

# FATF Mutual Evaluation Report on Hong Kong

On 4 September 2019, the Financial Action Task Force (**FATF**) released the Mutual Evaluation Report on Hong Kong. The report summarises the anti-money laundering/counter-terrorist financing (**AML/CFT**) measures in place in Hong Kong as at the date of the on-site visit from 31 October to 15 November 2018. It also analyses the level of compliance with the FATF's 40 recommendations and the level of effectiveness of the AML/CFT systems, and provides recommendations on how the system can be strengthened.

Although the report recognises that Hong Kong has a strong legal and institutional framework for combating money laundering (**ML**) and terrorist financing (**TF**), in addition to areas of moderate effectiveness and partially technical compliance, the report has highlighted a number of areas that would benefit from more detailed consideration. KPMG has summarised a selection of key topics below.<sup>1</sup>

01

## Fraud-related money laundering



- The FATF report noted that Hong Kong has an in-depth understanding of its main risks relating to fraud and common typologies used to launder proceeds. Fraud-related money laundering was considered the highest risk and accounted for 70% of the money laundering investigations between 2013-2017, whereas non-fraud related money laundering cases (considered medium-high risk) accounted for less than 30% of the money laundering investigations and covered drugs, foreign tax crimes, foreign corruption, goods smuggling and stand-alone money laundering where the predicate is unable to be identified. Notably, the report pointed to the disparity observed between fraud and non-fraud cases, which appeared wider than the difference expected between high and medium-high risks, even when qualitative factors (relative complexity, scale and magnitude of proceeds) were considered.
- The large volume of fraud cases meant that the majority of cases were lower-scale and not high-end money laundering cases. Accordingly, the FATF assessment team posed questions as to whether the approach was effective in combating large-scale or complex frauds and money laundering syndicates abusing Hong Kong and foreign predicate money laundering.
- In the banking sector, fraud risks in relation to money mules including individuals of various nationalities and corporates domiciled in different jurisdictions were identified as higher risk; whereas in the Designated Non-Financial Businesses and Professions (**DNFBP**) sector, fraudulent payments related to business email compromise scams were more prevalent; and in the Money Services Operators (**MSO**) sector, telephone deception using remittances was identified as a prevalent fraud typology.
- The Hong Kong Police's initiative to set up the Fraud and Money Laundering Intelligence Taskforce (**FMLIT**) and the Anti-Deception Co-ordination Centre (**ADCC**) has also contributed to positive outcomes. This includes supporting investigation units to stop suspicious payments through liaison with banks which has resulted in the withholding of HKD429 million, the disruption of over 90 scams and identification of more than 150 shell companies involved in fraud for the Companies Registry to remove from the companies register.
- Hong Kong's understanding of non-fraud related risks including foreign tax crimes and corruption are discussed in sections 3 and 7.

<sup>1</sup>Source: FATF Mutual Evaluation Report of Hong Kong, China 2019,  
<http://www.fatf-gafi.org/publications/mutualevaluations/documents/mer-hong-kong-2019.html>

02

## Politically Exposed Persons



- The FATF observed that the application of the requirements in respect of politically exposed persons (**PEPs**) varied depending on the institution. International financial institutions tend to go beyond local requirements and apply enhanced measures to both domestic and foreign PEPs, whereas smaller financial institutions follow local requirements and distinguish between foreign and domestic PEPs.
- The foreign PEP regime provided for in the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (**AMLO**) covers individuals who are or have been entrusted with a public function in a place outside of the PRC and sets out requirements with respect to these foreign PEPs. The report noted that the definition of a foreign PEP contained a deficiency, as it did not include foreign PEPs from mainland China and Macau SAR and accordingly, the additional requirements that would be required for a foreign PEP outside the PRC were not applied to foreign PEPs from the PRC. Accordingly, a priority action to close the technical gap in relation to the coverage of PEPs from the PRC was recommended.
- Further, as standalone financial leasing companies and non-bank credit card companies were not subject to AML/CFT requirements, the requirements with respect to PEPs were not applied.

