foreign Corrupt Practices Act (FCPA) and the UK Bribery Act.

The principal aim of these regulations is to prohibit the bribery of foreign public officials in international business transactions. This refers to government officials, representatives of the judiciary and members of parliament. A special emphasis is also placed on the members of government authorities and public enterprises. The anti-bribery regulations apply to all levels of public officials.

In the fight against money laundering, mid- and lower-level public functionaries are usually not considered to be PEPs (see EU-Directive above). However, if the functionaries hold important positions at regional or local level, then they should be viewed as PEPs. It is the responsibility of the investigating financial institution or company to check the circumstances and to make a risk-based decision on the PEP-status.

In turn, the anti-bribery conventions and regulations do not uniformly or clearly state to what extent they also apply to party officials. The FCPA explicitly refers to them, while the UNCAC, the OECD Convention and the UK Bribery Act leave room for interpretation. For example, the comments on the OECD Convention state that party officials (for example in one-party systems) de facto carrying out public functions or engaging as public authorities, were to be treated as public officials.

The accompanying documents for the UK Bribery Act note that according to the principles of risk analysis, certain business relationships bear higher risks, such as the use of agents in transactions with foreign public officials or ties to “politically exposed persons” if these ties involve a prominent public official. This should at least include the leadership of political parties, if not family members and close associates.

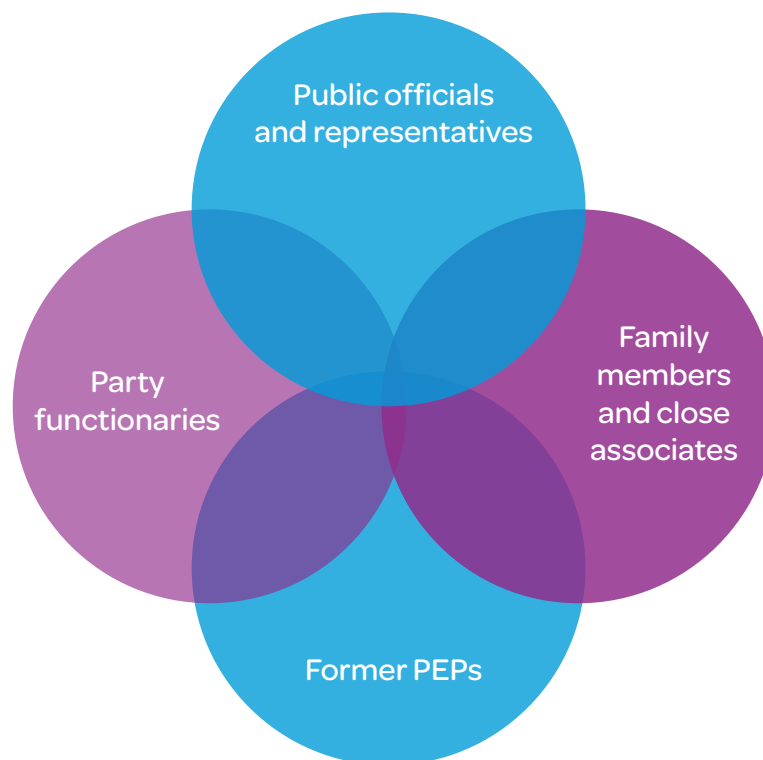
The FCPA and the OECD Convention as well as the UK Bribery Act sanction indirect bribery through intermediaries or agents. The objective of this campaign is useful, as the risk that a prominent PEP or a foreign public official could be covertly engaging in corrupt practices with the help of third parties needs to be considered.

2.3 Politically exposed persons - a central risk category

The regulations on anti-money laundering and anti-corruption are based on the risk-based approach. As a result, this leads to a convergence of the terms politically exposed person and public official. This is also appropriate given the factual correlation. The term PEP has the advantage that it includes both the group of those with formal political power, and the group of informal, but influential political actors. This is closer to the political reality in many countries, especially, when one is trying to understand the network of relationships between representatives of the individual groups of PEPs shaping a country's corruption and money laundering pattern.

