“Are You Throwing Out the Good with the Bad?”

Successfully Banking MSBs in the age of De-Risking

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Executive Summary

What does it mean exactly that banking Money Services Businesses ("MSBs") should be risk-based? The phenomenon of "de-risking" has come to mean the wholesale closure of MSB accounts without taking into account the subtleties of the risk presented within the MSB industry. If FinCEN has stated that banking MSBs should be based upon risk,[1] as have all the other banking regulators,[2] then why have banks continued to categorically close all of their MSB accounts? The FFIEC's definition of high-risk accounts that includes all MSBs in no way prohibits additional discrimination within the high-risk category. The techniques presented here will help a bank perform high-risk discrimination that will allow it to tailor its account portfolio to fit within its chosen risk assessment. The resulting portfolio will in turn provide the bank fee income that is well above and beyond the costs associated with the underwriting and monitoring of the portfolio.

This paper is geared for those compliance and/or Bank Secrecy Act ("BSA") officers within small to mid-level financial institutions[3] ("FI") that are often faced with questions by business lines about opportunities involving additional fee income as well as depository relationships with high-risk clients.[4] Developing a risk management program that can handle such clients as MSBs can be applied to other high-risk customer groups.

Background

The MSB industry is a big arena and even within the FinCEN definitions there are distinctions. FinCEN defines an MSB as a business that conducts the following activities: check cashing, money transmission (now including virtual currency exchangers), money orders and traveler's checks, currency exchange and dealing, and providing or selling prepaid accounts.[5] The proliferation of new technologies continues to blur these definitions as crypto-currencies become more mainstream, mobile wallets find themselves on more and more smartphones, and fintech companies continue to redefine what it means to have a bank account. As this paper is about defining and grooming a risk program for handling MSBs, the very definitions that

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[1] FinCEN advisory statement dated November 10, 2014.
[2] FFIEC BSA/AML Risk Assessment – Overview.
[3] 12 CFR 228.12.
[4] FFIEC BSA/AML Exam Manual, 11/17/20, provides many definitions and examples of activities, products, and geographies, that would make a client a high risk for money laundering.
[5] 31 CFR 1010.100(ff).

are provided by the regulations can provide the first level of a risk-based program. It is vitally important to take cues from these definitions and align your program to the regulations. The fact that check cashers are not required to file SARs [6] provides a clue that the risk of this activity is lower. In fact, check cashing is actually anti-money laundering as cash is placed back out into the populace and also contains both sides of a transaction. Working further up the risk scale, as an example, is the issuance of money orders. In this case, only one side of the transaction is known while check cashing provides both sides of the transaction. And a third example of yet a higher level of risk is money transmission where neither side of the transaction is known except by the money transmitter themselves. So by using MSB regulation definitions and identifying BSA requirements and the level of transparency provided by a particular MSB, risk is identified and mitigated. The banks offering their services to AFSs and program managers are in a unique position to oversee the activities of these businesses. As such, the regulators of these banks are looking for banks to determine if the activity of AFSs are legit or not, and if these banks have good controls in place to make sure the activity is commensurate with what is expected for the AFSs in question. Controls that not only include automated alert-based systems but are also staffed sufficiently to handle the manual control processes that are still necessary.

Regulatory definitions aside, the first step in identifying risk is to understand exactly how a particular customer or prospect fits within this high-risk category. As check volumes have fallen over the past two decades, check cashers and other MSBs have looked to supplement this particular line item with other products. So even if a particular product may not fit within the precise MSB definition, it would be useful to include them within the definition of an MSB as risks are defined. In fact, there are a number of industry designations that attempt to capture this concept such as non-bank FIs, financial services providers, and alternative financial services providers. Alternative Financial Services providers ("AFS") shall be used in this paper as a designation that includes MSBs and non-bank FIs as well as alternative lending and other products focused on the un- and under-banked population.

It should be noted that although the current customer base of AFSs are the unbanked or under-banked, the industry actually got its start

[6] FinCEN guidance issued January 1, 2003. It is this author's opinion that check cashers should still file voluntarily as it helps maintain critical relationships as well as maintain integrity of reporting that may be required for other products.

in the Great Depression where mounting bank failures made it increasingly difficult for the retail sector to cash checks drawn on other FIs. Entrepreneurs stepped in to assume that risk for a nominal fee. As these businesses expanded, the array of services expanded to include money orders, money transfers, utility bill payments, automobile license plates and stickers, public transportation passes, government benefits distributions, pre-paid phone debit cards, postage stamps and boxes, lottery tickets, tax preparation services, and since the late 1990's, deferred deposit check cashing, and other short-term loans.[7] So as stated above, for a risk assessment to have greatest use, these products should be categorized within a comprehensive risk assessment. Even though the focus is on developing the risk assessment and monitoring protocols for handling these accounts, the "why" is important in developing a bank's defense. *Why* should a bank have an interest in AFSs and *why* do they even exist? A background is presented on three primary AFSs, MSBs/check cashers, short-term/high rate lenders, and money transmitters to help answer those questions.