03

## Foreign corruption



- It was observed that while in general there was a good level of understanding of the money laundering and terrorist financing risks, the level of understanding on money laundering related to certain high risk areas, for example foreign corruption offences, should be further deepened. Both the percentage of investigations for corruption cases (83 domestic cases and 32 foreign cases related to money laundering between 2013-2017) and the prosecutions (13 of the 83 domestic cases and none of the foreign cases) were remarkably low in view of the high risk designation, although it was recognised that the latter tended to be harder to detect and investigate as following the trail in foreign cases relies largely on foreign cooperation.
- Authorities were urged as priority action to take further steps to review the threats arising from foreign corruption and to ensure information sharing consistent with the higher money laundering risks identified including foreign corruption, particularly in considering that aside from fraud, the highest number of mutual legal assistance requests are related to corruption.



- The FATF report noted that while an assessment of the money laundering and terrorist financing risks and misuse of legal persons and arrangements was performed, the assessment would benefit from a more detailed consideration of the range of legal persons established or operating in Hong Kong beyond locally incorporated companies to facilitate a more comprehensive understanding of the potential abuse of companies for ML/TF in Hong Kong.
- Similarly, while noting that trusts could be abused, the assessment in the Hong Kong ML/TF Risk Assessment Report issued in 2018 (**HRA**) appeared to be limited to trusts formed under the laws of Hong Kong. The only type of legal arrangements recognised under the laws of Hong Kong were express trusts, which covered charitable trusts and real estate investment trusts. Other trust structures formed under laws of foreign jurisdictions that were operated in Hong Kong and trust structures formed under the laws of Hong Kong but operating outside of Hong Kong would benefit from a deeper understanding of risks.
- The HRA identified that shell companies created in Hong Kong had been used to facilitate predicate crimes and money laundering offences. The understanding could be furthered by consideration of risks that may arise from links to Hong Kong as reported in the Panama Papers, Paradise Papers and Russian Laundromat which reported significant number of entities, officers and intermediaries with potential links to Hong Kong.

- Hong Kong's geographic location, its position as an international financial centre and the relative ease of company formation were considered to be factors exposing it to potential proliferation financing activities through the misuse of legal persons as shell/front companies. This was aggravated by the lack of supervision of Trust and Company Services Providers (**TCSPs**) until the AMLO was amended to introduce a licensing regime and impose AML/CFT requirements on TCSPs in March 2018. The main risks related to the abuse of companies to take part in sanction evasion (particularly with respect to North Korea) and the use of their bank accounts as repositories of crime proceeds.
- As the TCSP regime was recent and licensing was still underway, many of the first entities to receive licenses were well established TCSPs or part of international TCSPs. It was recommended that further work should be performed to understand the scope of unlicensed TCSPs that might still be operating and actions should be undertaken against these entities.
- With the exception of large international TCSPs, the understanding of the ML/TF risks in the sector could be improved: The concept of beneficial ownership was understood as legal ownership and instances were observed where reliance was placed on customer's self-declaration of beneficial ownership. Enhanced due diligence for higher risk situations, particularly in relation to PEPs were not thoroughly understood and the lack of adequate measures and systems to identify and detect customers who are PEPs or subject to targeted financial sanctions were reasons for concern.
- The volume of STRs filed by TCSPs was considered not commensurate with the risk profile of this sector, given the prevalent misuse of company structures and accounts. It was expected that the AML/CFT requirements imposed on TCSPs will help to identify and prevent the abuse of legal persons and legal arrangements over time, although it was acknowledged that more time was needed to assess the effectiveness of the measures.
- A residual gap was noted in relation to legal arrangements governed by Hong Kong laws that engage in activities outside Hong Kong and do not have a relationship with an AML/CFT-obliged entity in Hong Kong.

