Correspondent Banking Relationships: Terminations of Exchange Houses Accounts

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CONTENTS

CHAPTER ONE

INTRODUCTION

The exchange houses industry is extremely diverse around the world. These houses vary in size, from small businesses to international companies, and provide a range of services and products such as currency exchanges, money transfers, and traveler's checks. For different customer bases. In the Middle East region, the main service provided by exchange houses is Money or Value Transfer Services (MVTS), defined by FATF as "financial services that involve the acceptance of cash, cheques, other monetary instruments or other stores of value and the payment of a corresponding sum in cash or other form to a beneficiary by means of a communication, message, transfer, or through a clearing network to which the MVTS provider belongs. Transactions performed by such services can involve one or more intermediaries and a final payment to a third party, and may include any new payment methods. Sometimes these services have ties to particular geographic regions and are described using a variety of specific terms, including hawala, hundi, and fei-chen" (Glossary of FATF recommendation).

The methodology of the transfer operations followed by exchange houses is to send the transfers via their correspondents. For example, when an exchange house (X) located in Jordan wants to send a transfer on behalf of its customer to a beneficiary in the United Arab Emirates, it will send the order to its correspondent bank or exchange house (Y) located in the United Arab Emirates to pay the transfer directly to the beneficiary based on the approval of the regulators in each country and governed by a written contract between (X and Y). However, in cases where there is no mutual relationship with the terminal bank/exchange house where the beneficiary holds an account, they should use a correspondent bank as an intermediate to send the transfer to the terminal bank/exchange house.

As a result of the 9/11 attack, regulators set strict measures to manage the correspondent banking relationship (CBR) as the correspondent bank could be exploited by criminals for money laundering and terrorist financing. Therefore, the correspondent bank should have approval from senior management and the compliance team of the correspondent bank and apply enhanced correspondent due diligence procedures in order to mitigate the risk that could be generated from dealing with exchange houses as it is classified as highly risky business, and avoid the penalties they could receive from the corresponding relationship with exchange houses such as closure, partial closure, suspension, and substantial fines by the regulator. However, in fact, a large percentage of correspondent banks prefer to terminate the correspondent relationship with exchange houses rather than managing these relationships, which seriously impacts on the industry of exchange houses and forces them to shut down their businesses.

PROBLEM RATIONALE

Being one of those experienced in this field with five years spent working in one of the most recognized companies in Jordan, I recognized the consequences and risks involved in correspondent banking relationships termination of exchange houses companies. As a field researcher, I created this study as a scientific attempt to define the risks of dealing with exchange houses and how to manage them in order to address their risks rather than to terminate the correspondent relationships.

Therefore, the researcher transformed the problem into study questions as follows:

STUDY QUESTIONS

Question No. 1: What makes exchange houses riskier than banks?

Question No. 2: What are the drives of CBRs terminations?

Question No. 3: What is the impact of CBRs terminations?

Question No. 4: What alternatives may-be adopted for CBRs terminations?

OBJECTIVES OF THE STUDY

This paper aims to explore the scope of the resolution to the above-stated questions, and addresses the following:

- Issues that make exchange houses riskier than banks.
- The drives of CBR terminations.
- The impact of CBR terminations on the financial market.
- The alternatives that may-be adopted for CBR terminations.

STUDY BACKGROUND

Correspondent banking relationship (CBR) is a vital partner and the gateway for the financial system, which is essential to international trade and the global economy as it is a global financial network providing services for multiple financial institutions around the world. Based on FATF recommendations, (CBRs) have to follow the anti-money laundering and counter-terrorist financing measures. They are also required to identify, monitor and control these business relationships, and apply specific due diligence to manage and mitigate the risk associated with these businesses by:

- Gathering sufficient information about the respondent institution to fully understand 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 money laundering or terrorist financing investigations or regulatory actions (Recommendation 13 (a)).
- Assessing the respondent institution's AML/CFT controls (Recommendation 13 (b)).
- Obtaining approval from senior management before establishing new correspondent relationships (Recommendation 13 (c)).
- Clearly understanding the respective responsibilities of each respondent institution (Recommendation 13 (d)).
- With respect to "payable-through accounts", being satisfied that the respondent bank has conducted CDD on the customers having direct access to accounts of the correspondent bank, and that it is able to provide relevant CDD information upon request to the correspondent bank (Recommendation 13 (e)).

In recent years, pressure on CBRs has been associated with restricted access to financial services by certain categories of customers, business lines, jurisdictions or regions rather than on the management of these relationships. This has been an attempt to avoid possible money laundering or terrorist financing risks, but it creates a serious concern for regulators and international bodies, because termination of (CBR) drives financial institutions to search for new channels which could be less regulated. This has led to increased anti-money and terrorist financing risks.

SIGNIFICANCE OF STUDY

- This study is a scientific study examining the scope of risks that exchange houses may contribute to the financial market.
- This study is one of the first studies in this domain, as far as the researchers are aware of.
- This study may be considered a scientific base of research that can be referred to by other researchers to enrich the capacity of further such domain specific issues.
- This study may be raised to decision makers or ministries of relevance to design policies related to the issues in question.

