

What Should Auditors Know About Correspondent Banking Activities and De-Risking?



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**The views expressed in this paper are solely those of the author and do not represent those
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I. INTRODUCTION

“De-Risking” is a recent trend in the global financial market where correspondent banks are restricting and terminating their relationships with other banks and financial institutions that are classified as high risk or are operating in high risk countries. These actions are mainly due to two issues:

- *Increase compliance costs:* Lately, Know Your Customers’ Customers (“KYCC”) being done by the correspondent banks increased compliance costs since extra efforts are exerted by the correspondent banks to review and monitor the customers of the respondent banks classified as high risk or are operating in high risk countries; and,
- *Generate insufficient volumes:* Ability of the respondent banks to generate sufficient volumes to recover the compliance costs.

In Lebanon, the banking sector is the main backbone of the industry and one of the few sectors that was not damaged by the long years of war that Lebanon went through and remained one of the most important sectors in spite of the uncertainty in the region and neighboring countries.

To protect the Lebanese banking sector, the Central Bank has been very active, continuously issuing new directives to govern the banking sector and ensure strict adherence to global standards and proper implementation of international and local AML/CFT standards and sanctions programs.

Lebanon has always been considered as a gateway from the Middle East to Europe and the US. It was therefore vital for Lebanese Banks to have a secure access to US, European and other international financial markets and, more importantly, to foreign currencies through their relationships with international correspondent banks.

In his last visit to Lebanon on May 27, 2016, Mr. Daniel Glaser (*Assistant Secretary for the Department of the Treasury of the United States*), described the Governor of the Central Bank of Lebanon Mr. Riad Salameh as **“one of the best Central Bank Governors in the world”**.

Mr. Glaser also mentioned that **“Governor Salameh has been a very good partner and without a doubt we have a lot of confidence in him and his team”**

Lebanese banks look to mitigate the “De-Risking” performed by foreign correspondent banks through their auditors who have been tasked to ensure that a proper AML/CFT risk assessment framework is available and properly maintained and updated. The Framework covers the relationships with the correspondent banks and demonstrates a close adherence to global standards issued mainly by FATF, Wolfsberg and Basel as Lebanese banks operate in a high risk country. This may consequently reduce the compliance costs for the correspondent banks and eliminate one of the major components of “De-Risking”.

What should Auditors know about Correspondent Banking Activities and De-Risking?

Auditors ensure that the risk assessment framework in relation to the correspondent banking activities at the bank include at least ONE OF the following elements:

- Due diligence related to correspondent banking activities
- Enhanced due diligence related to correspondent banking activities
- Audit framework related to international transfers

Central Bank of Lebanon Basic Circular # 126 dated April 2012 states that Lebanese banks and financial institutions should perform enhanced due diligence in relation to cross border transactions through international Correspondent banks or financial institutions

II. DUE DILIGENCE RELATED TO CORRESPONDENT ACCOUNTS

1. Basic Indicators of the Risk Assessment Framework

Auditors take into consideration specific risk indicators when reviewing and assessing foreign correspondent banking relationships. Below are the major indicators that ought to be assessed by auditors:

a. Blacklisted Banks

Auditors review on a regular basis the correspondent banking relationships established with banks and financial institutions to ensure that the banks and financial institutions, their shareholders of significant influence and Board members are not blacklisted or listed on any local, foreign or sanction watch list. Auditors also ensure that all banks and financial institutions have a Global Intermediary Identification Number in accordance with FATCA regulations.

b. Shell Banks

Auditors ascertain that the correspondent banking relationships are not established with shell bank(s) or financial institution(s). It behoves on the auditors to check that the bank or financial institution:

- Exists based on submitted documentary evidence;
- Does not deal with shell banks;
- Has a good reputation; and,
- Is subject to good control and implements sufficient procedures to fight money laundering and terrorist financing.

In addition, auditors should also ensure that the respondent bank or financial institution does not permit their accounts to be used by shell banks or financial institutions.

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c. Ownership Structure and Key Personnel

In relation with correspondent banking activities, the auditors ensure that the legal due diligence is performed when establishing a new relationship with a correspondent applicant. Thereon, the files of the respondent banks should be checked on a regular basis and include all related legal supporting documents such as banking license, commercial register, etc...

When the respondent bank or financial institution is located in a high risk country, the auditors, are committed to verify the following on a regular basis:

- If the respondent bank or financial institution is a government owned entity;
- The list of shareholders and related percentages of the respondent bank or financial institution; and,
- Board members and key senior management of the respondent bank or financial institution.