The most recent Federal Reserve study in 2016 found that only 71% of the U.S. population is considered "fully banked." The other 29% of the population, approximately 70 million, use AFSs on a least an occasional basis. The growth of large AFSs within retail chains such as Wal-Mart, provide ample evidence of the need for such services. FiSCA, the national trade association, states that there are many reasons AFSs are used. "Traditional FIs are often difficult to find in working class and minority neighborhoods, having concentrated their locations in middle and upper class suburbs." In contrast, AFSs are frequently nearby and offer hours that are more accommodating to work schedules. Low to moderate-income individuals may also have need of more interpersonal services than those found at traditional banks. Other reasons that this population group uses AFSs may include having an aversion to using a bank based upon their cultural background, speaking a common language, a lack of liquidity (meaning living from paycheck to paycheck), and AFSs having a greater degree of transparency than that offered by traditional bank branches.[8]

The recent financial crisis also saw the loss of billions of dollars of credit availability,[9] which continues to support the lending industry

[7] FiSCA.org. Financial Service Centers of America, a national trade group for MSBs and lenders.
[8] FiSCA.org Fact Sheets, published June 2013.
[9] GAO-13-180, published January 16, 2013.

that is frequently associated with AFSs. The high-interest rate or fee-based lending industry got its start in the late 1990's as an outgrowth from the "rent-to-own" and "pawn" businesses. There are basically three distinct products within this market: deferred deposit loans (typically $50 to $500 for two weeks at $15 per $100), unsecured installment loans (up to $2,500 for six to 24 months), and title loans (mostly less than one-year installment loans secured by car titles).

There are numerous reasons these services are used as well. Although many lenders require that the borrowers have a bank account, banks simply are not able to profitably provide small loans, except possibly in the form of overdraft protection. Consumers are actually well informed and are able to judge that the cost of a short-term loan from an AFS versus a bank overdraft charge is cheaper.[10] Other users are looking for cash for emergency needs and other short-term needs. The problems with these loans arise when the argument for these loans being fee-based cannot be applied for loans that are "rolled over" or renewed by simply paying the fee and not the principal. Short-term loans are typically fee-based but also must adhere to Regulation Z and Truth-In-Lending regulations that equate these fees to an annual percentage rate. Most states have enacted rules governing short-term loans and the Consumer Financial Protection Bureau also has pending rules that will go into effect in 2019.[11] Like other AFS products, these loan products are highly regulated both by the states and soon by the Federal Government. The industry has responded that the fees that generally equate to high interest rates are necessary to cover the costs associated with lending to a higher risk consumer that frequently has poor credit or no credit, and limited access to alternatives.

The third primary segment within the AFS industry is money transmission. Money transmitter originators ("MTOs") are businesses that rapidly (within minutes or within a 24-hour period) send money from one geographic location to another. Consumers generally use these services for one of two reasons: sending money abroad to family or friends, or to send money to a buyer or employee for an online purchase. As stated within the Federal Register publications, most of the remittance transfers that occur are consumer-to-consumer transfers of low monetary value, often made via non-depository alternative financial providers by migrants supporting friends and relative in their home countries. A number of studies regarding related

[10] Federal Reserve Bank of New York Staff Report, December 2009.
[11] https://www.consumerfinance.gov/about-us/newsroom/cfpb-finalizes-rule-stop-payday-debt-traps/...although on January 16, 2018, the Acting Director announced the CFPB may reconsider the rule.

financial flows indicate that consumers in the United States transfer tens of billions of dollars abroad annually[12] with by far the greatest volume ($24.3 billion) going to Mexico. The total market of transfers including remittances, "top-ups," hawalas, business-to-business payments, and person-to-person payments is estimated at over $1 trillion.[13]

The point of this background is that there is an indisputable need for AFSs. It is a vast market that is barely tapped by the "mainstream" banking services but still has a great reliance upon banks for their entry points into the financial system. These AFSs are also highly regulated already. This point must be emphasized. AFSs are generally subject to Federal anti-money laundering laws and restrictions on transfers to or from certain persons and jurisdictions. AFSs are also subject to State licensing and the MSB activities are subject to audits by State FI regulatory bodies and the IRS, which audits MSB operators for FinCEN (Title 31(X) exams). Lenders are subject to Truth-in-Lending laws and are also subject to State and Federal examinations. When the Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law in July 2010, a number of its provisions affected this industry. Most notable was the creation of the Consumer Financial Protection Bureau ("CFPB") and the "Durbin Amendment." The Durbin Amendment affected the amount banks could charge for interchange fees among other things and the CFPB has most recently instituted rules governing loans that have access to a consumers bank account (through checks, ACH, drafts, etc.) or their car title. The CFPB and its rule making has affected and will continue to have a significant impact on AFSs both through the Reg-E requirements affecting prepaid access and money transmission disclosures and the lending industry through its Payday, Vehicle, Title and Certain High-Cost Installment Loans final rule.[14]

AFSs, in order to function, must have access to the U.S. financial system. Check cashers must be able to deposit third-party checks and obtain cash that is in excess of their related product cash origination. Or, they may need to deposit cash if their cash generation is in excess of the needs for cashing checks. MTOs must be able to deposit cash

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[12] Pew Research Center, Remittance Flows Worldwide in 2016, published January 23, 2018.
[13] Hugo Cuevas-Mohr, IMTC 2017. Top-Ups is a method of money transmission that is used for covering cell phone usage in foreign countries. Business-to-Business "B2B" and Person-to-Person "P2P" are method of transmitting money through payment applications from businesses to businesses, consumers to consumers, or variations thereof. Hawalas are informal, trust-based, money transfer systems that are based upon trade relationships between brokers in different countries.
[14] CFPB, Final Rule issued October 5, 2017, docket number CFPB-2016-0025.

generated from originations as well as transferring funds through their primary and correspondent bank accounts. Lenders must be able to also deposit cash and send and receive funds for crediting consumers for loan proceeds and debiting their accounts for payments. And, prepaid program managers must have access to the payments networks, which at least for the time being, are only granted to FIs that guarantee the payments.

