Auditing to the Inherent Risks of Real Estate Gatekeepers

I. Introduction

Owning a home in the United States (U.S) is no longer a dream isolated to Americans. Foreign buyers are investing in high-end U.S. real estate due to the ease of which it is to enter the market. One reason is due to lax controls in the real estate sector. Both Americans and foreigners can legally purchase real estate through the formation of legal entities or shell companies with minimal resistance. These shell companies afford people benefits to include asset protection and anonymity. The anonymity and ease of access into the market make real estate attractive not only to the wealthy but also to money launderers.

Money laundering through the real estate sector has been overlooked in the past as the real estate sector has largely avoided anti-money laundering (AML) regulatory obligations.[1] Financial institutions have carried the weight of AML responsibilities for years and the accompanied compliance expenses, examinations and fines that come along with it. Recent news events have exposed money laundering vulnerabilities in the real estate sector that have drawn public ire and the government's attention. As a result, a momentum shift has occurred not only in the U.S. but also in other international governments to shift more attention to the AML regulatory deficiencies in the real estate sector.

High-end real estate deals in New York and Miami Dade County shed light on the ease of which high net worth individuals and foreign buyers hid assets in U.S. real estate through the formation of shell companies. The New York Times revealed in the article "Towers of Secrecy" that over 200 shell companies were used to purchase condominiums in the Time Warner Center over the course of a decade. Investigations revealed a number of the foreign buyers tied back to foreign government officials or their close associates.[2]

The Panama Papers revealed how real estate gatekeepers, like the secretive law firm Mossack Fonseca, were utilized to create offshore shell companies for the rich and powerful. The Miami Herald revealed over 215,000 legal entities were established by the law firm for over 14,000 clients in 21 offshore havens.[3] Purchases of high-end real estate in the Miami, FL were tied back to clients of Mossack Fonseca. This uncovered how real estate gatekeepers are utilized to facilitate the anonymity of transactions and conceal legal entities' true ownership which further magnifies the inherent AML risks in this sector.

Several characteristics of real estate increase the risks of money laundering in this sector. Real estate provides a means to launder and conceal ill-gotten gains while providing a layer of anonymity to individuals. Criminals can invest their monies into a legitimate asset that has potential to appreciate over time while providing a means to generate income and liquidate into cash at a later time. In addition, fluctuations in real estate market values vary by region and numerous factors impact property values making it easier to manipulate and difficult to monitor criminal mischief. The culture of real estate lacks AML regulation and awareness; driven by sales, commissions and closing times make it ripe for illicit actors to take full advantage.

Regulatory efforts to curb money laundering activity in the U.S. real estate sector are lacking as real estate professionals were granted an exemption from complying with AML regulations. However, in 2016, the Financial Crimes Enforcement Network (FinCEN) gave notice of intent to begin monitoring real estate

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[1] FinCEN (Apr 2003) *Anti-Money Laundering Program Requirements for "Persons Involved in Real Estate Closings and Settlements"* (31 CFR Part 103) https://www.treasury.gov/press-center/press-releases/Documents/js1751.pdf

[2] New York Times, Louis and Saul, Stephanie (Feb 2015) *Towers of Secrecy: Stream of Foreign Wealth Flows to New York Real Estate*, https://www.nytimes.com/news-event/shell-company-towers-of-secrecy-real-estate

[3] Miami Herald and Internal Consortium of Investigative Journalists, Nehomas, Nicholas et.al. (April 2016) *The Panama Papers Investigation: The Secret Shell Game* http://www.miamiherald.com/news/local/article70347537.html

activities in the form of Geographic Targeting Orders (GTO). The GTO's signaled FinCEN's goal to broaden its visibility into potential suspicious activities in the real estate sector. Regardless of the current AML regulatory environment in this sector, the onus falls back to financial institutions to understand the nature and purpose of transactions that are conducted through their accounts. This includes assessing the risks of real estate gatekeepers and their account activity.

The objective of this white paper is to 1) provide awareness of the underlying inherent money laundering risks in the real estate sector, and 2) offer a thematic approach for financial institutions on how to audit to the risks for real estate gatekeepers.

II. Real Estate Gatekeepers

The Financial Action Task Force (FATF) is an inter-governmental body whose purpose is the development and promotion of national and international policies and standards to combat money laundering and terrorist financing. FATF developed recommendations that are recognized as the international standards for combating money laundering and terrorist financing.

FATF considers gatekeepers to be critical professions to help in the prevention of money laundering as they serve as the entry points into the financial system. Their services are sought after by criminals for this reason. To that end, gatekeepers are often considered high-risk customers. Gatekeepers include lawyers, notaries, trust and company service providers, real estate agents, accountants, auditors and other designated nonfinancial businesses and professions.[4]

For purpose of this paper, real estate gatekeepers include real estate agents, brokers, lawyers and accountants who are involved specifically in real estate transactions.

III. Background: Current U.S. AML Regulatory Environment

Bank Secrecy Act & USA PATRIOT Act

The two regulations that form the foundation of the U.S. AML regulations are the Bank Secrecy Act (BSA) of 1970 and the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act 9 (USA PATRIOT Act) of 2001. The regulations require institutions to establish Bank Secrecy Act/Anti-Money Laundering (BSA/AML) compliance programs, designate a BSA/AML Officer, establish a system of procedures and controls to detect illicit activity, and have an independent audit function to test the program. As part of this requirement, institutions are required to file suspicious activity reports (SAR) to FinCEN and also have a process to Know Your Customer (KYC) as part of an overall Customer Identification Program.

The institutions required under these regulations include a range of sectors including financial institutions, securities brokers or dealers, casinos, loan companies and currency exchanges. "Persons involved in real estate closings and settlements" were specifically noted in the regulation. However, FinCEN to date has not defined who is included in this category. In 2002, after lobbying by the real estate sector, a temporary exemption was granted to persons involved in real estate closings. FinCEN submitted an advanced notice of proposed rule-making in 2003 requesting feedback on how to define the persons involved in real estate closing and settlements.[5] However, there has been no further movement by FinCEN and the current exemption remains in place.

