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AML Challenges in Correspondent Banking

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Introduction

- **Correspondent banking** is the provision of services from one bank (correspondent bank) to another (respondent bank).
- The objective of the FATF Recommendations is to **reduce the financial crime risk** in the banking system.
- FATF issued Guidance for Correspondent Banking Services in 10/2016
- Important Recommendations for Correspondent Banking:
  - Customer Due Diligence
  - Record-keeping
  - Transaction Monitoring

De-Risking

Global financial institutions are increasingly terminating or restricting business relationships with local banks and remittance companies in certain regions of the world.

A World Bank study of 300 banks in 92 countries found that

- 27 per cent surveyed indicated they were experiencing a decline in correspondent banking relationships
- 72 per cent reported multiple challenges with correspondent banking viability and costs
- Some regions are more affected than others
- Smaller countries were found to be more affected than the larger ones.

Drivers of decline in Correspondent Banking Relationships

Business-related causes based on economic terms

Regulatory and risk related causes based on the ML/TF risk of the counterparty

Why is Correspondent Bank Considered Risky?

- Correspondent Bank has no visibility on the end clients or their business
- It relies on communication and confirmations provided by the respondent banks
- Reliance on certifications provided by respondent bank
- Lack of familiarity with business model, client base, client CDD standards, monitoring activities at the end of respondent bank
- Principle to Principle Transactions between banks tend to create a false sense of security
- Presence of Nested Accounts.

Why is Correspondent Bank Considered Risky?

Client → Fintech → Respondent Bank → CorBank → Ultimate Beneficiary

- Long chain
- Small payment and Large Value
- Clientele - how do you get KYCC details
- They can fly under the radar
- Speed of remittance – does the Respondent Bank have the capability to review a transaction as it happens
- Can it obtain all the information on originator of remittance

Why is Correspondent Bank Considered Risky?

- Inadequate appreciation and understanding of the business of Respondent Bank
- Risks associated with products, services, client profile, geographic locations and attendant risks are not factored in periodically
- Lack of visibility on underlying transactions
- AML program is not tailored to address correspondent banking matters
- Transaction monitoring is inadequate – far too high false positives or too few alerts.

FATF Recommendations and Wolfsberg Principles

- FATF Recommendations 2012, updated in 10/2020 deal with foundational guidelines for banks for Client Due Diligence
- FATF Guidance on Correspondence Banking, 2016 is the explanatory detailed guidelines supporting the Recommendations
- Wolfsberg Principles issued by a group of large international banks in 2014 are the global standards to establish correspondent banking relationship

FATF Recommendation # 10

Customer Due Diligence

- Banks are prohibited from keeping anonymous accounts or accounts in obviously fictitious names
- Identifying & verifying the customer using reliable, independent source documents, data or information
- Identifying the beneficial owner, and taking steps to verify the UBO
- Understanding the nature of business and relationship with the bank
- Continuous due diligence on relationship and transactions monitoring throughout the life of relationship to ensure that the transactions are consistent with the
  - institution's knowledge of the customer,
  - their business
  - risk profile
  - Source of funds

FATF Recommendation # 10

- CDD should be carried out before or during the course of establishing a business relationship or conducting transactions for occasional customers.

- Banks can complete the verification as soon as reasonably practicable following the establishment of the relationship, where the money laundering and terrorist financing risks are effectively managed and where this is essential not to interrupt the normal conduct of business.

- If these CDD steps are not done, bank should not open the account, commence business relations or perform the transaction

- Where CDD can not be done for existing relationships, bank should terminate the business relationship; and consider filing a SAR in relation to the customer.

FATF Recommendation # 13

CDD Obligations for Correspondent Banking

- While offering cross-border correspondent banking and other similar relationships additional responsibilities are imposed besides normal CDD
  - Understand the nature of the respondent's business
  - Its reputation, quality of supervision, history of money laundering or terrorist financing investigation or any such regulatory action
  - Assessment of its AML policies & practices
  - If "payable-through accounts" or nested accounts are maintained, ensure that the respondent bank has conducted CDD such customers having direct access to accounts of the correspondent bank
  - Can respondent bank provide relevant CDD information upon request to the correspondent bank

Wolfsberg CB Due Diligence Questionnaire

- De-facto standard for due diligence
- Final decision will rest with the specific correspondent bank
- Binary – to be answered in Yes/ No
- There is no right or wrong answer
- An exercise in identifying and managing risk, through a risk-based approach
- Accuracy of information provided is critical.