An ongoing argument used by banks that “de-risk” or exit the servicing of the AFS industry (discussed in the following section), is that their regulator makes them the “de-facto” regulator of the AFS. This means that although the Treasury Department has stated that banks are not responsible for the BSA programs of AFSs that they bank[15], there are still responsibilities the bank must assume as well as perceived or actual pressure exerted by the local field examiners. It is felt that not only is the bank responsible for the activities of the AFS (by virtue of the funds flowing through its accounts) but that it is also responsible for determining the effectiveness of the AFS’s BSA program through reviews of manuals, independent reviews, State exams, and Title 31 exams.[16]

This position has been reinforced through the many fines and deferred prosecution judgments that have been issued by the regulators over the years for lapses in their BSA programs. A recent example is the $7 million fine assessed against Merchants Bank of California.[17] In this case, FinCEN alleges that failures in Merchants’ AML program “allowed billions of dollars to flow through the U.S. financial system without effective monitoring to adequately detect and report suspicious activity.” (The fine, it should be noted, was a significant part of the bank’s equity, 80%![18]) However, as it appears with a number of other significant actions against banks, Merchants’ compliance issues appeared to have been ongoing for a significant period of time. There was a previous cease and desist order posted by the OCC in June of 2014, civil money penalties against three bank officers in 2012, and a formal agreement with the OCC to strengthen compliance with consumer laws and regulations in March of 2009. Further actions took place in 1991, 1998, and 2004.

[15] FinCEN guidance published April 26, 2005.
[16] It has also been asserted that this pressure not only pertains specifically to an AFS’s BSA program but also to other types of AFSs such as a lender’s compliance management system.
[17] FinCEN release Feb 2017.
[18] FFIEC call report for OCC charter number 21371.

The continued confusion arises, however, from these ever increasing fines in contrast to statements made by FinCEN directors[19] and the FFIEC exam manual itself that states: "the BSA does not require, and neither FinCEN nor the federal banking agencies expect, banks to serve as the de facto regulator of any NBFI industry or individual NBFI customer" and "while banks are expected to manage risk associated with all accounts, including NBFI accounts, banks are not held responsible for their customers' compliance with the BSA and other applicable federal and state laws and regulations."[20]

However, in spite of this confusion, a properly developed risk assessment and program will allow a bank to develop sufficient clarity to maintain certain AFSs that fall within their assessment while also providing sufficient return from a business perspective. Within these preliminary steps it is important to know the reasons AFSs exist, why your FI has decided to bank AFSs, and how AFSs exist within the existing State and Federal regulatory environment.

<u>De-Risking</u>

"De-risking" refers to the phenomenon of FIs terminating or restricting business relationships with clients or categories of clients to avoid, rather than mange, risk."[21] FATF also stated that "de-risking can be the result of various drivers" and that it is a misconception to characterize de-risking exclusively as an anti-money laundering issue."[22]

A properly designed risk assessment will, in the context of a bank's strategic plan, provide focus for the bank on what part of the MSB arena is an acceptable risk for which it is remunerated sufficiently. Categorically stating that all MSBs present excessive risk eliminates and possibly moves "underground" or out of sight of regulation, a fantastically huge part of the U.S.'s population and financial activity. Moving AFS activity out of the banking system increases the usage of such informal and unmonitored activities as used by hawalas and money transmitters that use the services of other AFSs like money order issuers. (Unlicensed or unbanked money transmitters can use money orders and package them in place of having their own bank

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[19] Jennifer Shasky Calvery, ABA Money Laundering Enforcement Conference, November 16, 2015.
[20] FFIEC exam manual, pg. 299, and NACUSO website, the National Association of Credit Union Service Organizations.
[21] FATF Plenary, October 23, 2014, World Bank, IMTC.
[22] FATF and N. Gurung, Columbia Business School, as presented at the International Money Transmitters Conference in November 2017.

accounts.) The activity that the U.S. Government needs to track the most becomes more opaque. The FFIEC has specifically stated that NBFIs are considered high-risk accounts along with other cash intensive businesses and occupations that offer access to the financial system.[23] However, the exam manual states itself that not all accounts within a high-risk category represent the *same* amount of risk. It is, therefore, imperative that a bank identifies its AFS portfolio as being high-risk but also that each particular AFS is assessed for risk on its own basis. Simply understanding and becoming knowledgeable on a particular subset of AFSs and banking only those AFSs that fall within its strategic plan, allows a group of high-risk accounts to be further discriminated. This high-risk banding allows risk to be automatically mitigated.[24]

"Blanket" de-risking is not the answer for so many reasons. Developing resources both within and outside of a FI to properly bank AFSs is not just a business decision but that decision can drift into moral obligations. The overall impact is to exclude much of the world's population to the financial system. The World Bank has indicated that about 700 million people globally rely on remittances as their only source of income.[25] Although this paper focuses more on U.S.-based AFSs, the problem of providing financial services to the U.S.-based un-banked population is similar. Eliminating accounts to those that serve this population is detrimental to the overall economy. In the U.S. alone, $582 billion was sent by migrants to relatives in their home country,[26] $106 billion in various products and services were offered to more than 30 million consumers through AFSs that are members of FiSCA, and over $50 billion in small loans were made to between 15 and 20 million American households.[27] Clearly, this is a substantial and important part of the U.S. economy that deserves support from AFSs, and in turn, the banks.