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[4] Financial Action Task Force, (July 2011) *Laundering the Proceeds of Corruption*. http://www.fatf-gafi.org/media/fatf/documents/reports/Laundering%20the%20Proceeds%20of%20Corruption.pdf

[5] FinCEN (Apr 2003) *Anti-Money Laundering Program Requirements for "Persons Involved in Real Estate Closings and Settlements"* (31 CFR Part 103) https://www.treasury.gov/press-center/press-releases/Documents/js1751.pdf

Although the real estate sector was granted exemption, FinCEN continued to keep a watchful eye on the activities in that sector. In 2012, FinCEN issued regulations requiring non-bank residential mortgage lenders and originators to establish AML programs and to file SARs.[6] The purpose of the regulation was to help mitigate mortgage fraud and scams that were prevalent in the U.S. real estate market at the time.

Due to the increased focus on the money laundering risks within the real estate sector, it is foreseeable that FinCEN will reevaluate the exemption. FinCEN's recent GTOs are a step in that direction.

FinCEN Geographic Targeting Order

In January 2016, FinCEN issued GTOs requiring U.S. title insurance companies and their affiliates to identify the persons behind companies used to pay all cash for high-end residential real estate transactions that met certain dollar thresholds in counties in New York City, New York and Miami, Florida.[7] The GTO's went into effect in May 2016 and were originally intended to expire after 180 days, but have been renewed with the most recent occurring in Aug 2017. The GTO's were expanded to include seven metro areas in California, Florida, Hawaii and Texas.[8]

FinCEN defines all cash transactions as transactions not involving a bank loan or external financing and the purchase is made, at least in part, using currency, cash equivalents (cashier's check, traveler's check, money order), personal check or business check. The August 2017 GTO advisory includes specific verbiage to include funds transfer – which was previously identified as a loophole to avoid reporting - to the list of transactions which indicates FinCEN intends to include wire transfers into their scope.[9]

The GTO requires title insurance companies to identify the beneficial owners who directly or indirectly own 25 percent or more of an entity if it is a party to a residential real estate transaction in one of the identified metro areas. Furthermore, title companies are required to obtain a copy of the beneficial owners' identification documents and report the information via Form 8300 to FinCEN within 30 days of the real estate closing.

FinCEN acknowledged that the current AML regulatory requirements cover 78 percent of the real estate transactions. The remaining 22 percent of transactions were all-cash transactions and are not covered transactions under the current U.S. AML requirements.[10] It is clear that FinCEN intends to utilize the GTO to analyze and understand the risks in all-cash real estate deals to mitigate the gap that currently exists. In addition, FinCEN noted they will evaluate efforts in the industry to avoid reporting as a result of the GTOs.

FinCEN disclosed that initial reports indicated 30 percent of the transactions reported as a result of the GTOs involve a beneficial owner or purchaser of interest that were previously reported in a SAR.[11] This tidbit of information only validates the concerns tied to the use of shell companies utilized to buy luxury real estate in all-cash transactions.

8300 Reporting

One of the existing cash reporting requirements is governed by the Internal Revenue Service (IRS). IRS requires reporting of cash transactions exceeding USD $10,000. It is commonly referred to Form 8300 in reference to IRS form 8300 that is required to be filed by the fifteenth day after the date of the cash transaction.

[6] FinCEN (Feb 2012) *Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Residential Mortgage Lenders and Originators*. (Federal Registrar Vol. 77 No. 30) http://www.gpo.gov/fdsys/pkg/FR-2012-02-14/pdf/2012-3074.pdf

[7] FinCEN (Jan 2016) *FinCEN Takes Aim at Real Estate Secrecy in Manhattan and Miami* [Press Release] https://www.fincen.gov/sites/default/files/news_release/20160113.pdf

[8] FinCEN (Aug 2017) *FinCEN Targets Shell Companies Purchasing Luxury Properties in Seven Major Metropolitan Areas* [Press Release] https://www.fincen.gov/news/news-releases/fincen-targets-shell-companies-purchasing-luxury-properties-seven-major

[9] FinCEN (Aug 2017) *Advisory to Financial Institutions and Real Estate Firms and Professionals* (FIN-2017-A003), Herein after referenced as FinCen GTO Advisory https://www.fincen.gov/sites/default/files/advisory/2017-08-22/Risk%20in%20Real%20Estate%20Advisory_FINAL%20508%20Tuesday%20%28002%29.pdf

[10] FinCEN, Shasky Calvery, Jennifer (Mar 2014) *Prepared Remarks of Jennifer Shasky Calvery, FinCEN Crimes Enforcement Director* https://www.fincen.gov/news/speeches/prepared-remarks-jennifer-shasky-calvery-director-financial-crimes-enforcement

[11] FinCEN GTO Advisory

The law states, “Any person in a trade or business who receives more than $10,000 in cash in a single transaction or in related transactions must file a Form 8300.” Persons include an individual, a company, a corporation, a partnership, an association, a trust, or an estate.” [12]

As it is written, real estate gatekeepers and title companies fall under the umbrella of this requirement. The IRS utilizes the information along with FinCEN to help combat money laundering, tax evasion and other illicit crimes.

Financial Action Task Force (FATF)

In late 2016, FATF published a mutual evaluation report detailing the current state of the U.S.' AML and counter-terrorist financing measures.[13] The report indicated several key observations. Overall, the U.S. was reported to have a robust regulatory framework for AML and counter-terrorist financing. Financial institutions were recognized as the most mature sector with an understanding of the AML risks along with carrying the majority of the obligations for BSA/AML requirements.

FATF identified significant gaps tied to lack of AML coverage for certain industries to include lawyers, accountants and real estate agents. FATF indicated significant concern regarding the lack of U.S. legal requirements to identify beneficial owners of legal entities. FATF noted that the risk is further magnified due to the lack of AML requirements on professions (lawyers, accountants, real estate agents) in sectors where these vulnerabilities can be exploited for money laundering and terrorist financing.

While FATF does not have legislative authority to mandate change in the U.S., they have strong influence to generate regulatory reform at the national level. The fact that these gaps were clearly called out by FATF in the 2016 report is an indicator that regulatory change may be forthcoming in particular for the real estate sector and the gatekeepers.

IV. Inherent Money Laundering Risks in the U.S. Real Estate Sector

Transparency International, a global civil coalition against corruption, identified key risks in four global real estate markets.[14] Below is a summation of inherent risks that are common to the U.S. real estate market.

