Role of Due Diligence in Combating Money Laundering in Lens of ESG: A Concept

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Abstract

This study focuses on the implementation of Customer Due Diligence (CDD) requirements under Section 16 of the Anti-Money Laundering Act (AMLA) in Reporting Institutions (RIs). While RIs have established policies and procedures to comply with AMLA and mitigate risks associated with money laundering, there needs to be more emphasis on gathering information to address Environmental, Social, and Governance (ESG) Factors. ESG concerns have become increasingly important in the financial sector, but many institutions need help integrating ESG considerations into their due diligence processes. This study explores the incorporation of ESG due diligence within CDD practices, as it is crucial for long-term value creation, investor returns, and mitigating ESG risks that might be exposed to money laundering. This research aims to identify and propose practical strategies for integrating ESG factors into the customer evaluation process of RIs OR investigate factors that influence the role of due diligence in combating money laundering through the lens of ESG. This paper examines factors that influence the function of due diligence in tackling money laundering through the lens of ESG.

Keywords: environmental, Social and Governance (ESG), money laundering, banking systems

1. Introduction

Customer Due Diligence (CDD) is verifying the identity and assessing customers' risk before establishing a business relationship with them. CDD helps businesses identify and manage the risk of financial crime, including money laundering and terrorist financing. CDD involves verifying the identity of customers and the intended purpose of their account relationship. It also needs to be conducted throughout the life of the transaction. The Reporting Institutions (RIs), i.e., any person, including branches and subsidiaries of that person, who carries on any activity listed in the First Schedule of AMLA, should implement CDD measures under the following circumstances: new business relationship, money laundering suspicion, unreliable documentation, transactions that exceed regulatory thresholds or involve entities in high-risk countries and as part of ongoing monitoring. CDD is part of the Financial Action Task Force's (FATF) 40 Recommendations. Malaysia's Anti-Money Laundering Act (AMLA) requires financial institutions to implement Know Your Customer (KYC) procedures to prevent money laundering and Terrorism financing. Bank Negara Malaysia (BNM) guides verifying individual customers for KYC purposes.

KYC involves verifying the customer's identity, risk profile, and financial position. The process typically includes a customer identification program (CIP), CDD, and enhanced due diligence (EDD). Generally, KYC involves establishing customer identity, i.e., collecting information such as the customer's name, address, date of birth, and government-issued ID, understanding the nature of customer activities and assessing money laundering risks associated with customers. KYC is essential for preventing money laundering and terrorism financing (Jose et al., 2021). By verifying the identity and background of customers, financial institutions can identify suspicious transactions and prevent criminals from using their institutions to launder their money. Environmental, Social, and Governance (ESG) factors are increasingly used to evaluate a company's performance. ESG factors assess a company's sustainability and ethical practices and can be used to make investment decisions (OECD, 2020). There are several reasons why ESG is important. Firstly, research has shown that companies with strong ESG performance tend to have better financial performance, especially during times of crisis. Secondly, ESG factors are becoming increasingly important in financial reporting and auditing, and companies that do not consider ESG risks may face negative consequences. Thirdly, integrating ESG criteria into investment strategies can support the transition towards more sustainable growth. Finally, ESG factors are also being considered in sovereign credit ratings.

ESG reporting has gained popularity among organizations and socially responsible communities. Stakeholders and fund managers believe that firms with high ESG disclosures yield better operating performance, higher returns, and lower firm-specific risk. Stakeholders can use ESG reporting to assess the material sustainability-related risks and opportunities relevant to an organization. ESG is essential for companies, investors, and society. It can lead to better financial performance, more sustainable growth, and a more responsible and sustainable future. The world has begun to be aware of money laundering around them (OECD, 2021). The money estimated to be laundered yearly ranges from $800 billion to $2 trillion in current US dollars, or between 2 and 5 per cent of the world's GDP. The United Nations Office on Drugs and Crime (UNODC) estimates that criminals may have laundered almost $1.6 trillion, or 2.7% of the world's GDP, in 2009. This number is within the previously defined range of 2-5% used by the International Monetary Fund to gauge the scope of money laundering. Less than 1% of illicit financial transfers worldwide are intercepted and frozen. According to the UNODC research, the entire amount of illicit proceeds made in 2009, excluding those from tax evasion, may have been around $2.1 trillion, or 3.6% of GDP in that year.