Blanket de-risking is the wholesale elimination of a category of accounts as opposed to the proper assessment of risk that causes particular accounts to be closed. There is no question that there are substantial risks in banking AFSs and it is abundantly clear that certain AFSs will fall outside of established risk parameters, but it is also apparent, based upon the variety of AFSs that lose accounts, that there has been no risk methodology that was developed specifically for

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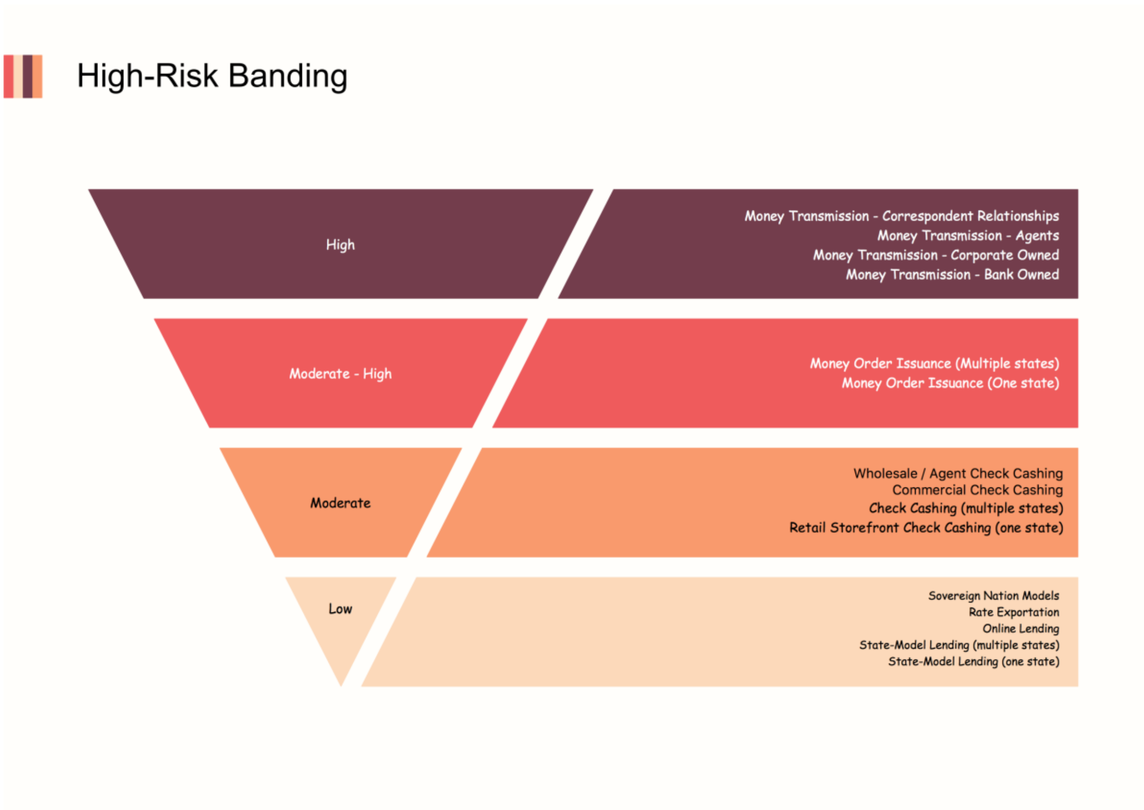
[23] FFIEC BSA/AML Risk Assessment-Overview.
[24] See Strategic/Definition/Banding Risk Assessment Diagram.
[25] World Bank G20 Survey.
[26] Pew Research Center, www.pewglobal.org, Remittance Flows Worldwide in 2016.
[27] FiSCA.org.

high-risk accounts. Risk management for a FI should encompass the entire organization but should also be comprised of smaller parts that define risks within particular business lines, products and services, and its own departments. These individualized risk assessments should flow up through all departments into the bank's overall summary. This is what would be generally called an enterprise risk program that is managed by senior management and the board of directors.



<u>Developing a Risk Assessment – Business Line</u>

The risks that apply to AFSs are unique but can still be categorized within the "traditional" banking risks of compliance, credit, reputational, operational, legal, and even possibly additional risks such as liquidity. And although the risk of losing a bank's reputation may be hard to quantify and if management personnel and regulators *perceive* there are risks that may not even exist, these perceived risks are still real and must be addressed. Risk perception, by its very nature, is subjective in nature and depends upon the different experiences people have encountered in their lives. This particular risk is one that can only be addressed through obtaining knowledge and experience within an industry and providing education and outreach to both management and regulators. There is no question that AFSs can and are used for nefarious purposes and are sometimes their own worse enemies in terms of public perception, but the overwhelming vast majority of all activity is legitimate and this must be conveyed through this educational outreach. Therefore, the start of the business level risk assessment starts with education and the needs of the populace that uses AFSs.