It is common knowledge that former public officials and elected officials do not lose influence, but rather assert it elsewhere and make use of the network they formed during their time in office. How long after the termination of the official activity the PEP status should continue is a contested issue. But again, whether a person should still be classified as politically exposed should ultimately be decided by using a risk-based approach. The suggestion to take former PEPs into consideration is therefore a pragmatic solution.

Diagram: Politically exposed persons and their circles



3. PEPs and political corruption

3.1 Red flags for high-risk countries

In order to adequately manage the corruption and money laundering risk emanating from PEPs, it is useful to look behind the scenes. In order to meet the requirements of money laundering legislation, it is necessary to identify an individual as a PEP and to ascertain whether he or she is the actual beneficial owner of an account or an enterprise, or whether he or she has somebody acting on his or her behalf. In the fight against corruption and according to the applicable conventions and regulations, transactions should not be made via third parties if there is a greater risk that illegal money transfers to PEPs could be involved.

How deeply a financial institution or a business delves into the enhanced due diligence of customers and business partners with contacts to politically exposed persons, also depends on a first analysis of the country-specific risks.

Often Transparency International's Corruption Perceptions Index (CPI) is used for the initial evaluation of the level of corruption in a country. The FATF has recommended the use of so-called red flags, which can be helpful in identifying PEPs originating from critical countries. These country-specific warning signals have been set out in the table below according to indicators of international or national risk profiles.

Red flags for PEPs from high-risk countries

International country risk profile	Insufficient implementation of the international anti-money laundering regulations
	Insufficient implementation of the international anti-corruption conventions
	Target of United Nations sanctions
	Export of illegal goods such as drugs
	Financing of international terrorism
National country risk profile	High level of corruption
	High level of organised crime
	Poor governance and insufficient transparency
	Political system based on personal (autocratic) rule, in which those in power enrich themselves or in which many appointments are made based on patronage.

Some of the warning signals focus on international behaviour, i.e. to what extent the country of origin of the PEP concerned has ratified the above-mentioned international anti-money laundering and anti-corruption conventions, and how well they have been implemented. It is important for the risk assessment if the country has been the target of United Nations sanctions. Given the high hurdles for such a decision, sanctions can indicate the possibility of substantial international misconduct on behalf of the country's government. Naturally, US and EU sanctions are also relevant, particularly when they target specific PEPs. Furthermore, the evidence that a country exports drugs or finances terrorism needs to be taken into consideration.

Red flags for the national risk profile are based on ratings and analysis, which classify a country as a stronghold for organised crime and corruption. Such indicators suggest a doubtful quality of governance and little transparency

in the decision-making process as well as the absence of democratic responsibility and the rule of law. In the countries concerned there is a significantly higher probability that a larger number of PEPs is involved in corruption. Countries with political systems that are based on personal rule, i.e. autocratic regimes, countries in which those in power enrich themselves, or countries that are notorious for making appointments based on patronage, are especially problematic.

Such country-specific red flags, the assessment of which is a fundamental part of every customer and business partner due diligence, describe the characteristics of systemic political corruption. Unfortunately the regulatory agencies hardly give further indications as to what exactly constitutes high levels of corruption – especially political corruption – in a country, what forms political corruption can take and what the role of PEPs might be in this context.

3.2 Mechanisms of political corruption

Political corruption is committed by persons in senior decision-making positions of a country, i.e. by persons who have been classified as politically exposed persons. The purpose of political corruption is not only one's own personal enrichment, but as a general rule for the procurement of funds to retain power. Evidently, both motives are closely connected (Inge Amundsen, Political corruption, U4 Issue 6, CMI 2006).

Political corruption committed by PEPs has to be differentiated from corruption on the bureaucratic level, e.g. in the form of bribes to accelerate the administrative process. However, if these forms of corruption are not isolated cases, but are ubiquitous in everyday and business life (endemic corruption), then this generally suggests that there will also be systemic political corruption at the higher level.

