Anti-Money Laundering Challenges Faced When Onboarding High-Net Worth and Ultra High-Net-Worth Chinese Clients

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Executive Summary

This white paper examines the anti-money laundering and know-your-client challenges faced by financial institutions when onboarding wealthy Chinese clients.

China has become an economic power since the late 20th century, and as such, many of its citizens became very wealthy. With wealth come opportunities for people to choose a better standard of living, such as to live in a cleaner environment or provide better education for their children. Many wealthy Chinese have chosen to leave China and bring their wealth with them when they settle in their adopted countries.

The concerns that arise when onboarding wealthy Chinese clients for financial institutions include questions around how clients get their monies out of China when there are controls over funds exiting the country, as well as their source of wealth.

This paper provides examples of how money exits China, the common typologies of wealthy Chinese clients, and some solutions to help gain comfort when conducting know-your-client due diligence.
The rise and exodus of wealthy Chinese citizens

During Chairman Mao’s era, China was closed off to the outside world, and was under a communist regime that supported equality between all citizens. The ideology is that nobody should have an advantage over others, such as to be richer than somebody else.

Before China shut itself off from the rest of the world starting in the 17th century, China had its glory days with a great history of exploration and trade which stems back many centuries. Going back six or seven centuries, China had a very advanced economy and traded heavily with various countries. By 1232, China had a navy and sent out “treasure ships” to India, Indonesia, Arabia and East Africa to trade various goods such as porcelain and silks in exchange for precious jewels, carpets, and exotic animals. However, China turned its back on the world by the 1600s when the country deemed itself self-sufficient and advanced enough to not be interested in the Western world. This self-contained mentality lasted for the next few centuries until the 1970s (Griswold, 2002).

This all changed when the Chinese government opened up the country to foreign investments and businesses, starting with market reforms introduced by Deng Xiaoping in 1978. He took over leadership after Chairman Mao, and wanted to combine the ideals of a free market and communism. Starting in the late 20th century, more and more businesses moved to China due to lower production costs and cheaper wages. With the economy booming, many people started to get wealthy. Bryan Borzykowski’s article with the BBC demonstrates the enormous growth of wealthy Chinese in the last couple of years (Borzykowski, 2014). The article notes more and more Chinese are spending money around the world, with overseas Chinese tourists climbing up quickly year over year. The high net worth population doubled since 2010, going up to more than 1 million people with a net worth of more than 10 million Chinese Yuan (about USD1.6 million) (Yan, 2015).

With money comes opportunities, including the potential of leaving the country for a better life. China’s huge population and economic boom has led to more pollution as a side effect. Many wealthy Chinese citizens desire a better environment to live in, so they look to move out of the country (Timiraos, 2014). In an article published by Radio Free China, the World Health Organization noted 7 million deaths were caused by air pollution in 2012, and one-third of these deaths occurred in China, as estimated by the International Energy Agency (Lelyveld, 2016).

Parents want the best for their children, especially with the one child policy, so it is natural parents would want to give the best to their child. With education being so highly valued amongst the Chinese, many Chinese children are sent to schools outside of China where it is perceived to be more prestigious to obtain a foreign education. With children studying abroad, many parents eventually choose to immigrate along with their children.

Another common reason for those who choose to leave the country or take money outside concerns the government and stability of the Yuan. Because the Yuan is semi-pegged to the U.S. dollar, many are concerned towards the devaluation of the currency, which happened in mid-2015 (Agence France-Presse, 2016).
For better education and standard of living, Chinese citizens take their wealth with them when they leave the country, which drives huge amount of funds to leave the country each year. According to a report by Hurun Research and Visas Consulting, the top destinations to immigrate to are the United States and Canada (Cendrowski, 2014).

Concerns for Anti-Money Laundering professionals and regulators

In recent years, the Canadian housing market has taken off substantially. In particular, the Vancouver and Toronto housing market has soared. Studies have indicated a contributing factor is due to the flood of wealthy Chinese citizens buying up real estate. In 2015, Vancouver’s home sales, which amounted to CAD38.5 billion, was made up of 33 percent by Chinese buyers, while Toronto had 14 percent of its CAD63 billion home sales purchased by Chinese buyers (Richter, 2016). It has raised some concerns for Canadian regulators due to the fact that a common way to launder money safely is to invest in real estate. As such, regulators have voiced concerns, in particular for the Vancouver housing market due to the city’s popularity amongst Chinese citizens.

