

Banks Must Cast Net Wide When Researching Correspondents' AML Programs

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By [Brian Orsak](#)

Corrections Appended

As any compliance officer knows, vetting a banking correspondent relationship is no simple matter. Initial evaluations of another institution's anti-money laundering program can be long, the cost high and reviews perpetual.

Section 312 of the Patriot Act mandates that U.S. financial institutions conduct enhanced, or greater, diligence when evaluating correspondent relationships for money laundering risk. The U.S. Treasury Department's Financial Crimes Enforcement Network (FinCEN) defines such relationships as any established for a foreign institution to receive deposits, make payments or handle financial transactions.

Under final 312 rules issued in August, financial institutions must obtain "reasonably available" information about the AML programs of certain institutions they have correspondent relationships with, including those with offshore licenses or licenses issued by countries deemed uncooperative with international money laundering principles.

Financial institutions must identify the beneficial owners of such banks if they aren't publicly traded, and also should identify the nature of the foreign bank's business and obtain information about the foreign regulatory system under which the bank operates.

While many banks engaged in correspondent relationships are multinational institutions with longstanding reputations, others are small operations in high-risk jurisdictions. Therefore, "the floor of information you need to get is usually pretty high," according to John MacKessy, a managing director of consulting firm FTI in New York.

And failing to collect, verify and review that data can result in costly enforcement actions. In 2005, for example, regulators penalized the Bank of New York \$38 million for failing to detect Russian criminal laundering totaling some \$7 billion. American Express was ordered to pay a \$65 million penalty this year due to due diligence breakdowns that allowed drug traffickers to move funds through a correspondent institution.

Below are recommendations from three AML consultants on how compliance departments can best assess their risks.

Throw the Net Wide: Collecting information and checking facts on another institution can take months, but is a crucial part of correspondent due diligence. Financial institutions should look not only to another institution for information—

its public records, statements and query answers—but to a wide variety of regional and global resources.

At a minimum, banks should confirm their correspondent partners' banking license, certificate of good standing and proof of regulatory affiliate status. Additionally, institutions should request statements on whether there are nested accounts, background information on management, including supervisory boards and financial data on the types of accounts and customers the institution deals with, according to Kenneth L. Bryant, managing director of Hayesville, North Carolina-based consultant Bryant & Associates, LLC.

Compliance officers will want to double check their information with public documents, local regulators and publicly available information, he said.

While the regulatory expectations are numerous, "you can't cherry pick" aspects of the required due diligence, according to Howard Steiner, a senior partner at ImpactAML LLC, a Las Vegas-based consultant.

"Everything that's in the FFIEC manual, you have to do and you have to interpret it fairly broadly," he said.

See It to Believe It: While much of the required due diligence can be done remotely, determining whether a foreign bank at the other end of a correspondent transaction is more than just an address requires physical verification, according to Bryant.

"You can't ask them if they're a shell bank because, if they are, they're not going to tell you the truth," he said, adding that sending a compliance officer or local private investigator to the bank should help answer questions.

Because some shell banks offer nonexistent addresses or share locations with other fraudulent businesses, investigators should verify that a legitimate business operates at the address, including whether a regular staff and clientele use the address, said Bryant. For higher risk relationships, compliance departments will want to check the address again as part of annual review.

Get It in Writing: Getting a copy of another institution's AML program, particularly in high-risk jurisdictions, is important, according to MackEssy, adding that many institutions in such regions should be able to provide an English translation.

But just as importantly, regulators will expect follow through, or some verification that the correspondent institution puts into practice its written program, according to Bryant.

"A lot of people ask for the compliance manual, but then nobody goes and verifies that they're doing it," he said. "Nobody does an inspection or asks for a random sample."

Check Your Sources: Background checks always require checking a financial institution's reputation, jurisdiction and clientele against available watchlists, media reports and other resources. Compliance officers should consult the Banker's Almanac, PEP databases, the Wolfsberg questionnaire, IMF and World

Bank Country reports, international terror lists, civil case history and FATF reports, whether the institution's jurisdiction is a FATF member or not, according to Bryant.

To check English translations of local media reports, compliance officers might want to check FACTIVA, he said.

The Follow-Up: Compliance departments should have a rigorous follow up with a bank in a correspondent account around three months after the initial assessment to see "what's actually happening versus what you established as a profile," said MacKessy.

Banks will need to verify information such as whether the amounts in correspondent accounts meet expectations and whether there are shell companies involved or nesting relationships that were previously unclear, said MacKessy.

"Always the first test will be when you start seeing some transactions you are uncomfortable with, and then the questions are 'How responsive are they?', 'What type of information did they provide?' and 'Are they cooperative?'," he said, adding answers to those questions should be reflected in the bank's annual review of the relationship.

Trust, With a Caveat: Because a privately owned bank may be unwilling to share information, or because local law prevents the sharing of data with other companies, financial institutions will, in some cases, have to rely on what their correspondent institutions are telling them, said Bryant.

"It's a trust-based system to an extent, but that's why it's important to get your due diligence across the board," he said, adding that checking for nesting or payable through accounts will depend on the forthrightness of the other institution.

Doing business in jurisdictions with strong privacy laws can be "more dicey," but banks may want to hire investigators or outside firms to make queries in the market place about the reputation of the firm, said MacKessy.

Know Your Limitations: Because U.S. regulation of correspondent banking is relatively new and has yet to be closely scrutinized by examiners, compliance departments may do best by narrowing their efforts to issues addressed specifically by regulation and guidance, said Steiner.

"What tends to happen in the AML world is that institutions are going on these crusades and fighting windmills when you should take a conservative approach and interpret things narrowly," said Steiner. "This is not crusade and we're not trying to save the world: we're trying to follow the law."

If a financial institution, at a minimum, follows the guidelines, regulators are likely to ask for improvements rather hit the bank with a costly fine or embarrassing enforcement action, he said.

And, in some cases, market factors may influence how aggressively the Treasury Department enforces AML provisions next year.

“Given all of the safety and soundness issues with subprime, you’re less likely to see huge AML fishing expeditions because the last thing a Citibank needs right now is a huge AML problem,” said Steiner.

CORRECTIONS: This update corrects the spelling of Howard Steiner and the name of his company, ImpactAML LLC, from the 11th paragraph.