Reputational Banking Risks through Offshore Transactions: Benefits of Neuro-Management

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1. Introduction

Offshore companies are legal entities created and registered in countries other than those in which they operate, to benefit from tax incentives and/or to provide financial management or service activity.

Companies prefer these forms of organization respond to the following needs: anonymity on the structure of shareholders and administrators and fiscal facilities: obtaining dividends with the reduction of the applicable tax rate, assignment of assets without VAT, etc. (Aron and Singh, 2005).

A previous research highlights the idea that offshore companies are often viewed as parasites that thrive by attracting tax cheaters and money-launderers (Picard and Pieretti, 2010)

In offshore territories, it is not a direct way to punish the actors involved, especially in money laundering. One of the main ways to identify money laundering trades is to implement customer knowledge standards and identify actual beneficiaries.

This paper seeks to identify ways to discover the mechanisms by which to hide the ultimate beneficial owner. The purpose of this approach is to identify ways in which banks can avoid making money-laundering transactions with the aim of avoiding sanctions imposed by control bodies. Neuro-management decision-making (Satpathy, 2012) can be regarded as a cognitive process resulting in selection of a course of action among several alternative scenarios that banks should consider when they assess money-laundering risks.

2. Literature review

Banks may have a relaxed behaviour regarding money laundering practices, but they are exposed to a reputational risk. The following research questions arise:

- Loss of reputation provides enough incentives for a bank to have a prudent policy?
- Which compliance policies should be adopted in the face of banking secrecy?

Following this idea, (Picard and Pieretti, 2010) tried to find patterns that can control the origin of money to prevent illegal money transfers, gaining tax benefits, and concealing ultimate beneficial owner.

There are situations where even banks are offshore entities. In his paper (Kane, 1999) stresses the role of regulatory authorities to prevent money laundering by banks for their own funds. He identifies three main roles that Central Banks must have:

- to control risks of fraud and contract non-performance;
• to operate a safety net designed to control the risks of fire-sale losses associated with insolvencies of financial services firms and unjustified bank runs;
• to operate the fraud controls and safety net honourably and at minimum cost to taxpayers.

The United States has begun since 2007 to implement mechanisms for identify offshore account through a combination of tools, including: whistle-blowers, exchanges of information pursuant to tax treaties, two major offshore voluntary compliance initiatives, and the threat of FATCA (Harvey, 2012). The Foreign Accountability Tax Compliance Act (FATCA) is an agreement implemented in 2010 by President Obama, and at that time he was criticized by the financial community.

In their activity, banks are exposed to the risk that the services provided to their clients will be used in making suspicious transactions, with funds resulting from illegal activities, facts incriminated by the legislation in force (Levi, 2002). Thus, banks adopt internal rules and procedures that set out measures to prevent it from being used for money laundering or terrorist financing (Madinger, 2016). Neuro-management techniques, based on Artificial Intelligence, have emerged as innovative methods in the fight against money laundering. Neural networks, and fuzzy logic have aided tasks such as link analysis - where associations between account or individuals are analysed for common features, including name and address, zip code, phone numbers, or other account details (Kingdon, 2004).

Offshore territories do not require the application of customer knowledge and record keeping procedures, equivalent to Romanian legislation (Law 656/2002, updated 2016), for the prevention and sanctioning of money laundering, as well as for the establishment of measures to prevent and combat financing terrorism.

In the banking system in Romania, there are 2 situations, respectively 2 types of clients: companies registered in offshore territories and Romanian companies that have offshore companies as shareholders.

3. The documentation requested by banks to enter business relationships with an offshore company

When entering banking relationships with an offshore or a Romanian company that has a structure an offshore firm must submit the following documents:

- Articles of Association;
- Memorandum of Association;
- Certificate of Incorporation;
- Register of Directors - is a list of the directors of a company that is legally kept on the company’s file at the company’s headquarters. This document must include the name and address of the company's directors, the date of their appointment, and the date of termination of office;
- Director named (nominated) - the person appointed instead of the real beneficiary, appearing in the company’s public records and subject to the responsibilities established by the real beneficiary;
- Register of Shareholders - a list of the active properties of a company's shares that is kept by law at the company's headquarters. This includes the full name and address of the shareholders, the number of shares held, the date the transfer was made and the name of the transferee;
- Share Certificate;
- Appointment of First Directors;
- Power of Attorney - a list of the active properties of a company's shares that is kept by law at the company's headquarters. This includes the full name and address of the shareholders, the number of shares held, the date the transfer was made and the name of the transferee;
- Certificate of Good Standing - state-issued document that shows that a corporation or limited liability company (LLC) has met its statutory requirements and is authorized to do business in that state.

There are listed documents that undoubtedly certify who is / are the real beneficiary of the firm:

- Declaration of trust - a written confirmation of the nominee shareholder * to the beneficial owner, in the sense that the designated person is actually the owner of the shares. This document clearly specifies the name of the beneficial owner as the real owner of those shares, and would also reiterate that the designated person can not transfer, negotiate or dispose of shares otherwise than on the express written instructions of the beneficial owner
- Share transfer - proves the transfer of the right of ownership over the shares from one person to another. The form is signed by the nominated owner and by two witnesses and made available to the beneficiary, who can exclude at any time the nominee;
- Letter of resignation - Undefined dismissal letter of the nominated director to the real beneficiary. Under this document the real beneficiary may at any time dismiss the nominated director.
- Resolution of director in writing - The form is signed by the nominated shareholder and made available to the real beneficiary. In this case the nominee shareholder has no right to sign, this right being reserved to the real beneficiary.
- Nominated shareholder - the person who holds the shares of the company only nominally, being able to transfer the shares he / she holds formally to the real beneficiary according to his instructions.
4. Case studies - ways to hide Ultimate Beneficial Ownership (UBO)

More and more business people resort to various commercial transactions through companies offshore to the institution of nominal officials.