Themes covered in Wolfsberg CBDDQ:

- Entity & Ownership
- Products & Services
- AML, CFT & Sanctions Programme
- Anti-Bribery & Corruption
- Policies & Procedures
- AML, CFT & Sanctions Risk Assessment
- KYC, CDD & EDD
- Monitoring & Reporting
- Payment Transparency
- Sanctions
- Training & Education
- Quality Assurance/ Compliance Testing
- Audit

CDD / EDD Issues

- Who is our customer? The respondent bank or the Customer of the respondent bank?
- Know Your Customer's Customer?
- KYCC has created its own challenges.
    - FATF has clarified that "FATF Recommendations do not require financial institutions to conduct customer due diligence on the customer of their customer (i.e. each individual customer)"
- In a correspondent banking world, if a correspondent bank detects reasons for suspicions on a client or a transactions, it can make a Request for Information from the respondent bank.

Elements of CDD / EDD

- What are the Products and services offered by your client bank ?
- What are specific AML / TF risks associated with these products ?
- What is the continuous monitoring process does the bank have ?
- What geographies does the bank operate in ?
- Does the geography pose any specific AML / TF risk ?
- What is the client profile for the bank ?

Banks should use a risk based approach to assess quality of AML programme of respondent bank so as to mitigate the risk emerging from products, customer base and jurisdiction

FATF Recommendation # 14

Money or Value Transfer Services (MVTS)

- Recommendation # 14 is an interplay of # 10 and # 13 asking countries to ensure
  - MVTS are licensed or registered
  - MVTS are monitored for compliance with FATF Recommendations.
  - Provisions for identifying and actions against unlicensed MVTS
  - MVTS maintain list of its agents, used to provide services
  - MVTS include such agents within their AML/CFT programmes and monitor them for compliance with these programmes.

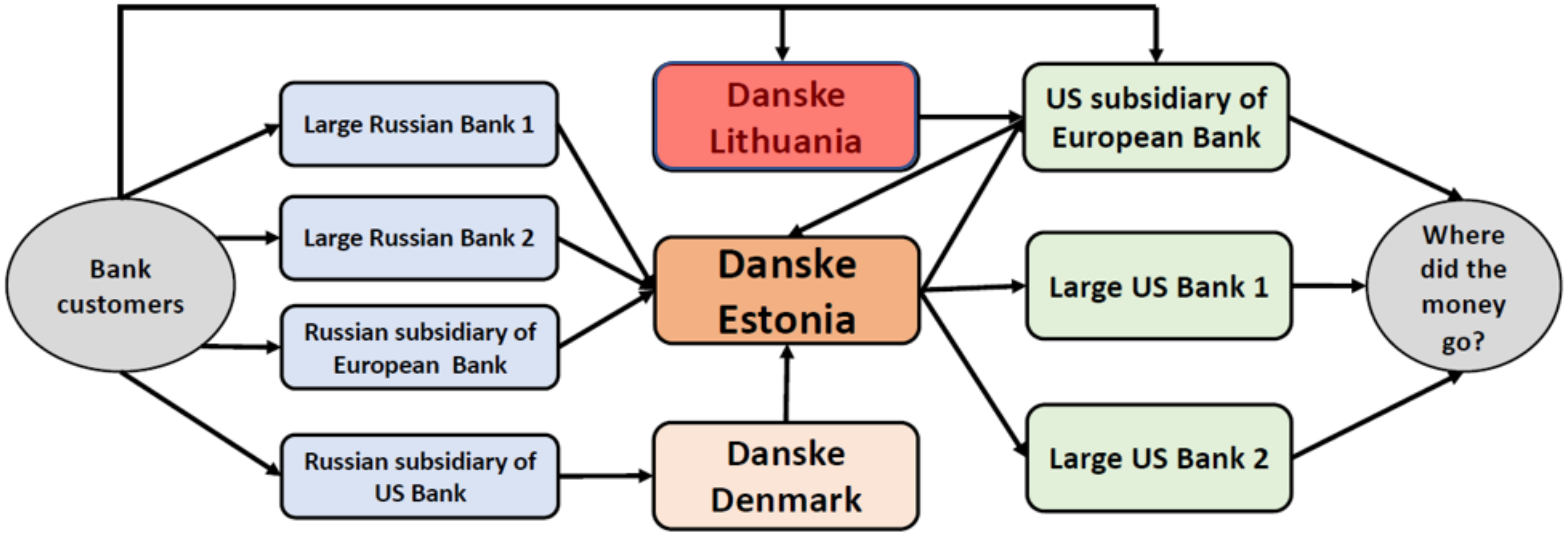
FATF Recommendation # 15

New Technology

- FATF has recognised the fast changing technological space and its impact on product offerings.
- It recognised that changing technology or new products can cause / change the money laundering and / or terrorist financing risk
- FATF has recommended that banks should assess / re-assess these risks whenever
  - A new product is developed
  - New technology is used for existing products / services
  - New delivery process is used or a process is changed