The AMLA has transgressed over the years, following the current trends to mitigate risks within financial institutions. The latest "in" within the industry is "the convergence between ESG and financial crime." ESG due diligence is the process of peeling a company's ESG policies and risk factors. This information informs ethical and less risky investment decisions, mergers, and acquisitions. ESG stands for environmental, social, and governance. ESG factors relate to a company's policies and practices in each area. It is vital to make ethical, sustainable selections when selecting suppliers. An entity can eventually create a resilient supply chain because there are fewer risks when choosing trustworthy partners. By conducting due diligence by ESG guidelines, an entity will be able to determine whether the businesses engaged are connected to ESG issues. ESG risk factors are constantly on the railing wheels to be relevant in every organization. It was associated with climate change, but due to the agreement in 2015 of the UN Sustainable Development Goals, the ESG horizon has been broadened on how to incorporate other environmental aspects such as nature conservation and social factors such as inequality or human rights violations. AML mainly focuses on predicate offences: the criminal activities that are the sources of dirty money. While drugs are an obvious source of ill-gotten gains, there are many more, and many overlap with ESG investors' concerns. The 6th EU Anti-Money Laundering Directive defines 21 predicate offences that range from human slavery (clearly a social factor in the ESG world), corruption (a classic governance concern) and environmental crimes such as the illegal export of waste or wildlife trafficking.

2. Background of Study

Referring to AMLA Section 16 for CDD, it is a requirement for RIs to conduct CDD and prohibited from conducting any business relationship or transaction involving false or erroneous names. CDD helps the RIs to further understand their customers, with whom they are making a business relationship, by gathering detailed information on what they do. Based on the information gathered, the businesses analyze the customers' level of money laundering from their risk profile to help them decide whether to enter, remain or terminate the relationship with their clients' Section 19 Compliance Programme states that RIs must adopt, develop, and implement internal programs, policies, procedures and controls to safeguard and detect any offence under AMLA. As CDD is a vital tool in combating money laundering, the Malaysian Institute of Accountants (MIA) also requires accountants to perform CDD under its Code of Professional Conduct (CPC). MIA highlighted that CDD is essential to understanding a client's business and risk profile, and it helps accountants identify and mitigate potential risks. The CPC emphasizes that accountants must "exercise due care and competence" in their work, including "understanding the client's business and risk profile". The Professional Standards state that CDD should be conducted in a "proportionate" manner, considering the size and complexity of the client's business. Accountants who fail to comply with the MIA's CDD requirements may be subject to disciplinary action, including suspension or expulsion from the MIA. Understanding the customer business also includes gathering information on compliance with regulations and governing policies to ensure they are not involved in ESG risk.

3. Problem Statement

While RIs have implemented policies and procedures for CDD as required by Section 16 of the AMLA to ensure they are not involved, implicated, or supporting their customers' activities that are considered offences under AMLA, the collection of information to mitigate involvement in ESG crimes is still lacking. There are 17 reporting institutions of CDD in Malaysia (refer to Figure 1). These institutions are required to report suspicious transactions to BNM. Of these, only a small number are currently considering ESG factors in their CDD process.