Nominal officers (nominee shareholders and appointed executives) are legal or physical persons who "cover" the true shareholder or director of an offshore company.

As we stated before, UBO can be hidden through various documents and procedures, which the laws of "fiscal paradise" allow to be used when offshore companies are registered in these territories.

In the two following examples, two ways to hide UBO are identified.

Case 1

If "X" does not want to appear as a shareholder in his offshore company, he can "hire" a person. Most of the time, it is a legal person that will appear in his place in the Company's constitutive documents. (Case 1)

Thus, no one can claim that the "X" has an offshore company than at the risk of a lawsuit. It can be demonstrated at any time by presenting the shareholder certificate of the offshore company in question, as a shareholder is not "X" but another company.

The question that is most often asked is: "What is the guarantee of the "X" that the nominal shareholder will not abuse his position in the detriment of X's interests?"

The guarantees are legal. The ownership of the shares is transferred by private signature (no legalization of the share contract is necessary). The law does not provide for a deadline for the shareholders to enter in the stock records. Thus, the nominal shareholder will issue a contract for the sale of the company's shares to X. This document is signed by the "seller" (by the nominal shareholder), but it is not dated.

By simply dating, X can always become the company's shareholder. The document may, of course, be overturned. The share sale contract between the nominal shareholder and the real beneficiary of the company is an internal document, unavailable to the curious eye of third parties. The nominal shareholder is also doubled by a nominal director.

There are two ways in which "X" can control the company from a "distance" in an anonymous manner:

The first is to request from the nominal director a general power of attorney to empower him to exercise all the rights he would have had if he had been a director. Thus, "X" will behave like the company's director, but will not be included in the offshore company acts as a director. In this way, the director is someone else, proof being the company's constitutive acts in which someone else appears as the owner of the position of director.

The second, characterized by a higher degree of protection of the offshore company's real director (beneficiary) identity. In this case, the nominal director (a foreign natural person or a professional consultant from Romania) will receive precise indications from "X" about the acts that the nominal clerk would take on behalf of the company. The nominee manager will sign the offshore company's contracts, will be able to sign even in the banks, will be able to give orders to the brokers, sign the articles of incorporation of the Romanian companies where the offshore company will become an associate, etc. The latter mechanism, however, has a major disadvantage, namely the high cost of the nominal director services.

In case of use of the nominal director, the guarantee against its abuse to the detriment of the rights of the UBO of the company ("X") is the resignation in white (undated). Thus, the director can be dismissed even retroactively, cancelling all acts made by the director after last resignation. They become null because the director has acted outside his competencies (he was not a director).
When does these documents require anonymization of this company’s structure? Typically, these mechanisms are used when, due to competition rules, a company owns more than 40% of the Romanian market. Frequently, recourse to nominal officials and to limit losses that may result from shares, bankruptcies, and so forth.

But the greatest value is the anonymization when a person wants, for various reasons, that his name is not associated with a business he wants to run. Any public statement in which the name of the “X” is related to the Romanian company or the business carried out by it, strikes the contrary evidence provided by the Romanian Trade Register, which certifies the lack of any connection between the person of his or her own business and the affair, the shareholder and the administrator No Tax Inc. based in an offshore territory. If, however, the investigator persists and identifies a possible link between X and No Tax Inc. in offshore territory, is getting into an even more delicate matter, because no one can bring evidence in this regard.

5. Conclusions

Reputational risk is the current or future risk of adverse profits and capital damage due to unfavourable image perception by customers, counterparties, shareholders, investors or supervisors. Transactions by offshore entities through accounts expose banks in Romania to sanction risk - applied by the NBR.

A sanction applied in Romania (like sanctions imposed by international regulators) can seriously affect a bank’s reputation, with direct effects on financial performance, stock market capitalization and customer perception. It can create a domino effect that can affect the entire banking system.

A very important role is played by the NBR, through the Supervision Department, which carries out periodic checks in all Romanian banking institutions for applying standard customer knowledge and identification of UBO.

Neuro-management as a concept provides opportunities for both big and small banks, in their quest to avoid wrong decisions regarding suspicious customer approach. Big banks, being characterized by an extensive client base and significant assets may be able to apply a very low risk affinity and to refuse clients which raise the slightest suspicion, using artificial intelligence techniques. Smaller banks, characterized by competitive pressures, may be inclined to accept such clients, at least if checks the background of the clients with multi-dimensional analytical tools (Geiger and Wuensch, 2007).

Considering the ideas grounded on neuro-management science, shared in a paper published in Harvard Business Review (Heskett, 2014), a future research direction will be based on brain scan tests to assess managers who have the requisite neural structure likely to enable them to think about to moving to offshore territories.

References