Furthermore, the auditors assess if key personnel are not listed on any local or international watch list, have a good reputation, and whether PEPs are involved in the respondent bank or financial institution's management or ownership structure and obtain appropriate understanding of their role.

Due diligence repositories can be accessed by banks to assist with their counterparty on-boarding and review process.

d. Purpose and Nature of the Correspondent Relationship

The intended or expected purpose or relation with the respondent bank or financial institution needs to be properly stated and documented. It is the duty of the auditors to check, in addition to the respondent bank or financial institution's risk profile, the purpose for opening the correspondent banking account. The nature of the account could be a Nostro account, Vostro account or trade finance relationship.

Nostro account refers to an account that a bank holds in a foreign currency in another bank.

A Vostro account is the account a correspondent bank holds on behalf of another bank.

Auditors make sure that all Nostro and Vostro accounts have the appropriate Senior Management approval in the files and the documentation is being reviewed by the compliance officer and updated on a regular basis when deemed necessary.

e. Policies and Procedures

In addition to all the abovementioned due diligence measures, the auditors must ensure that appropriate policies and procedures governing foreign correspondent banking relationships are in place, proper oversight is being performed by the compliance officers with appropriate escalations procedures.

f. Other Indicators

In some cases, where the respondent bank or financial institution presents a higher risk, the below elements should be reviewed and taken into consideration in the auditor's risk assessment, when available:

- Check the respondent bank's or financial institution's market reputation;
- Review reports prepared by reputable ratings agencies;
- Obtain the respondent bank's or financial institution's annual report;
- Determine and assess the nature of products and financial services offered;
- Request general information on the respondent bank or financial institution's categories of customers;
- Take into account information, if available, from law enforcement agencies or banking authorities; and,
- Obtain financial statements, audited if available.

Wolfsberg Anti-Money Laundering Principles for Correspondent Banking (2014) - Risk-Based Due Diligence Considerations:

1. Correspondent banking client geographical risk
2. Branches, subsidiaries and affiliates of correspondent banking clients
3. Branches, subsidiaries and affiliates of the institution
4. Correspondent banking client's ownership and management structures
5. The correspondent banking client's business
6. The correspondent banking client's customer base
7. Products and services offered to the correspondent Bank client
8. Regulatory status and history
9. Anti-money laundering controls
10. No business arrangements with shell banks

2. AML/CFT Risk Assessment Questionnaire

The AML/CFT risk assessment questionnaire includes an overview of the respondent bank or financial institution's risk profile, its governing compliance programs and policies and its procedures to mitigate AML/CFT risks.

Below are the key sections of the AML/CFT risk assessment questionnaire that are reviewed by the auditors:

a. General Overview of the Respondent or Financial Institution

The general overview section of the AML/CFT risk assessment questionnaire is reviewed by the auditor to check the ultimate beneficial owners of the respondent bank or financial institution and understand the respondent bank or financial institution's ownership structure.

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Furthermore, the nature and intended purpose of the relationship as declared in the AML/CFT risk assessment questionnaire are key indicators for the auditor to assess after a certain period of time the true purpose of the correspondent banking account in relation to the actual volume and type of transactions being performed on the account.

b. Customer Due Diligence

Questions related to Know Your Customer's procedures, customer due diligence and enhanced due diligence procedures are properly reviewed by the auditor to assess the risk exposure of the respondent bank or financial institution. Below is a sample of the questions reviewed by the auditor:

- Describe your Know Your Customer Policies - Provide information on account opening procedures including the identification of beneficial owners, verification of source of funds, etc...
- Describe your procedures for updating and reviewing customer information
- Describe your customer Risk Based Approach. How do you assess the overall risk rating of your customers? How frequently do you re-assess a customers' risk rating?

c. Transaction Monitoring

Moreover, questions related to transaction monitoring are also reviewed by the auditor to determine the risk exposure of the respondent bank or financial institution. Below is a sample of questions reviewed by the auditor:

- How does your bank assess money laundering risks associated with your bank's correspondent accounts for other foreign banks (nested correspondent bank activity)?
- Describe your policies and procedures for identifying suspicious activity. Is the monitoring process manual or automated? What is the process for escalating identified suspicious

FATF Recommendation 13: In relation to cross-border correspondent banking and other similar relationships, financial institutions should be required to:

1. Gather sufficient information about a respondent institution to understand fully the nature of the respondent's business, and to determine from publicly available information the reputation of the institution and the quality of supervision, including whether it has been subject to a ML/TF investigation or regulatory action
2. Assess the respondent institution's AML/CFT controls
3. Obtain approval from senior management before establishing new correspondent relationships
4. Understand clearly the respective AML/CFT responsibilities of each institution.