After defining the strategic risks based upon definitions, the second level of developing a suitable risk assessment comes at the level of risks that pertain to all parts of the department or departments overseeing AFSs. A successful management of AFSs should include compliance, credit, and operational risks, but risks, such as operational risks, span these partitions such as lack of sufficient staffing, unclear channels of reporting between the AFS-specific personnel and other departments such as BSA, poor inter-departmental relationships, and a lack of a strategic vision. It can be helpful to picture how the various inherent risks may be interrelated and such depictions may give rise to strong mitigating controls. A tried and true method includes performing a SWOT analysis[28] of this business line as part of the FI's strategic plan. The threats and weaknesses have an easy translation into the risks the business line is taking and the strengths and opportunities conversely apply to controls. Structuring the business line along the risk channels also makes sense. Finally, the total group of risks should include those identified in the supporting tiers of risk assessment, those specific to the business and those specific to each AFS.

The third level of risks pertain to standard risks specific to AFSs. The vast majority of published risks associated with MSBs concern compliance and BSA risk yet it can be argued that the prospect of financial loss from the MSB themselves is considerable. The inherent risk of credit exposure can be well mitigated if it is thought of in conjunction with operations and compliance.

Inherent risks that are more specific to an AFS business line include:

- Very cash intensive thereby giving rise to large cash orders, deposits, and storage concerns,
- AFSs typically need immediate availability of deposited funds,
- AFSs are heavy users of wire transfers and cash ordering,

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[28] A SWOT analysis is a comparative analysis of strengths against weaknesses and opportunities against threats.

- Multiple operating regions and multiple bank relationships present an environment that can allow kiting if cash flow is stressed or impaired,
- Improper management and returned deposited items can cause overdrafts,
- BSA and AML risks can be elevated because the FI is relying upon their customer to reduce any chances of money laundering or terrorist financing,
- Tax evasion is a possibility due to the cash nature of the business that in turn can affect the customer's viability as a going concern,
- The CIP and KYC aspects of BSA also have elevated risks as AFSs may have complex and/or foreign ownership,
- Commercial third-party customers is an ever increasing risk as AFSs look for new ways to earn income and the long time periods encountered for fraudulent endorsements and returns,[29]
- International activity increases the risk of being associated with foreign jurisdictions that may have lax or inferior AML controls,
- Correspondent banking adds a whole new set of risks that involve foreign jurisdictions and ownership and additional relationships that are formed by the correspondent that may not have sufficient oversight,
- Agent / wholesale relationships, which furthers the distance the end-user consumer or business has with the FI. (Instead of the FI being "once-removed" as in the case with a direct relationship with an AFS, the FI is now two or three times removed.)

Inherent and Residual Risk

A level of inherent risk should be assigned to the identified risk. "Inherent risk does not account for the factors that pertain to lack of control, but to the risk that a transaction would incur if no control is applied. Hence, inherent risk provides an indication of the worst-case scenario, in case all controls fail."[30] The inherent risk can be scaled based upon the impact it would cause if realized, i.e. residual risk, as well as the likelihood or probability of it occurring.[31] Each risk should have a corresponding control. These controls would in turn have a

[29] See 12 CFR 229.31, U.C.C. – Article 4, and Federal Reserve Banks Operating Circular No. 3.
[30] www.myaccountingcourse.com.
[31] Based upon definitions of residual risk found within the International Organization for Standardization, www.iso.org.

score. Then the final score may be plotted on a heat map that visually indicates to management the level of risk involved with a particular banded level of AFS since major differences between AFSs should have their own risk assessment. This resulting risk assessment has some usefulness "as-is" but is far more useful as it is tracked over time. The risk assessment will provide management with a method to see if the risk has changed over time due to factors that should have been captured within the assessment. Failures in audits, "outliers" within the banded AFS group becoming more common within the portfolio, and increases in risk in the AFS themselves are all contributors to increased risk that should be apparent with the assessment. An example of a heat map and a scoring model follow.

Residual Risk		Inherent Risk		
		Low	Moderate	High
Control Environment	Not Effective	Moderate	High	High
	Moderately Effective	Low	Moderate	High
	Highly Effective	Low	Low	Moderate

Risk	Inherent Impact	Inherent Likelihood	Inereht Risk	Controls	Residual Impact	Residual Likelihood	Residual Risk
Foreign Correspondents	6	1	7	Collection of FPA due diligence	3	1	4

Some examples of controls include:

- A document collection and analysis regime that verifies state and federal licensing,
- Underwriting the AFS for financial strength,
- Underwriting for compliance strength by identifying the quality and likelihood of proper implementation of policies and procedures and their independent audit,
- Establishing protocols for setting and implementing limits for such activities as remote deposit capture, wires, ACHs, cash orders,
- Limitations placed on the number of bank relationships,
- Credit established to handle occasional overdrafts,
- Daily monitoring of account activity including balances, deposited items, variances and trend reports,

- Collection and analysis of tax returns, financial reports, and state reports in relation to account activity,
- Agency oversight procedures performed by the customer especially if there are termination procedures and if they are effective.