PEPs, who engage in political corruption, are in the position to obtain their illegal earnings from various sources. This also includes the bribes paid by private businesses, e.g. in the form of "commissions" or "fees". These payments can be incurred in connection with public procurement procedures and the granting of government contracts, allocation of land and privatisation processes, granting of permits and licenses, tax rebates and the protection of certain privileges and rights. PEPs with the relevant position have a multitude of possibilities to solicit bribes from the private sector.

Moreover, PEPs are in the position to illegally favour businesses and transactions in which they themselves are the beneficial owners to the detriment of competitors. PEPs can also directly access state assets and channel part of the public resources past the public budget into their own pockets. This possibility for the theft of public funds is particularly likely to arise when there are large profits in certain sectors working with state licenses, such as the exploitation of natural resources. In such cases, a portion of the illegal funds is channelled off for their own gain or that of a trusted circle. This entails particularly high risks of money laundering for financial institutions, which maintain relationships with such individuals.

Further funds are usually again illegally used to retain one's own power. Political loyalty and support are bought through monetary gifts, favours or patronage. Political parties can play an important role in the organisation of clientelism, which supports the argument that party functionaries should also be included in the circle of PEPs.

In order to maintain the system, the institutions that would normally be independent and responsible for the prosecution of corruption have to be politically controlled. These institutions notably include investigative authorities and courts. Members of the opposition, or critical media representatives might either be bought or are silenced through politically motivated prosecution.

As far as the impression should be given that there are democratic elections, the party in power receives bountiful resources through covert donations from the business sector or through illegal use of public funds, so that the loyal candidates from their own ranks can easily compete against the disadvantaged opposition candidates. To ensure that the desired result is achieved, there is also the possibility to manipulate the members of the election committee.

4. Four patterns of corrupt PEP-relationships

The actual power structures in a country depend on who defines the rules of the game – the institutions or the acting persons. If institutions are only empty shells, the focus should be on the behaviour of the political elite, i.e. the PEPs and their informal relationships amongst each other. In these instances it is important to understand what kind of relationship patterns one is dealing with and what these relationship patterns say about the type and extent of political corruption in a country.

Research on corruption distinguishes four so-called syndromes of political corruption (Michael Johnston, *Syndromes of Corruption*, Cambridge UP 2005). This approach will be introduced here, as it can assist in matching the situation in a certain country with these four types. This in turn helps to understand the risks of money laundering or corruption with which a foreign financial institution or corporation is confronted. The following relationship patterns are ideal types. When undertaking the specific country analyses there are likely to be variants and hybrids.

Starting with the relationship patterns of the “influence markets” – an important basic scenario, which shows that political corruption can also affect democracies and market economies – the extent of political corruption strongly increases with the second risk pattern “elite cartels” and the third one “oligarchs and clans”. Political corruption is at its most extreme in the fourth relationship pattern – “official moguls”.

4.1 Influence markets

The relationship pattern “influence markets” concerns countries with established market economies and stable democratic institutions. When examining relationship patterns of PEPs, which could be an indication of political corruption, there is essentially one critical scenario that needs to be mentioned.

Representatives of interest groups and lobbyists try to get access to PEPs in order to influence political decisions, such as laws, regulations or public contracts, in their favour. This is both lawful and admissible as long as the influencing is not linked to a donation or the granting of a pecuniary advantage. A problematic area – also in established democracies – is the financing of political parties through donations from businesses, private persons or intermediaries. If they are not made transparently, the suspicion of “trading in influence” can easily arise. This offence implies that donations or advantages were granted in reciprocity for the benefited PEP abusing his political influence to bring about unjustified advantages for the original donor.

To what extent the offence of political corruption is fulfilled, however, depends on whether there is systematic collusion between PEPs and the private sector to cement existing power structures, or if the political competition is not restricted enough to prevent a democratic change in power. In influence markets a critical civil society, free media and an independent judiciary generally set effective limits for the beginnings of political corruption.