- Recent measures taken by Hong Kong focused on ensuring availability of beneficial ownership information for companies, including the amendment to the Companies Ordinance to require companies to collect and maintain accurate and up-to-date beneficial ownership information through the keeping of a significant controller register which were to be retained by the companies themselves. The Hong Kong Police and Inland Revenue Department (**IRD**) were able to access information maintained in the companies registry.
- A potential concern was identified with respect to whether the information would be available in a timely manner since companies were only obliged to file updates to the shareholding information during submission of annual returns. In addition, although legal ownership is said to only change when the register is updated, companies have two months to include the updated shareholder information in their register of members.
- There were also no measures to prevent misuse of legal arrangements and reliance was placed on general common law and fiduciary obligations as Hong Kong authorities considered that trusts were set up and administered through professional trustees which appeared to be the case for most of the trusts but not all of them. Private trusts that are popular for a range of wealth management purposes might also impose a higher risk.
- While large financial institutions and financial institutions belonging to international financial groups would typically have beneficial ownership information of their customers, the availability of the same information in the DNFBP sectors might not always be available. Also, as the regime for the DNFBP sectors was only recently implemented, it was considered that more time would be needed to assess the effectiveness of the measures applicable to DNFBPs.

- Similar to the observations in relation to foreign corruption risks, the FATF noted that the general good level of understanding of the money laundering and terrorist financing risks precluded foreign tax offences. As one of the priority actions, the FATF has recommended Hong Kong to continue efforts to review and update the understanding of money laundering threats arising from foreign tax crimes.
- With a simple and low tax system, and in particular the absence of any tax on foreign income and assets, the IRD considered the domestic threat of tax crime to be low. It also attributed the low number of outgoing requests made to foreign partners to the same circumstances. This said, the FATF report noted that the Joint Financial Intelligence Unit (**JFIU**), law enforcement agencies and the IRD should collaborate more closely to enhance intelligence on foreign tax crime proceeds and improve detection of foreign tax crime proceeds.
- Law enforcement agencies appeared to investigate foreign tax crimes reactively (i.e. responding to requests from foreign counterparts of which there has been a significant increase from 24 in 2012-2013 to almost 800 in 2017-2018) rather than proactively (e.g. following up with foreign partners). The reactive management and the significantly smaller number of outgoing requests (6 within the period from 2012-2018) were not in line with the medium-high level of risk and Hong Kong's exposure as an international financial centre to foreign tax proceeds. The FATF report noted as a priority action that investigations and prosecutions of foreign tax crimes should be clearly prioritised.
- The Hong Kong Police conducted over 40 foreign tax crime-related money laundering investigations during 2013-2017 (excludes tax fraud cases). The Customs and Excise Department (**C&ED**) conducted a number of foreign tax crime investigations in response to overseas requests or jointly with foreign counterparts with some cases also involving large amounts of proceeds. However, no tax-related money laundering cases have been prosecuted in Hong Kong. Hong Kong was recommended to improve confiscation in relation to foreign tax crimes to ensure that confiscation results align with the medium high risk associated with foreign tax crimes.

- Hong Kong introduced a system under the Cross-Border Movement of Physical Currency and Bearer Negotiable Instruments Ordinance in July 2018 to combat falsely declared or undeclared cross-border movements of currency and bearer negotiable instruments (**CBNI**) of over HKD120,000. The new regime requires individual travelers entering Hong Kong to make a declaration and allows law enforcement agencies to seek disclosures from travelers for exported CBNI. A declaration is also required for cargo entering or leaving Hong Kong.
- The majority of the declarations were bulk cash movements for banks. The total value related to HKD notes being reimported from Macau since these notes are taken out of Hong Kong for use in Macau where HKD is widely used as informal second currency. As for CBNI from mainland China, the China CBNI limit of RMB20,000 was considered as mitigating cash movement across the Hong Kong border.
- Potential residual risks could exist that involve attempts to circumvent Mainland CBNI and ATM restrictions. Closer collaboration with neighboring jurisdictions could further Hong Kong's understanding of its cash smuggling risk. Also, while cash smuggling was considered to pose a limited threat, the matter would benefit from regular review, considering developments in neighboring jurisdictions.
- The JFIU was also recommended to explore closer collaboration with the Immigration Department to ensure it has timely access to immigration information to trace the cross-border movements of suspects (e.g. money mules).