Recent Mishaps in Correspondent Banking

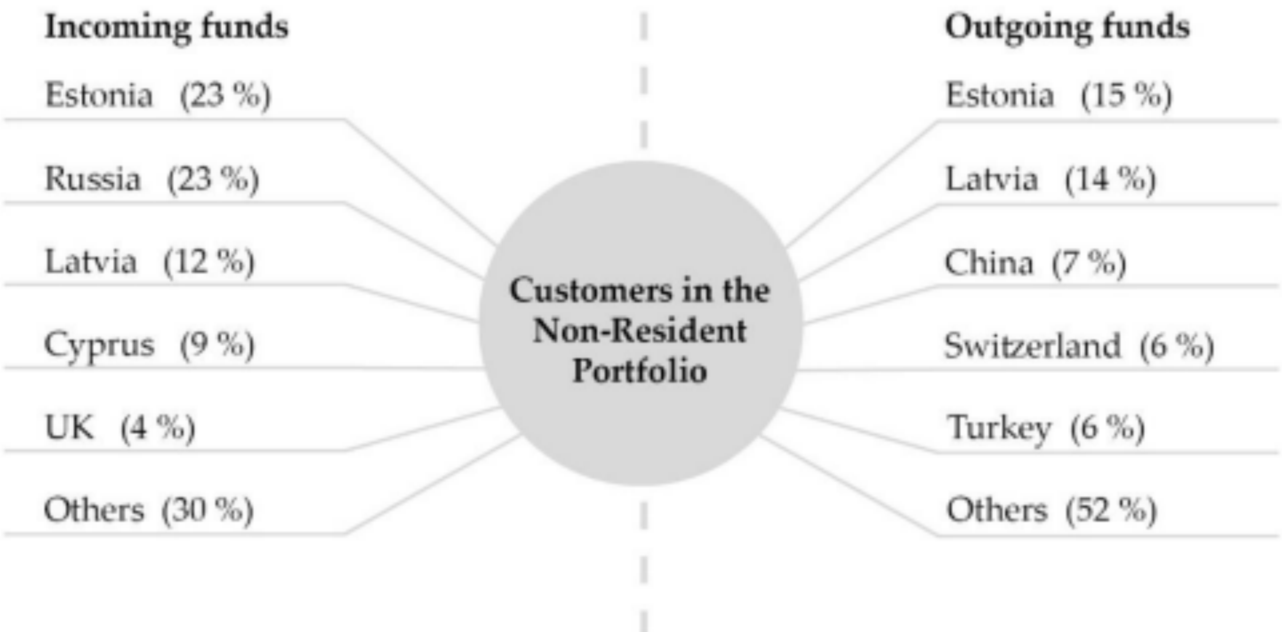
At least 10 banks were involved in the flow of EUR 200 billion of suspicious money through Danske Estonia…



Source : https://grahambarrow.files.wordpress.com/2018/12/flow-2.png

Danske Bank Flows and Countries Involved

The geographical distribution of the flow of EUR 200 billion is illustrated below:



Source : Report on the Non-Resident Portfolio at Danske Bank's Estonian branch
https://danskebank.com/-/media/danske-bank-com/file-cloud/2018/9/report-on-the-non-resident-portfolio-at-danske-banks-estonian-branch.pdf?rev=56b16dfddae94480bb8cdcaebeaddc9b&hash=B7D825F2639326A3BBBC7D524C5E341E

Correspondent Banking and FinTech

- FinTechs touted as great disruptors have emerged as a big business opportunity for banks
- The term fintech refers to the synergy between finance and technology, which is used to enhance business operations and delivery of financial services.
- Irrespective of success of the FinTechs in garnering customers, the nuts and bolts of moving money remain unchanged
- The funds movement remains within the traditional banking networks
- And so long as banks are moving money for FinTech clients, banks are accountable for all the regulatory compliances – FATF / Wolfsberg / Sanctions / Transaction Monitoring / SAR filings / local AML laws et el

Banks v/s FinTechs: A Cultural Clash?

Banks

- Process oriented
- Tradition bound
- Conservative
- Risk averse
- Highly regulated
- Legacy of past penalties
- Limited resources
- Legacy costs and systems

FinTechs

- Desire of Scaling-up at break-neck speed i.e. download rates
- How fast am I gathering operating clients
- Reliance on third parties for KYC / APIs for customer validations
- Building up eco-system for payment acceptance - global receivers
- Culturally a disrupters mindset – does it fit with the environment in which banks operate
- Low cost service providers competing with banks
- No legacy costs

Create a Safety Moat

- A sharp focus on policies, procedures, training, monitoring and auditing will help avoid expensive regulatory action.
- Learn from mistakes of others, continuously update your processes and challenge your own processes / monitoring practises to identify possible loopholes.
- An end-to-end visibility into transactions and customer details will help avoid 'siloed approach' to banking in general.
- **Finally, there is no substitute for eternal vigilance!!**

Banks need to ensure the following

- Effective AML Program
- Adequate CDD
- Adequate Transaction Monitoring