“Wholesaling” of homes has become a problem in Vancouver because it is unregulated and opens the door for money laundering. Unlicensed wholesalers work as an independent middle person who will approach homeowners as a representative to background investors. The wholesaler offers cash to homeowners, pitching to the homeowners they save on realtor fees with no attached conditions such as no home inspection required. Once the house is sold, the wholesaler gets a fee for their work and the home title would then go to the investors who flips the homes. In the end, the homes will be sold to Chinese buyers. The problem with wholesaling homes is there is no obligation to report the identity of homebuyers or the source of funds (Durden, 2016).

Along with the issue of identifying true beneficial ownership, another anti-money laundering concern that has gained traction recently is tax evasion. Current Canadian tax laws for home ownership is that no taxes need to be paid on any capital gains if the property sold is designated as the “principal residence” of the homeowner. As such, there have been many instances where a wealthy individual who does not live in Canada would buy properties and use the names of their spouse or children, who reside in Canada, as the homeowner. A recent exposé published by the Globe and Mail illustrates this problem perfectly (Tomlinson, 2016). The article talks about an individual who acts as a broker, whereby he would get investments from wealthy Chinese “lenders” who do not reside in Canada. The funding this broker receives would be used to apply for mortgage loans in his own name to purchase properties in the Vancouver area. The broker might hold onto the properties for a few years for it to appreciate in value, and to avoid any taxes if the property is sold within one year of ownership. Once sold, the lenders would get their original investment back along with interest, and the broker would pocket the rest of the profits. The anti-money laundering concerns that are raised is that the mortgage loans and properties purchased are never in the broker’s name as they are always listed in the name of the Chinese lenders (or the lender’s spouse and children), the loans given to the broker are facilitated in a way so they are not taxable, the parties involved are taking
advantage of tax loopholes so nobody pays any taxes on capital gains from the property sales, and the lenders’ identities are unknown to the banks who approves the mortgages for the broker because the broker is applying for loans in his own name.

Another concern is funds coming in from corrupt Chinese officials. In 2012, the Chinese government started a crackdown on corruption, and this has spread to getting cooperation from other countries to repatriate funds and extradition treaties. In an article published in 2014, it notes at least 18,000 Chinese officials and employees of state owned companies removed US$123 billion in illicit funds out of China to the U.S., Canada, Australia and the Netherlands (Francis, 2014). According to the National Post, there is indication that a large amount of illicit funds was funneled out of China to buy up Vancouver real estate. As such, Canadian law enforcement has been working with the Chinese government to catch suspicious individuals (National Post, 2015).

The housing market is just one of many ways for the wealthy to invest their money. With huge amounts of funds being transacted daily, not just in the real estate market, but through financial institutions, it would be tempting for unscrupulous individuals to launder funds under the guise of a legitimate transaction. As such, due diligence is vital to mitigate money laundering risks.

### Problems within the Anti-Money Laundering context

Anti-money laundering standards have changed drastically over the recent decades, and at the same time more and more Chinese people have moved funds out of China by opening bank accounts offshore or buying real estate properties. Due diligence is required for all clients, but it is more challenging when it comes to Chinese clients due to several reasons such as lack of documentation or records and privacy concerns.

An issue that arises when trying to understand a client’s wealth is how did the funds move out of China. There are three common ways a Chinese resident can move funds out of the country. The first is smurfing, which uses numerous people to circumvent the USD50,000 limit per person. A Chinese resident might get relatives and friends, or even strangers for a fee, to use their names to move funds out of the country.

A second method is to create entities in other countries and send funds as a business transaction. A common place to create a company is in Hong Kong, where the client will also open an account for the entity. A business transaction does not have the same monetary restrictions as does a personal transaction. A person could also open accounts overseas if their bank has offshore locations, and apply for loans with the overseas account (Huang, 2014).

Another way to send funds to a personal account is by using money changers. Popular in Hong Kong for mainland Chinese persons to use, money changers charge a relatively small fee to move huge amounts of funds. The client would deposit money from his/her domestic Chinese account to another mainland China account provided by the money changer. Once the transaction is completed, the money changer then deposits the equivalent amount in another currency (usually Hong Kong or U.S. dollars) to the client’s
Hong Kong account. This way, money has not moved out of China but the client now has funds outside the country (Bloomberg News, 2015).