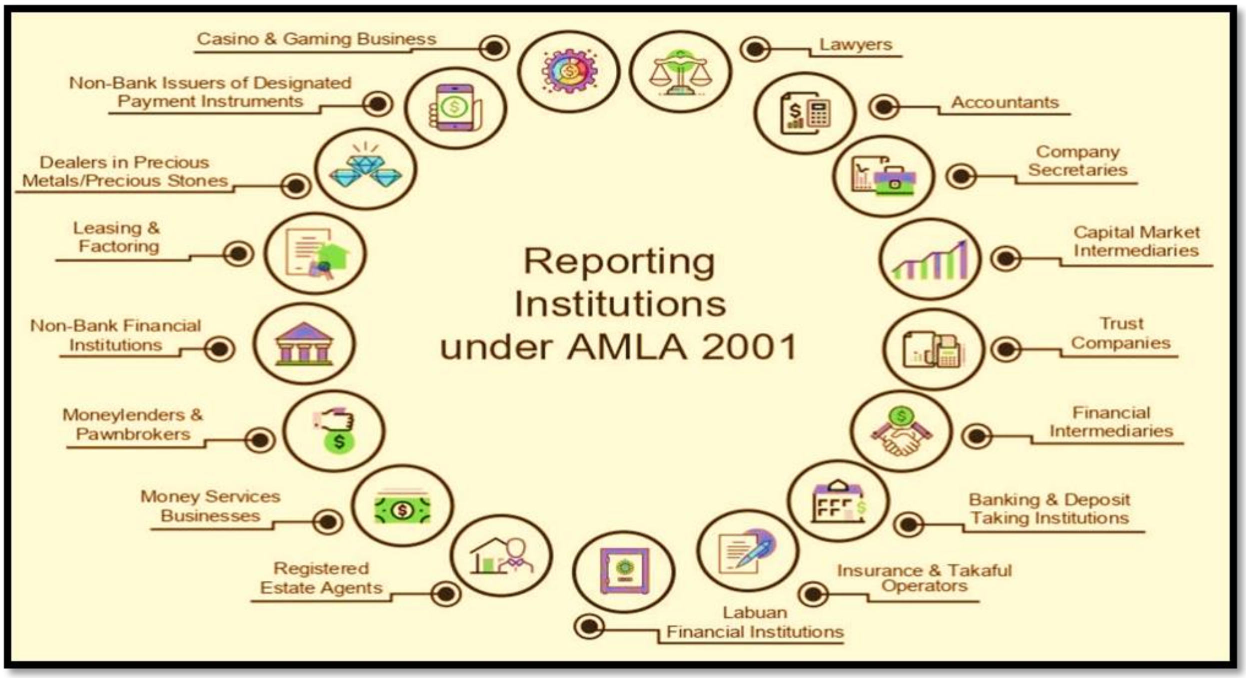

Figure 1. Summary listing of the common reporting institutions

RIs, especially financial institutions, should increase their effort in considering ESG compliance factors as part of their CDD activities throughout all business transactions. It is due to several factors, including the growing importance of ESG investing, the increasing availability of ESG data, and regulatory pressure to consider ESG factors. ESG investing is an investment approach that considers environmental, social, and governance factors when making investment decisions. It is becoming increasingly important as investors become more concerned about the impact of their investments on the surroundings and society. There is now a growing amount of data available on ESG factors, which makes it easier for reporting institutions to assess the ESG compliance of their customers. Regulators worldwide increasingly require reporting institutions to consider ESG factors when making lending and investment decisions. For example, the Securities Commission Malaysia (SC) has issued a guidance note on ESG investing, encouraging reporting institutions to integrate ESG factors into their investment decision-making process. BNM has been promoting a green financing agenda since 2019. By increasing their focus on ESG compliance factors, reporting institutions can help to mitigate risks, improve their reputation, and attract more sustainable investors.

ESG concerns have emerged as a critical issue for financial institutions in recent years, posing considerable obstacles to anti-money laundering operations. Despite increasing acknowledgement of ESG aspects' relevance in minimizing financial crime risks, many financial institutions need help incorporating ESG considerations into their due diligence processes. In Malaysia, the SC started in 2021, warning investors about the risks of ESG-related fraud. The SC stated that ESG-related fraud is a growing problem and that investors must be aware of the risks before investing in ESG-related products and services (So and Jae, 2021). ESG due diligence is vital as a way of looking out for long-term value creation that affects investor returns and mitigates ESG risks, including financial performance, environmental responsibility, and social responsibility. Usually, studies have been done in Western instead of developing countries such as Malaysia. Therefore, this study believes extended research to developing countries will create more awareness of money laundering to protect this country from collapse.

4. Research Gap

The gap in the research lies in the limited focus on integrating ESG considerations into CDD practices within RIs to combat money laundering. While previous studies have examined the importance of CDD in mitigating money laundering risks, few have specifically addressed the incorporation of ESG factors into the due diligence process. This study explores the convergence of ESG and financial crime, highlighting the significance of ESG due diligence in assessing long-term value creation and mitigating ESG risks associated with money laundering. By investigating the role of due diligence in curbing money laundering through an ESG lens, this research offers a unique perspective on the challenges and opportunities for RIs.