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activity to local law enforcement authorities. Describe your reporting requirements for suspicious account activity.

- Do you enable payable through arrangements without the knowledge of your correspondents?

3. Periodical Due Diligence

Auditors rely on their own risk assessment to review existing foreign correspondent banking relationships on a periodic basis or when material changes occur to the risk profile of the respondent bank or financial institution.

Periodic due diligence on foreign correspondent banking activities is crucial to constantly mitigating the compliance risks.

III. ENHANCED DUE DILIGENCE RELATED TO CORRESPONDENT ACCOUNTS

When reviewing the enhanced due diligence process related to correspondent accounts, auditors ensure that a site visit is performed for respondent banks or financial institution located in high risk countries, or when a material change to the respondent bank or financial institution's risk profile is perceived for consideration, and present their recommendations to the audit committee.

Furthermore, below are some considerations that auditors should take into consideration when the bank performs downstream correspondent relationships.

1. Site Visits

A site visit to meet senior management and compliance officers of the respondent bank or financial institution located in a high risk country is considered fundamental in the enhanced due diligence process to determine if the respondent bank or financial institution has reasonably designed due diligence policies, procedures and controls in place before establishing the banking relationship. Furthermore, site visits may also be conducted at the time when periodic reviews are due.

Auditors rely on the information presented in the site visit report to assess and mitigate the compliance risks related to the respondent bank or financial institution in question.

2. Downstream Correspondent Relationships & Payable through Accounts

Enhanced due diligence is performed when the respondent bank or financial institution's own customers have the ability to directly control funds at the institution or conduct direct transactions through the correspondent account. A proper Know Your Customer's Customer ("KYCC") policies and procedures are to be implemented to allow the identification of the ultimate beneficial owner of the transaction and mitigate the compliance risks.

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The auditors review and assess the enhanced due diligence process and present their recommendations to mitigate the compliance risks associated with these type of transactions.

IV. AUDITING INTERNATIONAL TRANSFERS

To mitigate the ‘De-Risking’ trend adopted by international foreign correspondent banks, auditors of the Lebanese banks constantly ensure that the AML/CFT risk assessment framework addresses, in addition to the standard requirements, specific controls related to international transfers performed through the financial system of the correspondent banks.

1. Standard Requirements

FATF Recommendation 16 related to wire transfers sets the regular standard requirements that should be available when performing cross border wire transfers.

Below is the standard minimum required information that should be checked when performing a wire transfer:

- Name of the originator, beneficiary and all other parties involved in the wire transfer are not listed on any local, international and sanctions lists;
- The wire transfer doesn’t involve sanctioned countries;
- Account number of the originator and the beneficiary are available;
- Address of the originator and other personal information such as the date and place of birth are available; and,

FATF Recommendation 16:

Ordering financial institutions should be required to ensure that all cross-border wire transfers of USD/EUR 1,000 or more are always accompanied by the following:

1. **Required and accurate originator information:**
 - The name of the originator;
 - The originator account number where such an account is used to process the transaction or, in the absence of an account, a unique transaction reference number which permits traceability of the transaction; and
 - The originator’s address, or national identity number, or customer identification number, or date and place of birth.
2. **Required beneficiary information:**
 - The name of the beneficiary; and
 - The beneficiary account number where such an account is used to process the transaction or, in the absence of an account, a unique transaction reference number which permits traceability of the transaction.

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- If the routing of transactions is being done through several jurisdictions and/or financial institutions and doesn't have any apparent purpose other than to hide the nature, source, ownership or control of the funds.

However, since the Lebanese banks are located in a high risk country, additional due diligence measures on top of the global wire transfer standards should be performed to mitigate compliance risks.

Auditors review cross border transactions based on a risk-based approach to ensure that appropriate due diligence measures are done and the transactions have a clear purpose and economic value.

2. Additional Controls to be performed in a high risk Country

Since international correspondent banks are dropping as much as one third of correspondent banking relationships, which has resulted in the closure of thousands of accounts, as per the study prepared by the Global Center on Cooperative Security on November 2015, auditors of the banks located in high risk countries have adopted a risk-based approach that includes additional elements when performing a cross border wire transfer through the financial system of an international correspondent bank:

FATF Recommendation 16:

Beneficiary financial institutions should be required to have risk-based policies and procedures for determining:

1. When to execute, reject, or suspend a wire transfer lacking required originator or required beneficiary information;
2. The appropriate follow-up action.

a. Relationship between the Ordering and Beneficiary Customer

The relationship between the ordering customer and the beneficiary customer should be well defined and documented and their full permanent addresses and account numbers should be provided.