4.2 Elite cartels

The relationship pattern “elite cartels” mainly concerns new, not yet completely democratised political systems with market economies, or older but degenerating democracies. Although there are elections, the political competition is de facto strongly restricted by the collusion between the PEPs of the upper political elite. Various informal networks have been formed, the members of which are party representatives, influential public officials and members of parliament, and representatives of the private sector as well as the security forces.

These networks coexist side by side and coordinate the division of the proceeds from privileges and corruption. This cartel-like cooperation should maintain the existing power structures and exclude unwanted competitors. With the help of the parties, these elite networks not only colonise the parliaments, but also functional levels and regional organisations of the administration, central regulatory agencies and state-owned enterprises as well as parts of the private sector, especially telecommunications and the media.

Apart from trading in influence and conflicts of interest of PEPs who pursue their own business interests, elite cartels corrupt public procurement and the privatisation of state-owned enterprises. The danger of being discovered and political corruption being prosecuted is low, as the controlling institutions cannot ensure compliance with the rule of law. Parliaments are not independent, the media and civil society are weak and the judiciary is largely not independent from politics.

4.3 Oligarchs and clans

The relationship patterns of oligarchs and clans can often be found in political systems following the end of dictatorships or armed conflicts. Its main feature is that some of the business leaders, who became rich quickly during the liberalisation of the markets, compete for economic and political influence. Frequently the origins of their wealth are of a dubious nature and are, for instance, linked to corrupt privatisations in the energy and commodity industries.

Oligarchs usually rely on a regional power basis, where they build clan-like patronage structures. Oligarchs are strictly speaking not PEPs, but they entertain corrupt relationships with certain PEPs. They pursue political influence for their own advantage through the clientelistic network of relationships. The public institutions are weak so that an atmosphere of distrust and uncertainty prevails. In particular for external observers it is often not possible to say who controls the central governing power within the state. Oligarchs assert their own claim to power by forming relationships with corrupt security forces or organised crime, and if necessary, by force.

The characteristics of political corruption, economic enrichment and the control of power are strongly developed in the oligarchic relationship pattern. Democratic processes have no meaning and the boundaries between the private and the public sector are practically non-existent. The oligarchs have instituted systematic corruption in large parts of the economy and government. The competition for power between them has worsened the potential for the general economic and social development.

4.4 Official moguls

The relationship pattern of official moguls is constituted by undemocratic, mostly authoritarian systems, where a dictator and a small trusted circle not only monopolise political power, but also economic potential. Unlike the competition between oligarchs, there is no competition in this system. It is clear who is in charge. There is centrally organised nepotism, which is based on filling key political and business positions with protégés and family members. Sometimes close followers are assigned whole sectors as monopolies.