5. Literature Review

According to KPMG (2023), AML has been part of the sustainability initiative within the Governance segment; the evolution of AML has opened the way to how sustainability can be achieved within the social and environmental fronts.

5.1 Environmental Factor

The first pillar of the ESG, environmental factors, emphasizes challenges relating to climate and environmental variation (Mehwish et al., 2022). Environmental factors in money laundering concern a company's environmental effect and efforts to be sustainable. More than ever, investors are worried about the environment, which impacts their investing decisions (Rooh et al., 2021). FATF published a study on the money laundering concerns associated with the illegal wildlife trade, urging nations to assess their risk exposure to this illicit trade (FATF, 2020). Environmental crime, such as unlawful mining, is used by terrorist organizations to generate cash and support their activities (FATF, 2021). Climate change poses a threat to all economic operations. It covers the financial services business, both physically and in terms of the effects of environmental catastrophes, such as consumers in impacted industries being unable to repay loans. (PwC, 2021). Potential dangers linked with unlawful actions such as illegal resource extraction, smuggling, or fraud related to environmental regulations can be found by evaluating environmental parameters. For example, companies engaged in illicit forestry or mining may produce substantial earnings that may be laundered through complicated financial transactions. Due diligence specialists may uncover possible money laundering threats and take necessary action by examining a company's environmental practices and compliance.

5.2 Social

Forced labour has grown in recent years. A simple comparison with the 2016 global estimates indicates an increase of 2.7 million in forced labour between 2016 and 2021, which translates to a rise in the prevalence of forced labour from 3.4 to 3.5 per thousand people worldwide. (International Labour Organization, 2022). S" stands for "social," and it refers to a company's dedication to social concerns (Littig & Griessler, 2005). The standard set of activities that the companies can implement are as follows: protecting human rights, fighting child labour, engaging stakeholders, protecting diversity, protecting and promoting equal opportunity, protecting privacy and data, providing support in humanitarian crises, supporting community development, supporting employee safety, education and health, and promoting work-life balance (Zaccone & Pedrini, 2020). The incident of a civil lawsuit against Anglo-American children from Kabwe has record-high blood levels of lead poisoning. It is known to cause lasting damage to internal organs and put pregnant women at harm. It is crystal clear that though Anglo-American training initiatives seem to be highly effective, Anglo-American still insufficient due diligence practices mean that these initiatives would not be able to sufficiently reduce the dangers of modern slavery that have been detected in the supply chain (Esoimeme, 2020). The company should take precautionary actions because engaging in illegal or unethical behaviour will tarnish its reputation.

5.3 Governance Factors

Governance factors include the impartiality and responsibility of the board of directors, the equal rights and benefits of shareholders, financial disclosure and openness, and anti-corruption legislation and measures (PRI, 2015). Dedication and responsibility for governance concerns, such as the rights and responsibilities of the company's stakeholders, are also essential (Filatotchev et al., 2019). Governance has high risks because banks frequently face financial fines for governance failures in money laundering, tax evasion, and other violations (Bhaskaran et al., 2023). According to an S&P Global governance study, organizations that rate below average in excellent governance tend to mismanage and risk missing out on future commercial opportunities. These aspects include managerial quality and diversity, board structure, corruption, political donations, and other governance difficulties. Financial crimes such as fraud and money laundering are more prevalent in companies with poor governance. As a result, ESG risk analysis concentrating on governance concerns is a critical component of the due diligence process.

The 1MDB case can be highlighted as an example of governance failure and the significance of due diligence in combatting money laundering in Malaysia. Embezzlement, bribery, and money laundering were alleged in the case, with billions of dollars taken from the fund. Significant governance shortcomings, such as poor due diligence processes and weak supervision systems, were noted, allowing criminal actions to occur. In the instance of 1MDB, a lack of sufficient due diligence allowed illegal funds to move undetected through the banking system. Financial institutions engaged in the transactions failed to thoroughly investigate the source of funds and the persons involved, allowing the money laundering scheme to continue for an extended period.