Real estate gatekeepers are not covered under U.S. anti-money laundering regulations. Real estate agents, brokers, lawyers and accountants who are involved in real estate transactions are not subject to the requirements of the BSA or USA PATRIOT Act. These professionals are under no legal obligation to establish an AML compliance program, identify customers, conduct due diligence and report suspicious transactions. The U.S. Government and FinCEN have been slow in bringing these professionals into the regulatory fold despite growing criticisms from the international community to include FATF.

Further complicating the matter, the National Association of Realtors (NAR) has been reluctant in supporting any legislation that would impose AML requirements on their professionals. The NAR message to FinCEN is that AML risks are mitigated in the real estate sector by the fact the majority of real estate transactions are completed through the use of a covered entity (i.e. financial institution) that is obligated to follow BSA/AML regulations.[15]

Without existing AML regulations to abide by, the following risks become more pervasive:

- **No legal requirement for reporting suspicious activity.** Real estate gatekeepers may voluntarily file a SAR to FinCEN when they have identified suspicious activity. Real estate gatekeepers play a key role in detection of unusual activity as they have vital insight on clients to include their interests and intended use of the property. However, there are no current requirements that

[12]IRS 8300 rule https://www.irs.gov/businesses/small-businesses-self-employed/form-8300-and-reporting-cash-payments-of-over-10000
[13] FATF Mutual Evaluation Report (Dec 2016) http://www.fatf-gafi.org/publications/mutualevaluations/documents/mer-united-states-2016.html
[14] Transparency International, Martini, Maira (2017*) Doors Wide Open: Corruption and Real Estate in Four Key Markets*.
[15] National Association of Realtors, (Feb 2011). *Letter to FinCEN Director James H. Freis Jr.* http://narfocus.com/billdatabase/clientfiles/172/3/1011.pdf

mandate such reporting. The only current regulation that is required by the real estate sector to report suspicious activity is the receipt of $10,000 or more in cash by trade or business as discussed earlier in the IRS 8300 rule.

Research was conducted by FinCEN on the reporting of suspicious activity (via SARs and 8300s) by or on the real estate industry from 2003 to 2011. The analysis provided an alarming discrepancy. The number of reports filed on the industry (over 22,000) far outweighed volume of reports filed by the industry (under 1,100).[16] While there were no reasons provided for disparity, one can surmise that a lack of reporting obligations in the industry was a contributing factor.

- **Lack of identification on the source of funds**. Real estate gatekeepers have historically focused on factors such as financial capacity (the ability for a buyer to pay), credit history and loan-to-value ratios to qualify buyers for residential properties. The industry lacks a level of due diligence to question the originating source of the money as long as buyers prove they have financial assets to pay by the closing date. This potentially can lead to risks that go unnoticed. This includes monies loaned to real estate investors from private investors, foreign investors, or anonymous investors that are not accounted for during the due diligence process.

- **Insufficient training on money laundering risks in the industry.** Most registered agents, brokers and title companies are unfamiliar with AML typologies, risks and how they can be exploited in the real estate industry. There has historically been a lack of understanding of the BSA/AML laws as registered agents and brokers are not required to complete any type of AML training. The NAR published AML guidance for Realtors and Brokers in 2012.[17] The information while informative is of a voluntary nature and the industry's focus has historically been on methods to identify fraud risks such as mortgage fraud.

U.S. real estate market is open to foreign buyers. The U.S. lacks regulation on due diligence standards on foreign buyers and Politically Exposed Persons (PEP). Outside of the current sanctions screening requirements, the U.S. government does not impose restrictions or additional due diligence requirements on foreign individuals, foreign companies or PEPs wishing to purchase U.S. property. These buyers can do so through assistance from a real estate gatekeeper. Foreign buyers are also not required to disclose beneficial ownership and real estate gatekeepers are not legally obligated to obtain the information, unless the purchase meets the current FinCEN GTO requirements in one of the seven metro areas.

From Apr 2015 to Mar 2016, Chinese buyers accounted for 42 percent of all foreign buyers of real estate purchases over $1 million in the U.S.[18] This was attributed to the surge in China's economy and Chinese citizens looking to safeguard their assets turned to investing in stable overseas markets resulting in a buying spree of million dollar mansions in Los Angeles, California.[19] In 2017, the Chinese government put restrictions on the monies allowed by its citizens to purchase overseas properties to help curb the outflow of money. Similar restrictions to limit foreign buyers are not imposed today by the U.S. government.

Insufficient due diligence on all-cash transactions. Parties involved in all-cash transactions are not covered under U.S. BSA/AML requirements and it has been a gap that FinCEN is attempting to analyze through the use of GTOs. Buyers conduct these all-cash transactions without the typical financing such as a mortgage, but utilize other funding methods such as currency, checks, cash equivalents or wire transfers. Historically, the real estate sector has relied on the financial industry to perform due diligence as banks and mortgage brokers have incentive to ensure they are collateralized should a buyer default. In comparison,

[16] FinCEN (July 2012) *Real Estate Title and Escrow Companies: A BSA Filing Study.* https://www.fincen.gov/sites/default/files/shared/Title_and_Escrow_508.pdf

[17] National Association of Realtors (Nov 2012), *Anti-Money Laundering Guidelines for Real Estate Professionals.* https://www.nar.realtor/articles/anti-money-laundering-guidelines-for-real-estate-professionals

[18] National Association of Realtors (Jul 2017) *2017 Profile of International Activity in U.S. Residential Real Estate*, https://www.nar.realtor/sites/default/files/reports/2017/2017-profile-of-international-activity-in-us-residential-real-estate-07-18-2017.pdf

[19] Los Angeles Time, Pierson, David (Feb 2017) *Mega-mansions in this L.A. suburb used to sell to Chinese buyers in days. Now they're sitting empty for months*, http://www.latimes.com/business/la-fi-san-gabriel-housing-20170223-story.html

the real estate sector lacks due diligence standards as there is no incentive to delay the transaction and no obligation to perform the due diligence.

No requirements to identify beneficial owners. Anonymous companies, LLC's or trusts can easily acquire properties and launder money due to the lack of rules to disclose beneficial ownership information. Real estate agents, lawyers and accountants involved in real estate closings are not required to identify the beneficial owners[20] of their legal entity customers.