Source: Bloomberg

Another method that poses anti-money laundering concerns are checks from underground banks. A client exchanges Yuan with the underground bank for a check that is issued from a non-domestic account. Once the client exits China’s border, the check can be cashed (Bloomberg News, 2015).

Source: Bloomberg

Other methods used to get funds out of China is to buy goods on debit or credit and return the goods for cash, or carry cash in suitcases (Bloomberg News, 2015). At Vancouver’s airport, over CAD15 million was seized between April 2011 and June 2012. From this CAD15 million, CAD9.7 million came from China (McKnight, 2013). If a person is caught with undeclared funds, a penalty ranging from CAD250 to CAD5,000 is levied.
Another method which is less commonly seen is getting government approval to move a large amount which exceeds the USD50,000 limit.

A persistent issue within the anti-money laundering context is source of wealth documentation. Corroborating source of wealth is made difficult due to the lack of documentation available in public sources. For years, Chinese documents were all in paper format with no online access. In North America, it might be easy to find documents about a corporation if it is requested through a law firm or a paid search portal such as Lexis Nexis, but in China, there are no such services available.

Corroborating source of wealth can also be made difficult because many Chinese clients might cite privacy concerns and are unwilling to disclose pertinent information. Citing privacy reasons can lead to difficulties in ascertaining something that is a regulatory requirement or leave some room for questions. For example, there have been instances where wealthy female Chinese clients would indicate they are in the offshore country due to immigration or their children study in the country. Their wealth is declared to be self-made, but there is no mention of a spouse. In these scenarios, there is difficulty in ascertaining whether the client is connected to any politically exposed persons by declining to divulge any information on close family members. Under Canadian regulatory requirement, it is required to disclose such information. It also leads to open-ended questions as to whether any part of the client's wealth came from a spouse given the close relationship between two partners.

If the client still resides in China, lack of communication might arise which leads to problems with updating know-your-client information and account dormancy.

**Common typologies of a wealthy Chinese client**

When documenting source of wealth for a Chinese client, there are common themes as to how their wealth was accumulated. One common typology is wealth from real estate. Before the Chinese government opened up the country to allow freer economic development, companies were usually state owned. It would be very typical for employees to be allocated housing by the company, with some employees being given multiple units depending on position and seniority. Employees would also be paid a salary that was usually not spent on living expenses because of subsidization by the company. When the Chinese market opened up, which in turn brought up housing prices, people could sell their properties for substantial amounts, especially in the major cities such as Beijing and Shanghai. Some clients might have sold a property or two and bought other properties before the real estate market really took off, which led to even greater gains in wealth from buying and flipping properties.

Another common wealth story is the self-made millionaire. When the Chinese market opened up, some Chinese clients might have taken their knowledge and went into business of their own. Using their savings over the years, they could start their own business with their expertise and intimate knowledge of their home country to make their company a success or attract foreign business.
Lastly, one other common typology of a wealthy Chinese client is wealth coming from investments in the stock market. With accumulated savings over the years they worked, some wealthy Chinese clients invested in the stock market as the Chinese economy took off. With gains from their investments, clients might have reinvested more in the stock market or went into the real estate market.

**Best practices to gain comfort for know-your-client/anti-money laundering purposes when onboarding Chinese clients**

Even though the abovementioned issues are not uncommon when dealing with Chinese indicia clients, there are some best practices a financial institution can do in order to gain more comfort when conducting know-your-client due diligence at client onboarding.

One of the common reasons advisors tell compliance why they cannot obtain client information is that the clients themselves do not feel safe about disclosing so much personal information. Advisors should be trained on how to communicate with clients about why know-your-client information is necessary, and explain why it is required. Clients may not understand that their information is kept confidential within a financial institution, so it would be beneficial to explain that there are laws in place to protect client information.

Another way to position this discussion with clients would be for an institution to properly service and advise clients, the advisor must have a clear understanding of the client’s financial situation, personal background and investment objectives. All of these factors are crucial for a well-documented know-your-client file.

Know-your-client information might have to be supplemented with research done independently of what the client tells an advisor. It is not very difficult to substantiate wealth if a client works for a publicly traded company, as it will be quite easy to do an Internet search. However, often times a client’s wealth is from private companies, therefore it takes a bit more effort to obtain corroborating evidence.