Names of both ordering and beneficiary customers should truly reflect the parties involved in the transaction. Fronting is prohibited which means payments conducted on behalf of an individual or entity are not allowed.

b. Amount of the Transfer

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The amount of the transfer should be in line with the profile of the customer, his/her business activity and the movement of accounts. When unjustified round amounts and/or repeated amounts are noticed on the account, a full explanation should be requested.

When unusual or exceptional transfers are performed by the customer, a full explanation should be requested.

c. Reason of the Transfer -Vague or Missing Information

Information should be clear, formulated in a comprehensible and detailed manner. Abbreviations, numbers and imprecise words or sentences should be avoided and replaced by a clear description of the true purpose of the transaction. Broad words such as “Expenses” and “Charges” are only accepted when supported by valid documents.

In addition, words such as “Personal” or “Private” should not be permitted since they do not reflect the clear purpose and reason of the transaction. Words such as “Gift”, “Donation” and “Financial Aid” are only accepted when complete explanation or justification are available.

Transfers with missing or incomplete reasons should be prohibited.

d. Reason of the Transfer - Proper Documentation

In relation with Contracts and Agreements

When the transfer necessitates any kind or type of agreements or contracts, a duly signed and dated copy of said agreement should be provided. The agreement must reflect the parties related to the transfer. Shareholder loan agreement should be supported by legal documents proving the entity’s structure and ownership in addition to a duly signed and dated loan agreement.

Capital increase must be supported by legal documents including the legal entity’s structure and ownership in addition to minutes of meetings resolving the capital increase. When a shareholder or owner is paying on behalf of a company, supporting legal documents reflecting the company’s structure and ownership are needed.

Dividend distribution has to be supported by full documentation related to the distribution in question, including company’s legal documents, structure, ownership and financial statements.

In relation with Investments and Fees

Fees, honorarium and retainer fees must be supported by full documentation, agreements and invoices. Commissions, introductory fees and royalties have to be well defined and documented by means of appropriate agreements stating clearly the parties involved as well as the amount to be paid. Consultancy, management and services agreements should be dated and duly signed by both parties involved in the transaction.

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Funds, trusts and escrows must be supported by proper documentation related to the funds, trusts and escrows in question. Investment, private investment, personal investment and family investment must be supported and evidenced by sound and valid documentation showing full details related to the type of investment, place of investment and any other related information demonstrating full details pertaining to the investment in question. As for the liquidation of portfolio it should be supported by proper documentation related to the entity in question in addition to financial studies pertaining to the liquidation in process.

Refund payments and tax returns have to be supported by a proper documentation related to the initial amount paid in addition to full details related to the reason of the return payment. Insurance premiums must be supported by proper documentation and invoices including the insurance agreements.

In relation with Purchased Assets

In relation to purchased assets, a dated and duly signed copy of agreement must be provided in addition to proper and full documentation regarding the asset purchased or to be purchased.

Transfers involving payment of rent or leases are not accepted without proper documentation including a copy of a duly signed and dated agreement determining the amount to be paid and the property in question.

Transfers involving the purchase of luxury items, watches and accessories must be supported by duly dated and signed invoices in addition to any necessary details pertaining to the items involved. Transfers involving the purchase of gold and diamonds have to be supported by a proper documentation including sound invoices in addition to any necessary details pertaining to the items involved. Transfers involving the purchase of arts, antiques and collectibles should be supported by a proper documentation including valid certificate of origin and sound documentation related to the auction house if involved. Transfers related to yachts must be supported by documents showing the full details of the yacht, its ownership and management in addition to the related agreements.

In relation with Shipments and Invoices

When the transfer includes an invoice, a valid, signed and dated copy of the invoice has to be provided. The invoice must be addressed to the ordering customer and should justify the economic purpose of the transfer in question. When the amount of the transfer is a partial payment of the invoice, this should be clearly stated in the remittance information.

Transfers involving shipments must be supported by related documentation including a full and detailed description of the goods in addition to the related invoices and bill of lading if available.

e. Reason of the Transfer - Transfers to specific types of customers

Transfers of “Commercial” purposes performed from personal accounts to corporate accounts are prohibited.