In 2016, FinCEN finalized what is commonly referred to as the Customer Due Diligence (CDD) rule that requires certain financial institutions to strengthen customer due diligence requirements through risk-based approach to understand the nature and purpose of accounts.[21] As part of the CDD rule, financial institutions must collect beneficial ownership information from legal entity customers. While the new CDD rule is not a requirement for real estate gatekeepers, one can foresee the goal of the U.S. government is to gain more transparency into the underlying ownership of legal entities.

Lack of Federal Regulator supervision. Real estate gatekeepers are not subject to examination and supervision by federal regulators. The lack of oversight can significantly impact the ability to develop best practices and establish consistent methodologies as the industry attempts to combat money laundering.

V. Money Laundering Schemes in Real Estate Sector

There are several traits within the real estate sector that make it appealing for potential exploitation by money launderers. This paper will explore the common money laundering schemes in today's environment.

A. All-Cash Transactions

All-cash transactions, meaning without a mortgage or other credit financing, have the potential to avoid traditional AML measures. While buyers who show up to a real estate closing with a suitcase of currency would hopefully set off red flags, all-cash transactions can also take the form of buyers paying with cashier checks, wires or other electronic funds transfers to complete the real estate deal.

The use of all-cash transactions cannot be understated as a potential money laundering concern. It enables large sums of money to be integrated into the U.S. financial system with little to no traceability. Illicit actors who purchase real estate in cash may utilize the property for asset preservation, rent the property to obtain income or sell the property making it difficult to trace back the monies to their original origins.

Although all-cash transactions account for only 22 percent of existing home sales,[22] they also pose a higher level of risk when considered with other factors. All-cash transactions are more prevalent in high-end real estate purchases and are a more common payment method by legal entities and foreign buyers. In New York, 58 percent of overall purchases in 2015 were made in cash rather than mortgages. In Miami-Dade, Florida, 56 percent of sales were made in cash.[23] In addition, foreign buyers are more likely to conduct all-cash transactions as statistics indicated they were prevalent on 72 percent of non-residential properties and 35 percent of the time on residential properties.[24]

All-cash transactions provide a unique challenge as there is not a sound method to verify the source of wealth. A real estate gatekeeper may ask the source of the monies but that information can be misleading based on what information the buyer is willing to divulge. Currently, parties to a real estate transaction will

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[20] FATF defines a beneficial owner as *""*the natural person(s) who ultimately owns or controls a customer and/or the natural person on whose behalf a transaction is being conducted. It also includes those persons who exercise ultimate effective control over a legal person or arrangement*".*
[21] FinCEN (May 2016) *Customer Due Diligence Requirements for Financial Institutions.* (Federal Registrar Vol 81 No. 91). https://www.gpo.gov/fdsys/pkg/FR-2016-05-11/pdf/2016-10567.pdf
[22] National Association of Realtors (Jul 2017) *2017 Profile of International Activity in U.S. Residential Real Estate.* Herein after referenced as NAR Report. https://www.nar.realtor/sites/default/files/reports/2017/2017-profile-of-international-activity-in-us-residential-real-estate-07-18-2017.pdf
[23] The Washington Post, Swanson, Ana (Apr 2016). *How secretive shell companies shape the U.S. real estate market*. https://www.washingtonpost.com/news/wonk/wp/2016/04/12/how-secretive-shell-companies-shape-the-u-s-real-estate-market/?utm_term=.ea8fa167f601
[24] NAR Report

ask from buyers to provide evidence of financial capacity to pay; however, it is uncommon for them to ask the source of wealth. This may also be challenging when cultural or language differences make it difficult to communicate when dealing with foreign parties to a transaction.

All-cash transactions in real estate gatekeepers' accounts at financial institutions may go undetected and be obscured in the numerous channels (i.e. wires, electronic funds transfers, checks) that are processed through a financial institution whether in commercial or retail accounts. Typical control failures for financial institutions include the lack of suspicious activity monitoring to detect real estate AML typologies, insufficiently trained personnel and the lack of visibility into the real estate transactions.

B. Loan Schemes

The objective of using complex loans is to obscure the true owner or origins of the funds leaving it difficult to detect a money laundering scheme. The appearance of complex loan schemes that are outside the normal financial institution sector can signal a potential red flag for money laundering activity.

Loan Back Scheme - Criminals or their organizations directly or indirectly loan themselves money through the use of one or more shell companies for the purchase of a real estate property. These shell companies - often overseas - are established and can be held by front men (gatekeepers) for the criminals to disguise the ownership. The monies are then loaned from one entity to another entity through a series of transactions to give the appearance of legitimacy. In actuality, a legal loan agreement did not exist or was invalid. The loan back transaction deliberately masks the identities of the true persons involved and the true source of the monies.

For financial institutions, failure to monitor pass-through activity where monies are deposited from offshore accounts and then immediately transferred out to foreign banks could be a control gap which allows this type of activity to go undetected. In addition, lack of AML real estate typology training of employees in key operational positions could lead to the activity being misinterpreted as legitimate business transactions. Furthermore, suspicious activity monitoring scenarios or models may be tuned to detect structuring type activity from offshore banks and may not necessarily alert on large monetary transactions that are often associated with real estate transactions.

Straw Buyer Scheme - A straw buyer is a person who is paid a fee from a criminal or other illicit actor in exchange for allowing the person to use the straw buyer's personal information to obtain a mortgage or series of mortgages. The straw buyer does not occupy the properties and has no involvement in the payment of the loans. Criminals use this method to launder their illicit monies through the payments on the loans.[25]

Control failures within financial institutions that assist in perpetrating these schemes are the automated underwriting approval in their mortgage systems to expedite the closing process commonly associated with real estate transactions. These automated systems may lack pattern recognition looking for indicators of discrepancies with age, income and location of property relevant to the buyer. In addition, employees of financial institutions or mortgage lenders may lack training to detect fabricated documentation that is often associated with straw buyer deals.

Mortgage Scheme - The preferred method for money launderers is to apply for and obtain a mortgage through a lender for a property. The mortgage itself is not suspicious. The activity can become potentially suspicious when criminals utilize illicit funds for monthly payments or pay off the mortgage in full within a short period of time after the closing. Additionally, individuals who repeatedly pay off mortgages early can be an indicator of unusual activity.