For example, if the client owns a business, there are Chinese provincial government websites to search for company registries. These searches will usually disclose the name of the legal person, name of the entity, type of business, when the company was formed and maybe the shareholders of the entity. However, the drawback to using this online tool is that if the entity was formed more than 15 years ago or so, it might not be listed due to the lack of digital record keeping in the country at that time. Source of wealth narratives can also be substantiated by obtaining evidence such as sale deeds along with property addresses if a client’s wealth comes from the sale of real estate. If a client made their wealth from the stock market, explain how the funds grew. Conduct research to show the rise in the stock(s) prices as evidence. Clients might explain seed money was used to make investments or real estate purchases, so it is prudent to understand if the amount of money saved is plausible based on the salary earned, economic situation and living standards during the time horizon of client’s source of wealth story.
Another best practice is that a financial institution should have a clear understanding as to why a Chinese client wants to open an account with the firm. Clear documentation should be noted as to why an offshore account is being opened if the client still resides in China, and there should be a reasonable tie to the offshore country. Common explanations are the client has family who reside outside of China and they visit often, planning to immigrate or has children who are studying in the offshore country. It is not uncommon to see clients opening an account with the explanation they are planning to immigrate, but the immigration plan does not come to fruition. At this point, compliance should bring it to the attention of the advisor to ask is it reasonable to keep this relationship if the client will not have any reasonable ties to the offshore country. If an entity account is being opened, document the purpose of the entity. An explanation of “for tax purposes” is not sufficient; there should be a clear understanding as to why the entity exists.

Last but not least, it is important to get a clear understanding of the expected transactions. If it were a wealth management account, one would expect to have frequent communication with the client (at least annually) and see investments made in the account. If an account does not show any transactions, compliance should question the purpose of the account. This leads into expected frequency of contact with the client. Often times, communication might not happen, and this would leave the account in a dormant status. Asking how initial funding is expected to come in is a good due diligence question during client onboarding. If a large amount is coming in from another domestic financial institution, some comfort could be gained knowing the funds are already in the country and the receiving institution should have done their due diligence. If the initial funding deviates from what the client had stated, this would immediately raise some concerns.

Conclusion

There is no foolproof way to guarantee against money laundering, so financial institutions should ensure all staff, from front line to second line, are trained to pick up on red flags to mitigate risk. As anti-money laundering standards change and become increasingly more complex, financial institutions should be prepared to demonstrate why they were comfortable with onboarding their clients, and how they conduct ongoing monitoring. Failure to comply with anti-money laundering/anti-terrorist financing rules handed down by regulators can lead to loss of reputation for the institution and/or significant monetary fines. For example, Barclays Bank was fined £72 million in 2015 for failure to conduct enhanced due diligence and monitor some ultra-high net worth clients who were connected to politically exposed persons. The problems discussed when it comes to Chinese indicia clients is not only limited to Chinese clients, and it should be kept in mind that due diligence standards should apply across the board when onboarding all clients.

Financial advisors are the front line of defense so it is important they understand what the requirements are from a regulatory and compliance perspective. In a wealth management environment, heightened due diligence is required when it comes to onboarding a client because of several reasons.
One is that there is a common tendency for high net worth and ultra-high net worth clients to have complicated wealth structures for various reasons, such as for tax efficiency or family wealth planning. With complicated structures comes the potential for obscuring beneficial ownership.

Another reason for enhanced due diligence is that many high net worth individuals tend to have investments in various countries and financial institutions. This leads to huge amounts of funds moved cross border.

As second line of defense, compliance personnel should be comfortable with the information provided by the front line. Due diligence completed by an affiliate location might not satisfy regional requirements, so it is important that compliance reviews and assesses whether the source of wealth and corroborating evidence provided by the front line is satisfactory and plausible.

The best type of corroborating evidence are ones that the front line can obtain independently from the client, such as conducting online searches, using a reputable paid search portal or requesting documents from law firms. Source of wealth stories might be easy to write based on whatever a client wants to disclose to the front line; by including substantiating evidence it gives the narrative more plausibility in order to gain comfort during due diligence documentation.

Solid know-your-client due diligence should cover the purpose of the account, how the client made their wealth and supporting evidence to substantiate client’s source of wealth story. At the end of the day, if there is any doubt or there are questions that linger, the best course of action would be to exit a relationship.

References