5.4 Effectiveness of CDD in Anti-Money Laundering

CDD is an essential component of anti-money laundering (AML) and combating the financing of terrorism (CFT) measures. The effectiveness of CDD in AML can be seen in studies conducted in countries like Bangladesh and Pakistan. These studies suggest adequately implementing CDD, correspondent banking, and new technology can help control money laundering risk. (Jafrey et al., 2020). To improve AML/CFT control measures' effectiveness and efficiency, ensure that the FATF standards support collaborative CDD (Koker et al. n.d). Additionally, Banks should focus on simplifying the process of implementing FATF rules and regulations, regularly monitoring, and providing training to staff in CDD, correspondent banking, and new technology (Jafrey et al., 2020). Nevertheless, the challenges in implementing CDD in AML/CFT may include the lack of compliance with legal requirements, maintaining secrecy laws that hinder international cooperation, and the need for better implementation and monitoring of AML/CFT regulations and training programs (Anti-Money-Laundering (AML) & Countering Financing of Terrorism (CFT) Risk Management in Emerging Market Banks, 2019). Kakebayashi et al. (2023) suggested that a tiered system based on the level of assurance, collective CDD, automated analysis and evaluation, and sufficient human resources for judgment and reporting is an essential part of the design from the AML/CFT aspect. A good practice note published by the International Finance Corporation (IFC) guides emerging market banks to advance their knowledge and capabilities in AML and CFT risk management and facilitate and support the maintenance of correspondent banking relationships (Anti-Money-Laundering (AML) and Countering Financing of Terrorism (CFT) Risk Management in Emerging Market Banks, 2019). Regulatory bodies should allocate unique resources and budgets for training and capacity building of employees and other stakeholders on CDD (Jafrey et al., 2020).

6. Conceptual Framework

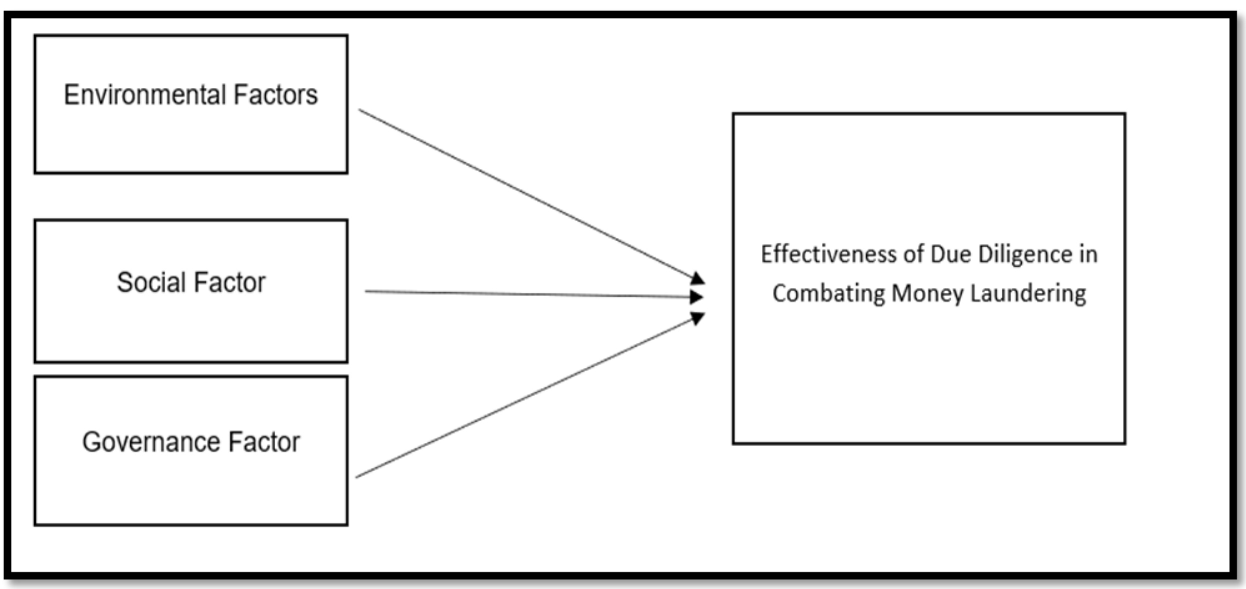

Figure 2. The Proposed Conceptual Framework for the Role of Due Diligence in Combating Money Laundering in the Lens of ESG: A Concept Paper

Figure 2 depicts a conceptual framework of the role of due diligence in combating money laundering through the lens of ESG. A factor is preventing due diligence from combating money laundering due to needing to be appropriately addressed or implemented. Therefore, this conceptual paper emphasizes the need for ESG due diligence in determining long-term value creation, investor returns, and mitigating ESG risks connected with money laundering. This research also provides a new perspective on the problems and potential for RIs by analyzing the role of due diligence in combating money laundering via an ESG lens.