Financial institutions lacking controls to monitor for payments from third parties not associated with the mortgage or payments originating from offshore banks could be more susceptible to this type of suspicious

25 FinCEN (April 2008) Suspected Money Laundering in the Residential Real Estate Industry. https://www.ffiec.gov/bsa_aml_infobase/documents/new_6_08/SuspectMLResidenRealEstate%20Indust.pdf

mortgage scheme. In addition, financial Institutions may not associate the payment of mortgages shortly after closing as a potential indicator of money laundering as this could be mistaken for refinancing activity.

C. Under-value or over-value properties

This scheme involves the buying or selling of a property at a price above or below its market value which is accompanied by successive sales or purchases. These transactions have the potential for illicit actors to inject illicit monies into the transactions and into the financial system resulting in the masking of the true source of the wealth. Criminals utilize techniques such as under the table agreements between parties or utilization of false appraisals to inflate the value of the properties.

The detection of this scheme can be challenging. Analysis of over/under-valued properties followed by subsequent or frequent sales of the same property are potential indicators into this scheme. It can be difficult to estimate the true value of a property due to market fluctuations in local areas. This is where local real estate agents and brokers who are familiar with market prices in their area are vital as they are adequately positioned to detect this activity.

Due to a lack of uniform and reliable property value information, financial institutions may find it difficult to implement controls to detect this type of activity. Sophisticated pattern recognition software may assist in detecting collusion schemes that are often associated with groups that include appraisers, loan officers and real estate gatekeepers. In addition, the ability to detect frequent sales of the same property where there are significant increases in value may be difficult in redeveloped areas where there is prevalence of real estate investors involved in house flipping.

D. Use of Gatekeepers

To complete real estate transactions, in some stage of the process involvement of a gatekeeper is unavoidable. It is common to seek out the assistance of real estate gatekeepers such as real estate agents, brokers, lawyers, tax/financial advisors or accountants. Real estate gatekeepers may willingly or unwillingly assist in the placement and layering stages of money laundering by concealing the true beneficial owner and/or origin of monies through a number of specified activities. These activities may include:[26]

- Creation of legal entities or shell companies
- Opening and managing accounts at financial institutions in their own name for the purpose of their client
- Managing their clients' money or accounts
- Buying and selling real estate
- Buying and selling business entities

As part of the Panama Papers investigation, the Miami Herald identified 19 foreigners that created offshore companies with assistance from Mossack Fonseca. The shell companies were used to purchase high-end real estate in Miami, Florida.[27] Of the 19 foreigners; eight were identified as having ties to criminal activities in their home countries.

This illustrates how real estate gatekeepers can become prime targets for bad actors due to their ability to establish legal entities and assist in investing their ill-gotten gains. At the same time, real estate gatekeepers are uniquely positioned to identify beneficial owners of their clients and report suspicious activity to the government or law enforcement.

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[24] FATF (Jun 2008) *Guidance on the Risk-Based approach for Real Estate Agents* http://www.fatf-gafi.org/media/fatf/documents/reports/RBA%20Guidance%20for%20Real%20Estate%20Agents.pdf

[27] Miami Herald and Internal Consortium of Investigative Journalists, Nehomas, Nicholas et.al. (April 2016) *The Panama Papers Investigation: The Secret Shell Game* http://www.miamiherald.com/news/local/article70347537.html

For financial institutions, the detection of suspicious activity in real estate gatekeeper accounts can be difficult without a solid understanding of the intended use of the account. The failure to collect adequate CDD information at the account opening may lead to a misinterpreted risk profile and insufficient enhanced due diligence controls in the long term. For instance, real estate gatekeepers may establish a commercial account with the intent to pool monies on behalf of several clients through a series of deposits, transfers and withdrawals making it difficult for financial institutions to monitor activity and ultimately determine the beneficiary of the transactions.

E. Use of Shell Companies

The goal of money launderers is to obscure the origin of their ill-gotten gains. They utilize a number of methods to convolute the transparency of their transactions. One method is the use of shell companies. Shell companies are typically non-publicly traded corporations, limited liability companies (LLCs) or other legal entities that have no physical presence, provide no economic value and typically have no employees.[28]

Shell companies are not illegal and are formed by individuals and businesses for legitimate purposes, such as protection of assets. They also provide advantages that are attractive to criminals by masking their true ownership and providing a means to store wealth. Shell companies can be established in multiple parts of the world without disclosing their beneficial owners and they are permitted to conduct transactions with little scrutiny. Criminal proceeds can be deposited into the shell companies and transferred in and out of accounts in a manner to disguise the origins of their monies.

In July 2016, the Department of Justice seized multi-million dollar real estate properties claiming the properties were among more than $1 billion in U.S. assets bought with stolen money from Malaysia's sovereign wealth fund by family members and associates to the Malaysian Prime Minister Najib Razak. The complaint indicated the parties used shell companies and gatekeeper accounts to embezzle monies and conduct the transactions.[29]

One of the U.S.'s largest ever terrorism-related forfeitures involved an office tower in Manhattan, New York owned in part by a shell company. The office tower at 650 Park Ave. was majority owned by the Alavi Foundation, which was found guilty in 2017 of violating U.S. sanctions by engaging in money laundering activity with a shell company. The shell company, Assa Corporation, who owned 40 percent of the building was later determined to be owned by an Iranian state-controlled bank.[30]

The U.S. has been sorely lagging behind the rest of the world when it comes to regulation of shell companies. Shell companies are able to purchase properties and launder monies for criminal organizations due to the lack of formal regulation and enforcement in the U.S.
Financial institutions with lax KYC controls to identify legal entities established in foreign countries, countries that are known for weak regulations or corruption may unknowingly open accounts for foreign shell companies and allow them to conduct activity through their institution. In addition, for institutions that offer foreign correspondent banking services, lack of adequate policies, procedures and processes to identify the customer types and transactions permitted through the correspondent bank may lead to foreign shell companies having access to the U.S. financial system.