- The ML/TF risk understanding of the C&ED and the Registrar of Money Lenders (**RML**) need important improvements in the risk understanding at the sectoral and institutional level. In particular, the supervision of MSOs was called out as needing improvement, as studies showed that MSOs have been misused as conduits for foreign predicates, and about 4% of the major cross-border money laundering cases involved MSOs.
- The MSO sector had 1,300 active MSOs handling over USD 1 billion in transactions with the United States, Singapore, the United Kingdom and mainland China accounting for 74% of the outward remittances.
- There were more than 2,000 money lender institutions with a total asset size of USD 9 billion in 2018 providing commercial, mortgage and vehicle loans mostly to the local population. Unlike MSOs that are subject to the AML/CFT requirements of the AMLO, money lenders were not subject to the statutory requirements but the RML supervises money lenders for compliance with AML/CFT as part of the licensing conditions. This said, the CDD requirements for money lenders are not set out in law.
- Money lenders should focus on understanding the ML/TF risks of their customers and products and services, cross-border financial flows, risks posed in respect to non-resident customers and foreign PEPs.
- The level of reporting particularly for MSOs and money lenders was low, which was considered not to be in line with the sector risk assessed as medium-high risk. Also, the quality of the STRs filed by MSOs suggested that the obligations on identification of suspicious transactions might not be well understood by the two sectors.



DNFBPs have only recently been placed under the statutory AML/CFT regulatory framework, and current supervisory efforts are mainly focused on outreach and building awareness. Guidelines issued to the DNFBP sectors appear not yet to have had an impact on the level of effectiveness of preventative measures.

Separately, the report noted the following on specific DNFBPs:



#### Dealers in precious metals and stones

- DPMS was assessed to be medium/low – medium risk are not regulated or supervised for AML/CFT requirements, although the exemption from regulation was not based on proven low risk.
- Retail sales of jewellery and precious metals accounted for approximately USD 9 billion, while total exports accounted for approximately USD 60 million in which USD 47 billion were re-exported.
- FATF has suggested that Hong Kong review and put in place the appropriate level of AML/CFT requirements for the DPMS sector.



#### Financial leasing companies/credit card companies

- Standalone financial leasing companies and credit card companies operating independently of financial institutions are not regulated or supervised for AML/CFT requirements.
- Although their ML/TF risk was assessed as low, it was not clear that there was an independent assessment of the low ML/TF risk to exempt these credit card companies or that it was endorsed by the Central Coordinating Committee on AML/CFT. There is only one non-bank credit card company operating in Hong Kong which is regulated as an MSO in Hong Kong
- FATF has suggested that Hong Kong review the risks associated with standalone financial leasing companies to exempt them on the basis of proven low risk or to ensure that they implement the appropriate level of AML/CFT measures



#### Non-Profit Organisation

- International and local NPOs demonstrated a good understanding of their potential misuses to move funds to support terrorism overseas. The vast majority of the 9,000 NPOs in Hong Kong focus on the provision of social or community services within Hong Kong and are accordingly assessed low in risk for being abused.
- It was further observed that NPOs employ preventive measures to prevent their misuse, for instance, prohibiting donors from dictating the ultimate use of their donations, screening and vetting both donors and the organisations and entities receiving donations for distribution. Terrorist financing intelligence has been analysed and investigated and no substantiated case or reasonable suspicion of terrorist financing had been identified.

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