These controls, as with the inherent risks, are calibrated using a similar thought process as to the inherent risk and should lower the resulting figure into what is called the residual risk.[32] The residual risk is essentially what is plotted (an average may be used) and is used for establishing trends of risk of the business line. Residual risk is what, for example, the board of the FI is accepting as their source of return for being in the business of servicing AFSs. Using these controls can help structure a business line, which should facilitate the processes and communication between the functional areas such as the BSA and compliance departments.

Risk Assessment – AFS Customer Base

When the risks associated with the servicing of AFSs have been fully addressed, i.e. the divisional risk assessment as shown above, a risk profile must be developed for the AFS themselves. This is certainly the main sole discriminator when it comes to determining whether a particular MSB is outside the bounds of acceptable risk, all other things within the business line being equal. The individual AFS risk assessments can be combined to provide an overall risk profile that may be tracked but the primary purpose is for discriminating those customers that are higher risk so that additional due diligence procedures may be applied. Whereas the divisional risk assessment will provide risks and controls on the division as a whole, the controls may be applied in varying degrees based upon the AFS individual risk assessment. As an example, a divisional risk assessment for money transmitters may address the risk of not performing proper oversight of an agent network:

Controls: Site visits both with agents and the MTO scheduled according to established risk factors. Established termination procedures if agent fails to adhere to Principal's requirements.			
Risk Level			
Inherent Risk:	14	**Residual Risk:**	6

32 www.iso.org.

But how does one know how often or to what degree the agent network should be visited? How often should data be collected? This is accomplished through the AFS Individual Risk Assessment.

This development of individual risk assessment comes through knowledge of the industry and the ongoing pursuit of this knowledge through conferences, interactions with clients, auditors and examiners, and trial and error! The basic risk assessment includes what could be considered baseline qualifiers such as types of products sold, length of time the business has been in existence, the types of products sold, personnel qualifications, the strength of their compliance program, and transactional activity. But as stated in other words previously, applying typical risks factors on all accounts simply places all AFSs into the high-risk category.

What is needed is more detail within that high partition. So a qualification of the how long the business is established should be how long have they operated or managed a highly regulated business such as an MSB. How many locations as a risk factor should also include in how many states or foreign jurisdictions the AFS operates. Further breakdown is needed for AFSs with agency relationships: firstly – are there agents or are all locations corporate owned, second – how many foreign agency networks are involved, and – number of foreign payout correspondent relationships, number of countries or corridors, and finally these agency risks should be categorized by volume. Products should focus on the risks that are specific to the AFS:

- what products generate cash (greater risk of money laundering),
- what products use cash (less risk of money laundering),
- check cashing uses cash, and, the issuance of money orders or other money transmission generates cash,
- are currencies (virtual or fiat) exchanged (generate cash),
- are phone cards or top-ups sold (generate cash)?

Risk Factors	
Time Established	Score
Products & Services	Score
Is similar to banding…	
MTOs, agent networks	
Sources of cash	
Review of Compliance Program	Score
Internal controls	
Audit results	
Qualification of BSA officer	
Transactional Activity	Score
External / Legal Activity	Score
Financial Performance	Score
Within established parameters	
Financial trends	
Total:	Score

Sample Individual Risk Assessment

"Hybrid" AFSs that offer other types of products should be comprehensively assessed for risk. Lending organizations tend to offer more of risks that are associated with compliance and reputation. The lending models should be assessed for risk and appropriateness to the FI's risk appetite as well as established policy. Vendor management risk also pertains to lenders especially in such areas as debt collection and lead generation. An AFS's establishment of a vendor policy will help reduce the FI's risk and will help with the AFS in establishing new products such as gift card exchanges and crypto-currencies where almost all CIP and BSA compliance resides at the vendor. A level of comfort should be reached with the AFS's vendor management that should be quantified within the individual risk assessment. These qualifiers could include:

- whether or not the AFS documented their due diligence on their choice of vendor and what criteria they used,
- continuing due diligence and onsite visitation reports,
- is vendor management included within their own audit or review scopes,
- and, have they incorporated their vendors within their own risk assessment.

Transaction activity should be captured within the assessment of an AFS' risk to a FI as well. And, as discussed in the next section, a number of these transactional quantities are usually not caught in automated systems. These include:

- the number of financial relationships,
- the interplay of funds between related companies that may not all be housed at the same FI,

- volume of CTRs and SARs,
- number of subpoenas received by the FI that can be further broken down by client and the customer's customer,
- and, the quantity of the AFS's customer base that may represent a higher risk.

Quantifying the Qualitative

These inherent risks are not exhaustive and are all for the most part quantitative. Therefore they may be open to incorporating into automated systems, but risks that are associated with the lack of the AFS to mitigate their own risk seem to be more qualitative in nature. As shown above in the sample individual risk assessment, the risk assessment should provide some qualification of the AFS's personnel. In addition, the scoring methodology (which should be contained within both the divisional and individual risk assessments) should contain how points are assigned to these assessments:

- Is the compliance officer qualified,
- are there PEPs involved in some fashion, either through the domestic or foreign primary entity or agencies,
- are questions answered timely and are documents received timely?

These inherent risk factors should also include a qualification on the AFS's own compliance program. How may such a thing be judged? Further evidence of the efficacy of their program can be obtained such as Title 31 exam results, independent BSA review audit results, and the ability and willingness of the AFS to incorporate recommendations (these themselves should be reviewed for thoroughness along with qualifications of the company and reviewer), the number of cases that may have developed on the AFS as well as on their customers, and onsite visits that observe the program in action. These judgment calls then can be quantified for the risk assessment.