VI. Recommended Controls for the Real Estate Industry

The following are recommendations for the Real Estate Industry to help strengthen the current AML weaknesses discussed earlier:

[28] FinCEN GTO Advisory

[29] United States Department of Justice (Jul 2016) *United State Seeks to Recover More Than $1 Billion Obtained from Corruption Involving Malaysian Sovereign Wealth Fund*.[Press Release] https://www.justice.gov/opa/pr/united-states-seeks-recover-more-1-billion-obtained-corruption-involving-malaysian-sovereign

[30] New York Times, Wang, Vivian (Jun 2017) *Manhattan Skyscraper Linked to Iran Can Be Seized by U.S., Jury Finds*. https://www.nytimes.com/2017/06/29/nyregion/650-fifth-avenue-iran-terrorism.html

Amend the BSA/AML Regulations to Cover Real Estate Gatekeepers. Real estate professionals who are parties to a real estate transaction in the U.S. should be required to establish a BSA/AML Compliance program. Similar to their financial institution counterparts, real estate gatekeepers should be obligated to have processes to include KYC, CDD and be subject to periodic independent audits. The requirements should also mandate AML training for new professionals to the industry and ongoing training for existing professionals. The requirements to report suspicious activity should be set to a dollar threshold that is in line with real estate industry transactions.

The collection of information as to the source of wealth should fall under the CDD section of the program. These requirements would add a key sector as an additional layer of identification and detection to U.S. AML regulatory foundation.

Expand Geographic Targeting Orders. The current FinCEN GTO should be expanded across the country to become a regulatory requirement to ensure AML obligations cover for all-cash transactions. The dollar threshold should be set to an amount that can be effectively managed by FinCEN and the real estate industry. The requirement to report the all-cash transactions should be implemented to mitigate the 22 percent of real estate transactions not currently covered by BSA/AML requirements.

In addition, considerations should be taken to include commercial real estate purchases into any future GTO requirements. The NAR indicated that 72 percent of foreign non-residential real estate deals involved all-cash deals compared to only 35 percent for foreign residential real estate transactions. Commercial real estate transactions are a potential gap that is not addressed by the current GTO that could expose additional illicit activity.

While not required to implement controls in response to the FinCEN GTO, it would be prudent for financial institutions to incorporate controls to monitor real estate transactions occurring in their real estate gatekeeper accounts. These controls may include enhanced due diligence on the population of real estate gatekeeper accounts to assess the type of activity conducted through their accounts. Financial institutions should consider a periodic review of these accounts with attention on those customers who reside in the GTO areas or where there is evidence that transactions are being conducted in the GTO metro areas. Additionally, financial institutions should give consideration to monitoring of transactions at or near the GTO dollar thresholds in the designated GTO metro areas. These controls can help provide evidence to federal regulators that a financial institution is being vigilant as part of the evolving AML environment in the real estate industry.

Require Identification of Beneficial Ownership. Real estate gatekeepers should be included as part of the current CDD regulation to identify beneficial owners at 25 percent ownership level as well as control owners of a legal entity. The requirement allows these professionals to identify and maintain records on legal entity beneficial owners prior to completion of a real estate transaction. With such a large percentage of high-end real estate occurring through the use of shell companies, expanding the requirement to real estate gatekeepers would further help the U.S. government and law enforcement to identify the underlying owners of these legal entities.

Enhanced Due Diligence on Foreigners. Legislation should be enacted that mandates stricter requirements on foreign individuals and legal entities that are parties to a U.S. real estate transaction. The requirements should prescribe enhanced due diligence standards for identification of foreigners to include PEPS and their family members.

In addition, foreign legal entities should be required to furnish the beneficial and control ownership information prior to being able to move forward with a real estate transaction. Failure to provide the information should prohibit the completion of the real estate transaction and prompt a requirement by real estate gatekeepers to file a SAR.

Designate a Federal Supervisory Agency for the Real Estate Sector. The regulatory agency would oversee the real estate industry to ensure adherence and effectiveness of the AML regulations. In addition, this regulatory agency would have the authority to enact sanctions and penalties for professionals who fail to comply with the regulatory standards.

Canada provides an example that the U.S. government can leverage to establish similar legislation. Financial Transactions and Reports Analysis Centre of Canada (FINTRAC) is the financial intelligence unit equivalent to FinCEN in the United States. FINTRAC enacted legislation under the Proceeds of Crime (Money Laundering) and Terrorist Financing Act (PCMLTFA)[31] to combat money laundering and terrorist financing in Canada.

The PCMLTFA imposes requirements upon real estate developers, brokers or salesman to a real estate transaction. The legislation requires the establishment of a compliance program to include policies and procedures, a risk assessment, training plan and a requirement to review the program every two years to test effectiveness. The law also includes requirements for KYC, reporting of suspicious transactions, record keeping for receipt of monies and penalties for non-compliance. As FinCEN mulls over future AML legislation for the real estate industry, they can utilize what has been established in Canada as a sound example.

VII. Financial Institutions Audit of Real Estate Gatekeepers

In the absence of formal AML regulations on the real estate industry, much of the burden falls on financial institutions. Financial institutions must stay vigilant to ensure their BSA/AML compliance programs are effectively mitigating AML risks that are applicable to the products and services they offer to their customers to include real estate gatekeepers.

This is where the role of independent audit is essential. Through the use of an audit function, an institution has greater visibility into the inherent AML risks and the effectiveness of their controls. The text below describes a thematic approach to auditing for real estate gatekeepers' accounts at a financial institution.

A. Understand Composition of Accounts

Evaluate the BSA/AML risk assessment to determine if real estate gatekeepers are addressed as part of the overall customer portfolio and if the customer risk profiles are commensurate to the institution's risk profile. If these occupation types are not included, this can be an opportunity to incorporate them into the next refresh of the AML risk assessment.

To understand the underlying risk exposure to an institution, a crucial step is to identify the makeup of real estate gatekeepers' accounts (retail, commercial and small business accounts) in comparison to the overall population of accounts held at the financial institution. Based on the results, a risk analysis should be performed to determine within the population of gatekeeper accounts where the AML risks are the greatest. Factors that may increase the risk include geographic location, annual gross income and a number of foreign transactions to name a few.[32]

In addition, financial institutions should stau up-to-date on changes in the AML regulatory space. These regulatory changes may not directly impact their institution. However, as is the case with the FinCEN GTO, there are opportunities to strengthen controls for customer industry or occupations as they are impacted by regulations. In order to sufficiently do so, a financial institution must sufficiently understand the types of customers they onboard. Audits should consider as part of their scope a review of the governance process for their institutions on how they review, update and implement policy and procedures as a result of AML regulatory updates.