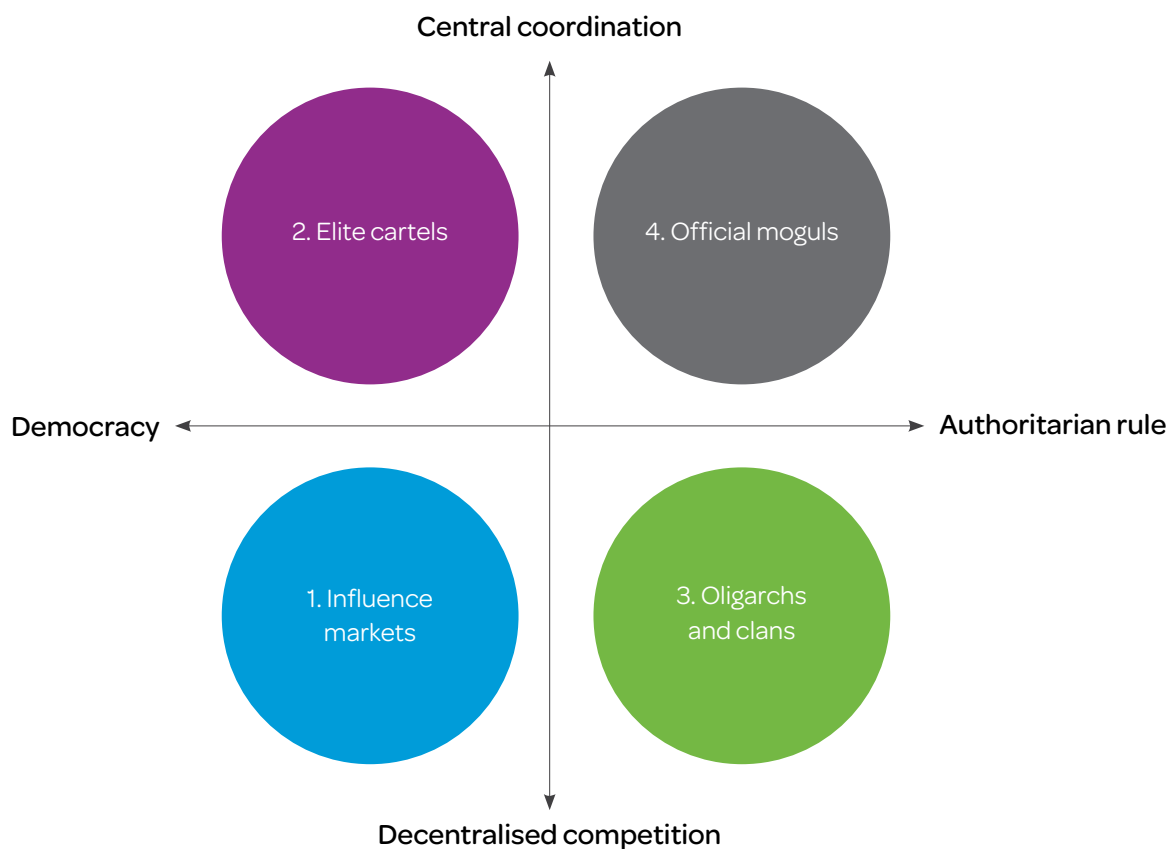
The dictator and his leading PEP followers represent the most extreme form of political corruption, as they can loot the country with impunity. Opportunities for this are particularly prevalent when proceeds from natural resources such as oil and gas, gold and minerals or precious woods can be made use of.

The involvement of the military plays an important role in this relationship pattern of political corruption. The leading members of the military – also PEPs according to definition – obtain ample opportunities to pursue their own business interests and to enrich themselves. It is thus ensured that the security forces suppress all opposition.

There are no effective national institutions, such as a parliament or an independent judiciary, which could limit the looting. Or if they do exist, they are only for the sake of appearances. The risk of encountering corrupt PEPs when doing business is greatest here.

In the following diagram the different relationship patterns are summarised in the two relevant dimensions. The horizontal axis depicts the degree of democratic government or authoritarian rule respectively. The vertical axis differentiates the degree of decentralised competition or the central coordination between the political elites when organising political corruption.

Diagram: Country-specific relationship patterns of corrupt PEP-networks



5. Conclusion: Politically exposed persons and business partner due diligence

Politically exposed persons pose an increased risk for money laundering and corruption. It thus seems appropriate, both for legal and methodical reasons, to ensure that the identification of PEPs, their families and close associates is a standard element of the risk-based due diligence process. This can be achieved using a PEP database and screening platform.

To summarise, here are some key considerations:

- International corporations and financial institutions should assess ties to PEPs as being high-risk, in particular where those ties could retrospectively be perceived as trading in influence, or which could be interpreted as breaching the principle of transparency and competition to the disadvantage of third parties.
- As a first step the respective PEPs need to be classified according to the specific relationship pattern formed by a country's political and business elites. Publicly available sources on the Internet, including social media, as well as structured news databases can be consulted, in order to assess potential leads for a dubious integrity.
- Where the network of relationships is particularly complex, enhanced due diligence should be conducted. Also, since the PEP status can change overnight, it is important to use screening tools for ongoing monitoring purposes.

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