Compliance programs and a compliance management system are still relatively new concepts for AFSs. The days have passed now when all that would concern an owner / operator is whether a check was good or not, whether an agent would be a good credit risk or not, or whether the only concern to sign a contract with a vendor is whether or not a good price was obtained. The concern that should be developed by now by the AFS is whether they *should* be doing business with a person or entity; do they want to be associated with that entity or not; is the AFS comfortable that this vendor or entity is ethical and conducts their own compliance. That conceptual thinking should be apparent in some fashion in the AFS's compliance program (such as in vendor management) and should work itself into the risk assessment of the AFS.

Up until now, we have looked at assessing the risk of serving AFSs and the risks presented by each individual AFS. A risk factor that is frequently overlooked in assessing the risk of an AFS is their financial condition. A financial analysis is critical in assessing the risk posed to a FI for many reasons.

A strong company will have resources to devote to their BSA and compliance programs. As the FI may be financially liable if checks or ACHs are returned, wires sent on uncollected funds not honored, etc., a financially strong company will help alleviate this risk through their own equity and their owners' wherewithal. In addition, a stressed company will promote higher risk behaviors. Some of the risks listed earlier will have a higher chance of happening such as kiting and accepting higher risk customers in the hopes of obtaining higher fees. An AFS should be evaluated from a credit perspective to provide assurance that they can handle their financial obligations and not jeopardize the FI, can afford to turn away suspect customers, can support their compliance programs, and not have the owners dipping into the tills to support unsustainable lifestyles. This risk can be incorporated into the individual risk assessment as shown above or could be incorporated into an assessment of the AFS such as a call report (see below). Financial performance should reflect observed activity. Using parameters similar to standard commercial loan underwriting, financial performance may be quantified for the risk assessment.

<u>The Big Picture</u>

It is time to bring the risk factors together into something that can provide the overall picture of an AFS. Again, the idea is that having a holistic view of the AFS will provide the answer to whether or not it is an outlier from the FI's portfolio and whether or not it represents a higher risk in relation to its return. This holistic picture can be in the form of a call report or memo or other type of template and is based upon the credit and operational risks. This process is itself based upon the risk inputs.

This is arguably the most challenging part of the process. The risks are frequently identified through differing channels, different departments, and different systems. The audience of various risks may also differ. Part of any compliance management system should be a process improvement aspect. Many banks of the asset size mentioned above have fully automated risk-monitoring systems for BSA, but it can be argued that no system at this point in time can be fully automated. Both the capturing of risk factors and the subsequent investigations into an AFS have manual components. The subjective risk factors listed previously should be incorporated into the BSA monitoring system but their very nature require personal judgment. In turn, when the system produces a final risk score (the more automated it is, the more often it should be updated), the process begins of putting together the total holistic view of the AFS, which incorporates many manual and subjective factors.

As most FIs know, one of the ultimate purposes of the individual risk assessment is to allocate limited resources. The score will influence the frequency and level of investigation into the AFS and their activity. The results of these investigations then can get summarized within the comprehensive report. Investigations can take many forms but should be tailored to the particular risk associated with a particular AFS.

For example, the activity seen within a bank account for a money transmitter ("MTO") typically would be a "bulk" transfer from a U.S.-based domestic account to their U.S.-based correspondent account. These probably occur on a weekly or slightly more often basis and represent many, perhaps thousands of various individual transactions. Onsite visits (the frequency of which would be dictated by the individual risk assessment) would provide a basis that the MTO is doing their own due diligence on their originators and beneficiaries but this information can be provided in certain volumes and at certain times based upon risk to the FI. This would allow the FI to determine the relationship between volumes, dollars, and the sales reports, to further determine if the FI is in fact seeing the proper amount of activity. This information can also be used to apply rules-based and model-based calculations to ferret out structuring, multiple originators sending to single beneficiaries, and vice-versa. This information can possibly be incorporated into the common automated system. And, as was stated previously, we know that it is the MTOs responsibility to monitor and report suspicious activity, but the FI must also develop that comfort that nothing is being overlooked. The knowledge obtained also furthers the entire relationship and supports KYC. This information can be used to support the MTOs sales reports that should also correlate to tax returns, thereby reducing any tax evasion risks. These types of reports can also provide a check and balance as it concerns the foreign payout risk such as sending to countries that may be on a sanctions list. Although most wire systems can provide both inputs into automated systems as well as provide their own alerts, these risk-based investigations can make sure the accounts are coded properly as well as providing a basis of the necessary scope to be developed prior to onsite visitations.