B. Review the BSA/AML Program to Include the AML Risk Assessment, Policies and Procedures

[31] Financial Transactions and Reports Analysis Centre of Canada (Dec 2001), *Proceeds of Crime (Money Laundering) and Terrorist Financing Act (S.C. 2000, c. 17).* http://laws-lois.justice.gc.ca/eng/acts/P-24.501/FullText.html
[32] A list of real estate red flags can be found in Appendix A.

Assess the financial institution's BSA/AML program to determine if it adequately addresses the institution's risk with specific focus on their higher-risk products, services, customers and geographies as identified in their AML risk assessment.

Specifically, review the BSA/AML program and AML risk assessment to determine if real estate gatekeepers are noted, and if the customer AML risk profiles for these occupation types are commensurate to the institution's AML risk profile. Focus should be given to product segments that would be utilized by real estate gatekeepers. Products that may have more real estate AML exposure include retail banking, commercial banking and small business products. If a risk-based approach is utilized, evaluate the approach to determine its effectiveness in monitoring for real estate gatekeepers and if the reasoning is sound.

It is highly recommended for financial institutions that offer foreign correspondent banking to pay particular attention to the risk assessment, policies and procedures in place to monitor these foreign banks. A robust audit should ensure there are adequate controls in place to evaluate the correspondent bank's customer types and account types. The audit should assess the controls at the financial institution to understand the types of high-risk customers, to include real estate gatekeepers that are permitted to conduct business and whether there is sufficient monitoring in place for these high-risk customers.

C. Test the Effectiveness of the Know Your Customer (KYC) and Customer Due Diligence (CDD) Programs

Evaluate and assess the onboarding process for real estate gatekeepers to ensure the amount of CDD information collected is sufficient for the institution to 1) understand the nature and purpose of the account and 2) to perform suspicious activity monitoring. If a risk-based approach is utilized, evaluate the procedures to determine if they are proportionate based on the customers' risk profile. As an example, gatekeepers' accounts opened in higher-risk jurisdictions should be subject to enhanced CDD checks.

A review of the quality assurance (QA) programs should be considered as part of the audit scope to assess if controls are in place to ensure the appropriate level of CDD information is obtained based on the type of real estate gatekeeper account. Financial institutions should also evaluate their legal entity accounts to ensure compliance with the beneficial and control ownership requirements of the CDD rule. In doing so, institutions are better positioned to evaluate the number and type of accounts that their real estate gatekeepers may be acting on behalf of other third parties.

D. Test the Effectiveness of the Enhanced Due Diligence Programs.

Evaluate the effectiveness of the enhanced due diligence (EDD) process by testing a sample of gatekeeper accounts to determine if the level and frequency of the due diligence performed is proportionate to the customer risk profile. A sampling of the various risk levels of real estate gatekeeper accounts should be considered to calibrate that the risks levels are adequate.

When conducting an audit of the EDD process, items to review include how the financial institution obtains and refreshes CDD information to included intended purpose of account, source of funds and beneficial ownership or control ownership information. In addition, any review should also evaluate how the institution addresses changes to a real estate gatekeeper's profile (ex. Location, expected activity) and the process to reassess the customer risk rating.

A review of the due diligence documentation should be conducted to ensure the documentation obtained is in line with real estate gatekeeper risk level. The type of documentation obtained for real estate gatekeepers may include the examples below:

a. Income statements
b. Financial statements
c. Description of their client makeup (foreign/domestic)

d. Description on types of real estate transactions conducted (residential, commercial, foreign)
e. Compliance program documentation (if any) to include BSA/AML procedures
f. AML training for staff to include type and frequency of training and the job roles included in the training

E. Test the Effectiveness of Transaction Monitoring to Identify Real Estate Red Flags and Typologies.

Transaction testing is a valuable tool that is utilized to evaluate a sample of transactions that are of higher risk to determine if the institution's transaction monitoring is effective. An audit should assess the types of transaction monitoring activity scenarios that are utilized by an institution to alert and detect unusual activity associated to real estate AML typologies. Whether they are automated or manual, obtaining a list of active models, scenarios and/or reports is a good starting point before conducting transaction testing.

When auditing to AML risks in real estate, an audit should include transactions involving cash, cash equivalents, activity to/from legal entities and high dollar or excessive wires to both international and domestic locations.[33] In addition, for financial institutions that have correspondent banking, the audit should evaluate the transaction monitoring controls in place for activity that does not fit the foreign bank's profile such as large transactions to and from foreign shell companies.

An audit should assess the real estate AML typologies that the financial institution is susceptible to and determine if they have adequate transaction monitoring controls in place to detect the activity. For example, for a financial institution that offers mortgage products, the audit could evaluate the transaction monitoring controls to monitor for mortgage fraud and collusion schemes.

It is vital as part of the transaction monitoring testing phase to evaluate if the institution is adequately calibrating the risk of the customer to the transactions that have occurred. For instance, transaction monitoring scenarios to identify cash structuring to avoid 8300 reporting may not account for transactional activity occurring in a real estate gatekeeper account that is part of a larger real estate pass-through scheme.

F. Review of the AML training

Evaluate the financial institution's departments and personnel to determine the employee segments that have a higher likelihood of detecting real estate AML typologies based on their job responsibilities. Based on this review, the auditors can segment the critical employee functions from the lower-risk job functions. As an example, mortgage underwriters and employees in the small business or commercial banking departments are ideally positioned to identify red flag activity and therefore should be given more thorough training on AML real estate red flags.[34] Furthermore, AML employees responsible for real estate transaction monitoring should be provided rigorous AML training on real estate typologies to ensure they are adept at identifying activity in real estate gatekeepers' accounts such as pass-through, loan schemes, and all-cash transactions.

As part of the evaluation of the AML training, the audit should assess the type and frequency of the AML training specific to real estate typologies and red flags that is given to both AML staff as well as to the higher-risk employees. Consideration should be given as to the content and frequency of the training to determine if the content is refreshed to stay current on changes in the regulatory environment (ex. FinCEN GTO) and effective in providing awareness to the AML real estate red flags. In addition, the audit should assess if previous real estate suspicious activity has been incorporated into the AML training updates to ensure that the information is passed back to employees as a lessons learned opportunity.