7. Recommendation

ESG factors are becoming increasingly important in the fight against money laundering. This is because ESG crimes often involve complex financial transactions that can be difficult to trace. Financial institutions can better identify and prevent these crimes by understanding the ESG risks associated with their customers. Financial institutions should adopt a risk-based approach to ESG factors in their due diligence processes. It means they should assess the risks posed by ESG factors to their business and then tailor their due diligence procedures accordingly. For example, a financial institution with clients with business operations in a country with a high risk of corruption may need to conduct more rigorous due diligence.

Regulators such as BNM and SC should guide how RIs can integrate ESG considerations into their AML and CFT compliance programs. This guidance could include clarifying expectations for risk assessments and providing examples of best practices. For example, regulators could clarify that RIs should consider the following ESG factors when conducting due diligence and risk assessments, as part of their continuous CDD activities:

(1) Environmental factor / Climate change: Financial institutions should assess the risk that their customers may be involved in activities that contribute to climate change, such as the extraction of fossil fuels or the deforestation of rainforests.

(2) Corruption: Financial institutions should assess the risk that their customers may be involved in corruption, such as bribery or embezzlement.

(3) Social responsibility: RIs can identify customers who are involved in businesses that are not socially responsible. Money launderers may be more likely to use these businesses to launder proceeds from activities harmful to society, such as pollution or corruption.

(4) Human rights violations: Financial institutions should assess the risk that their customers may be involved in human rights violations, such as forced labour or child labour.

The integration of ESG factors into AML is a complex and challenging task. However, it is an important one. For financial institutions, by taking steps to address ESG risks, they can help to make the financial system more secure and sustainable and ensure that the financial system will not used to facilitate ESG risk crimes. In addition to the benefits mentioned above, there are some other reasons why RIs should consider incorporating ESG factors into their AML compliance programs. These include:

(1) Compliance with regulations: Many jurisdictions require RIs to consider ESG factors when conducting AML due diligence. For example, the European Union's 4th Anti-Money Laundering Directive (AMLD4) requires RIs to assess the ESG risks associated with their customers as part of their AML due diligence.

(2) Risk mitigation: By considering ESG factors, RIs can identify and mitigate a broader range of money laundering risks. This includes risks that may not be immediately obvious, such as money laundering through businesses involved in ESG-related activities.

(3) Reputational protection: RIs that are seen to be taking ESG factors seriously are less likely to be targeted by money launderers. This is because money launderers are more likely to target RIs that they believe are less likely to be vigilant about AML compliance.

It is crucial to call for future research on AML to have more studies performed on the role of CDD from the perspective of ESG risk crime as part of a safeguarding mechanism that could analyze and detect ML/TF. This research could help to identify new ways to detect and prevent money laundering and terrorist financing. For example, researchers could develop new algorithms to identify suspicious activity patterns associated with ESG risk crimes.

8. Conclusion

RIs must put policies and procedures on CDD as required under Section 16 of the AMLA and part of the FATF recommendations. This ensures that their customers are not involved in or implicated in activities deemed as offences under AMLA. By enhancing their due diligence processes and factoring in ESG factors, RIs can effectively identify and mitigate potential money laundering risks while advancing their commitments to responsible and sustainable financing services.

ESG factors, or Environmental, Social, and Governance factors, are non-financial factors that can impact a company's long-term performance. These factors include climate change, human rights, and social responsibility. Money launderers often look for ways to hide the proceeds of their crimes. They may do this by investing in businesses that are involved in ESG-related activities, such as renewable energy or sustainable agriculture. By understanding the ESG risks associated with their customers, RIs can better identify and prevent money laundering.

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