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Where the customer is a regulated exchange house, proper documentation showing the actual identity of the ultimate beneficial owner and the purpose of the transfer. International inward transfers where the customer is not a regulated exchange house are prohibited.

f. Reason of the Transfer - Relationship between related companies

The relation between related companies defined below should be clearly proven and identified by means of proper legal documentation.

- *A parent company is the owner of legally separate entities known as subsidiaries or affiliates. The parent company establishes ownership by either creating a separate legal entity or acquiring voting shares of stock.*
- *An affiliate is a legal entity whose parent company possesses only a minority stake in the ownership of the company.*
- *A subsidiary is a legal entity whose parent is a majority shareholder (i.e. 51 percent or more of the voting stock).*
- *Sister companies are subsidiary companies owned by the same parent company; sister companies are independent and operate separately and the only connection between them may be their common association to the parent company.*

3. Enhanced Due Diligence related to the Correspondent Accounts

The risk assessment framework reviewed by the auditors includes, in addition to all the elements mentioned above, the following non-exhaustive transactional behaviors that should be checked for the correspondent account:

- Wire transfers in large amounts, where the correspondent account has not previously been used for similar transfers;

- Unusual large numbers of wire transfers;
- Unexplained repetitive or unusual patterns of wire transfer activity;
- Frequent or numerous wire transfers either to or from a bank located in a Non-FATF Cooperative Jurisdiction; and,
- The routing of transactions through several jurisdictions and/or financial institutions without any apparent purpose other than to disguise the nature, source, ownership or control of the funds.

FATF Recommendation 16:

Implementation of Targeted Financial Sanctions

Countries should ensure that, in the context of processing wire transfers, financial institutions take freezing action and comply with prohibitions from conducting transactions with designated persons and entities, as per obligations set out in the relevant UNSCRs relating to the prevention and suppression of terrorism and terrorist financing, such as UNSCRs 1267 and 1373, and their successor resolutions.

V. CONCLUSION

As a result of the stringent regulations and sanctions programs implemented by the regulators, foreign correspondent banks are adopting “De-risking” strategies. As such, they are reducing their correspondent relationships with respondent banks and financial institutions located in high risk countries to limit their exposure to potential fines that regulators may enforce as a result of any violations of laws, rules, or sanction programs.

The Federal Reserve Board announced a **\$58 million penalty** and consent cease and desist order against **Deutsche Bank AG**, of Frankfurt, Germany, related to violations of U.S. sanctions. The order requires Deutsche Bank to implement an enhanced program to ensure global compliance with U.S. sanctions administered by the U.S. Department of Treasury's Office of Foreign Assets Control. *November 4, 2015*

The Federal Reserve Board announced a **\$90.3 million penalty** and consent cease and desist order against **Crédit Agricole S.A.**, of Paris, France, related to violations of U.S. sanctions. The order requires Crédit Agricole, including its foreign subsidiary, Crédit Agricole Corporate and Investment Bank, to implement an enhanced program to ensure global compliance with U.S. sanctions administered by the U.S. Department of Treasury's Office of Foreign Assets Control. *October 20, 2015*

Accordingly, auditors of respondent banks located in high risk countries should ensure that:

- AML/CFT processes are well established and enforced across all relevant departments;
- A proper AML/CFT risk assessment framework is developed, taking into consideration specific risk indicators that are regularly reviewed not just to optimize the framework operationally, but also to adapt it in accordance to any regulatory changes; and,
- An enhanced due diligence is performed for international transfers using the financial system of foreign correspondent banks.

VI. REFERENCES

- USA Patriot ACT
 - Section 313: Prohibition on correspondent accounts for foreign shell banks
 - Section 319 (a): Forfeiture from U.S. correspondent accounts
 - Section 319 (b): Records relating to correspondent accounts for foreign banks
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- Basel: “Customer Due Diligence for Banks” issued in October 2001
- Wolfsberg: “Guidelines on Anti-Money Laundering Principles for Correspondent Banking” issued in 2002
- Wolfsberg: “Anti-Money Laundering Principles for Correspondent Banking” published in 2014.
- FATF 40 recommendations issued in 1990, revised in 1996, 2003 and 2012.
- European Union: Third Directive based on elements of the FATF’s revised 40 Recommendation, adopted in 2005.
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- Law number 318 issued by the Lebanese parliament in April 2001
- Law number 32 issued by the Lebanese parliament in October 2008
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- Basic circular number 83 issued by the BDL in May 2001
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