[33] A list of AML red flags for the real estate industry is contained in Appendix A.
[34] See Appendix A

G. Review of Previously Filed Suspicious Activity Reports

As activity is identified that is not consistent with a customer's profile or the activity is unusual given the institution's risk profile, SAR should be filed to FinCEN. A sound audit practice would include the review of SARs filed by the financial institution in respect to real estate suspicious activity. Particular attention should be given if there is no previous history of SARs filed by the institution although the existence of real estate gatekeepers' accounts exists. Other factors to consider are the action taken by the financial institution, if any, as a result of previous SARs filed on real estate gatekeepers' accounts. For instance, if the relationship was maintained post-SAR filing, is there enhanced due diligence taking place and at what frequency?

A review of the QA process for SARs should be evaluated to ensure controls are in place to evaluate if SARs are in line with regulatory guidance. For example, in a situation where a SAR was filed on real estate activity tied to a recently identified PEP, a review of the QA process to ensure the correct verbiage such as "Senior Foreign Political Figure" and "foreign corruption" are being checked and that the narrative thoroughly describes the proceeds of corruption as directed by the FinCEN guidance.[35] In addition, a review of the QA may uncover if further action was taken by the financial institution from a look back perspective to determine if any previous SAR filings should be amended for the customer in light of the new information.

VIII. Conclusion

Real estate has long been a relative secret that criminals utilized to hide their assets. It has been overlooked for years as the government and financial institutions found it difficult to detect due to the complex nature of the transactions and the level of anonymity that is permitted in real estate transactions.

Recent news events exposed high-end real estate as a vehicle to money launder millions of dollars by criminals and corrupt individuals. These headlines have drawn the attention of the general public, the U.S. government, and the global economy. The results of the FATF mutual evaluation report may have only increased the momentum to impose AML regulations on the real estate sector.

History has shown that criminals will continue to utilize the services of real estate gatekeepers to gain access to the U.S. financial system until the government imposes legislation. The question now becomes what will the U.S. government's next steps be to enforce tighter AML controls on the real estate sector?

The long term solution appears evident. FinCEN and the U.S. government should adopt legislation to impose the current BSA/AML obligations on real estate gatekeepers. The current FinCEN GTO's are an indication that the U.S. government is aware of this gap and is taking deliberate steps in that direction. To what degree those AML obligations will be imposed has yet to be made public.

While the current AML regulations for the real estate sector remain in flux, the responsibility to carry the weight of BSA/AML compliance will continue to reside on financial institutions. It is critical for financial institutions to perform due diligence on their customers, to include real estate gatekeepers, while educating themselves on the AML typologies in the real estate industry.

Appendix A: AML Red Flags for the Real Estate Industry[36]

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[35] FinCEN, Guidance to Financial Institutions on Filing Suspicious Activity Reports regarding the Proceeds of Foreign Corruption. (FINC-2008-G005)
36 Financial Action Task Force (June 2007) Money Laundering and Terrorist Financing Through the Real Estate Sector. http://www.fatf-gafi.org/publications/methodsandtrends/documents/moneylaunderingandterroristfinancingthroughtherealestatesector.html

Customer Risk

- Location of property relative to the location of the buyer with no reasonable explanation.
- Foreign Buyers or Sellers – particularly if they reside in countries known for being tax havens or under political unrest.
- Involvement of Intermediaries/third parties - Individuals acting as Gatekeeper or intermediary on behalf of another individual or group of individuals to include foreign/non-resident individuals. Example from NAR: Titling a residential property in the name of third party; for example, a friend, relative, business associate, or lawyer.
- Senior Foreign Political officials or family members or close associates.
- Negative News – if any persons who are being tried or have been sentenced for criminal activities or linked to court proceedings involving possible money laundering.
- Anonymous Investors and Buyers – There are indications that the parties are not acting on their own and avoid transparency to the Investors and are trying to hide the identity of the true customer.
- Multiple transactions by one person or entity – several transactions that appear linked together that tie back to one individual or group.
- Individuals who unexpectedly repay problematic loans or mortgages or who repeatedly pay off large loans or mortgages early, particularly if they do so in cash.
- Characteristics of the buyer do not match the type of transaction (High dollar –all cash).
- Property purchases inconsistent with the individual's occupation or income. Where the property purchased appears significantly beyond the purchaser's means.
- Foreign entities – especially if recently established and if located in a known tax haven country
- Charitable organizations – if the purchase and the closing (funding) do not match the stated purpose of the organization.
- Recent formation of legal entity for which the sole purpose is to provide a straw man or intermediary party between the property and the ultimate beneficial owner.

Transactional Risk

- Cash transactions (non-mortgage) Transactions in which payment is made in cash, bank drafts, or other monetary instruments where the true payer is not stated (ex. cashier's check).
- Transactions in which the party asks for the payment to be divided into smaller denominations with short time gap intervals.
- Transactions where there are doubts as to the validity of the documents submitted with loan applications.
- The documentation is foreign making verification difficult.
- Transactions in which a loan granted or an attempt was made to obtain a loan, using cash collateral or where this collateral is deposited abroad.
- Transactions in which unusual or unnecessarily complex legal structures are used without any economic logic.
- Transactions in which there are signs, or it is certain, that the parties are not acting on their own behalf and are trying to hide the identity of the real customer.
- Transactions which are begun in one individual's name and completed in another's name without a logical explanation for the name change. (For example, the sale or change of ownership of the purchase or option to purchase a property which has not yet been handed over to the owner, reservation of properties under construction with a subsequent transfer of the rights to a third party, etc.).
- Transactions relating to the same property or rights that follow in rapid succession (for example, purchase and immediate sale of property) and which entail a significant increase or decrease in the price compared with the purchase price.

- Under or over-valued transactions. Transactions is at a value significantly over or under the appraised value of the property or significant different than market values.
- Purchase is completed where the buyer shows no interest in viewing the property or other significant considerations of the property (location, repairs/renovations, prior history)
- Buyer does not appear interested in obtaining a better price for the transaction or in improving the payment terms.
- Buyer shows a strong interest in completing the transaction quickly to include foregoing the property inspection without a reasonable explanation.

Geography

- The customer or source of payment originates from a country with known lax money laundering laws.
- Location of the property in relation to the buyer.
- Countries identified by credible sources2 as lacking appropriate AML/CFT laws, regulations and other measures.

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