Any process involved in the monitoring of AFSs that can be varied based upon the individual risk assessment should be conducted based upon their score. Looking at some of the processes already mentioned, and that follow, the individual score should affect:

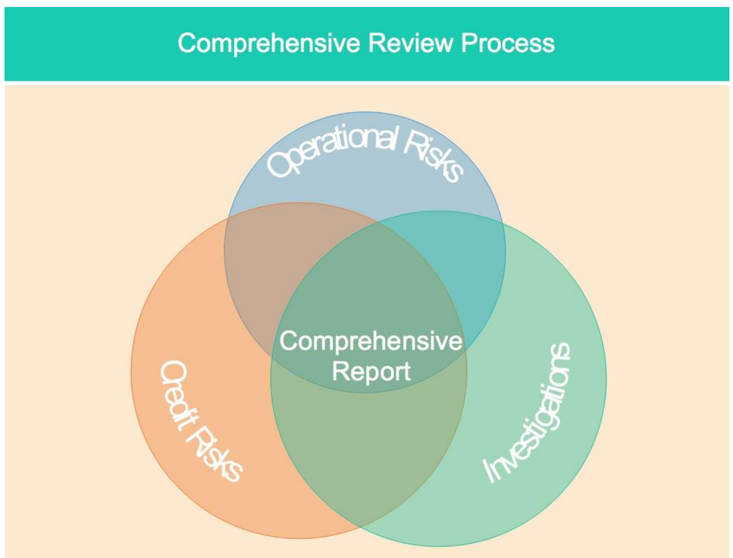
- number of onsite visits and call reports,
- thresholds for variances,
- collection of information such as independent reviews,
- dissemination of report results to senior management and other departments such as BSA and compliance.

Other investigative techniques can be applied to other AFSs such as looking at cleared images. A method of focusing this effort based upon the risk must be developed as looking at thousands or millions of images is impractical. Checks that clear from third parties provide a transparent means of seeing both parties to a transaction but the risk score can limit the amount of review. Improving technology has allowed an investigation to link together multiple parties, both payees and payors. Circular transactions and networks of seemingly unrelated parties can and should be identified through addresses (geographies), endorsements, and even check stock. Structuring should also be very easy to identify and is a risk that can still apply to checks since the underlying transaction may be cash based. Cleared images can also contain items that are being paid by the FI. A third party such as one that may be contained within a FI's AFS portfolio may issue these items. These items may be purchased by consumers from numerous AFSs and combined and therefore it is incumbent upon the FI to look for suspicious activity across many relationships. This may be further complicated by multiple processing relationships. Multiple processors and software systems must be able to be aggregated irrespective of the risk posed by individual AFSs although the review process would be based upon thresholds that are dependent upon their score.

AFSs may also include non-MSB related activity that should also be investigated to mitigate the FI's risks to its reputation as well as financial risk from fraud. These additional investigative techniques can center around the AFSs customer base, compliance through sample testing of various lending regulations such as Regulation Z and Truth-

In-Lending, as well as the various state requirements. Understanding of the AFS's policies and procedures and the FI's investigative testing can help an FI gain comfort that their AFSs are "playing by the rules" and that the FI has knowledge of those rules as well.

The comprehensive review report can be prepared on the basis of risk and will bring together the risks identified previously and combine them along with the subjective judgment of the preparer, which should include site visitation, online and negative news searches, and document review.



This is a chance to finally determine if the AFS represents a risk that is above and beyond the FI's business line risk assessment. The report should provide a summary of the risk factors that attempts to correlate them in a fashion that allows the reader to understand if there is anything outside of what is expected. The operational risks are addressed with the transaction volumes such as cash deposited, cash ordered, wires sent and received, anomalies in individual transfers, violations of state regulations and subsequent fines, and subpoenas received on the AFS and/or their customers. This is related within the report to the credit risks that are demonstrated by sales volumes, documentation review, and financial assessments of both the AFS and its owners. These risks are further matched against onsite assessments, news searches, results of investigations, and further document review and feedback from the AFS that may be prompted as a result of the investigations.

Finally, a narrative is drafted that can follow in the footsteps of the recommendations made for SAR narratives.[33] The ***who? what? when? where?*** and ***why?*** can be incorporated into the narrative making sure it is both complete and clear. The likelihood that these reports are produced and the frequency of alerts, cases, and SARs, is based upon the individual risk assessment. The narrative will provide a conclusion making sure that the various operational risks correlate within an accepted variance to the credit risks as well as those conclusions reached from onsite due diligence, document review, and investigations. The summary must draw the conclusion that transactions seen within the FI are reasonably close to what would be expected from an onsite visit, and then in turn, do the transactions and onsite activity correlate within reason to what is being reported to the FI through financial and sales reports and tax returns. These conclusions, if all satisfactory, can be used to support continuing the relationship. If any conclusions are in conflict or are in excess of those risks identified as acceptable within the business lines' risk assessment, the comprehensive report can be used to present to the appropriate venue such as an AML committee for identifying the next steps in exiting the relationship or mediating and reducing the risk this relationship poses to the FI.

It is imperative that FIs, AFSs, and their regulators take a methodical and informed approach to identifying risks. All stakeholders must approach these risks knowing what they are and why they arise, how they can be mitigated and to what degree, how to evaluate residual risk, and most especially, how to communicate to all stakeholders how effective are the controls. This communication, although not part of the previous discussion, can help or harm those with much to lose. Simply laying out the risk assessment at the start of any discussion with examiners, compliance personnel, or bank officers, can immeasurably strengthen effective communication. This lack of understanding of true risks and the inability to present them is at the heart of many banks discontinuing their services to AFSs. A complete, tested, and functional divisional risk assessment fueled by processes steered by individual risk assessments can make their already challenging environments that much easier and avoid mass terminations of AFS bank relationships.

[33] FinCEN guidance on preparing a SAR narrative, pg. 3