METHODOLOGY

The researcher adopted a historical approach by referring to literature as a base for studying the issues in question. Main concepts will be dealt with through relevant literature, and worldwide experiences will be considered pillars for the main concepts of the study. Concepts will be studied, analyzed, and compared; and recommendations will be provided in light of domain specific issues.

In addition, a group of experts will assess the scope of relevance of worldwide experiences to that of Jordan and examine how to adopt such practices for the validation process of the Jordanian financial market.

LIMITATIONS OF STUDY

The limitations of the study are as follows:

- Objective limitations: the study's objective is investigating correspondent relationship terminations for exchange houses.
- Time limitations: the study period was from May, 2018 through March, 2019.
- Terminology limitations: the study uses the procedural definitions of concepts presented in the study.
- Scarcity of resources in terms of previous studies made it difficult for the researchers to adequately compare the results of the study with those of previous related studies.

STUDY TERMINOLOGIES

- ***Bank***: An establishment authorized by a government to accept deposits, pay interest, clear cheques, make loans, act as an intermediary in financial transactions, and provide other financial services to its customers.

- ***Black market***: A series of transactions that has some aspects of illegality or is characterized by some forms of noncompliant behavior with an institutional set of rules.

- ***Correspondent bank***: A bank that provides banking services to another bank (the "respondent bank"). Large international banks typically act as correspondents for thousands of other banks around the world. Respondent banks may be provided with a wide range of services, including cash management (e.g., interest-bearing accounts in a variety of currencies), international wire transfers of funds, check clearing services, payable-through accounts and foreign exchange services (AML glossary of terms-ACAMS).

- ***Correspondent Bank Relationships (CBRs***): This is where one bank (the correspondent bank) provides services to another bank (the respondent bank). Banks set up these correspondent relationships across the globe to provide services in jurisdictions where they have no physical presence. Large international banks have thousands of correspondent banking relationships. The respondent banks obtain services such as: cash management (e.g. interest bearing accounts in a range of currencies), international wires, cheque clearing, payable through accounts, foreign exchange. Credit worthy banks can be offered credit products such as letters of credit or credit card account service (ACAMS study guide).

- ***Exchange houses***: Licensed financial institutions offering various financial products and services to their clients such as currency exchanges, money transfers, traveler's cheques, etc.

- ***Expert***: A bachelor degree holder with at least ten years of practical experience in the field of banking and finance.

- ***FATF***: An international policy-making body that sets anti-money laundering standards and counter-terrorist financing measures worldwide. FATF was chartered in 1989 by the Group of Seven industrial nations to foster the establishment of national and global measures to combat money laundering.. Its Recommendations do not have the force of law. Thirty-five countries and two international organizations are members. In 2012, FATF substantially revised its 40 + 9 Recommendations and reduced them to 40. FATF develops annual typology reports showcasing current money laundering and terrorist financing trends and methods. (AML glossary of terms- ACAMS)

- ***HAWALA***: An informal value transfer system that is common in the Middle East, North Africa, and the Indian sub-continent. The system operates outside traditional banking systems. In a basic form, a customer contacts a hawala broker and gives him money to be transferred to another person. The hawala broker contacts his counterpart where the recipient person lives, and he in turn remits the funds to that person. A running tally is kept between the hawala broker and its recipient counterpart (AML glossary of terms- ACAMS).

- ***Hawaladar***: A hawala broker (AML glossary of terms- ACAMS).

- ***Risk Based Approach (RBA***): The assessment of the varying risks associated with different types of businesses, clients, accounts, and transactions in order to maximize the effectiveness of an anti-money laundering program (AML glossary of terms- ACAMS).

- ***Respondent bank***: A bank for which another financial institution establishes, maintains, administers, or manages a correspondent account (AML glossary of terms- ACAMS).

CHAPTER TWO

STUDY RESULTS

Question no. 1: What makes exchange houses riskier than banks?

- *Dealing with cash.*

Criminals usually use cash as an instrument to facilitate money laundering especially in the placement stage because their criminal activities normally generate cash profit. As cash is still the main factor that triggers suspicious transactions reports within the financial system, and as exchange houses deal with cash more than other financial institutions, they are usually considered high-risk industries as compared with other financial institutions.

The auditors of the correspondent should review whether the exchange houses apply robust control and procedures to identify the source of funds provided by the customers and to obtain full KYC information about the customers and their business profiles to confirm the legitimacy of the funds.

- *Dealing with walk-in customers.*

The majority of exchange houses customers are walk-in due to the nature of services provided such as currency exchange, and transfers. If the service amount is below the threshold set by the exchange house, the exchange house to record the basic information about the customer such as the customer's full name, nationality, and date of birth. On the contrary, banks, in such cases, require the filling of the full KYC form before any dealing. Therefore, the correspondent bank usually prefers not to deal with exchange houses for this reason. Hence, the auditors of the correspondent should review the customer acceptance policy that is applied by the exchange companies, verify the KYC information is collected, review the supporting documents requested from the customer service provision, and review that confirmation was applied to all kinds of transfers (inward and outward) and services. These are essential to ascertain that exchange houses deal with walk-in customers with best practice.

- *Lack of regulations*

In some countries in the Middle East, the regulations and supervision for exchange houses are weak compared with the banking sector regulations. This reflects badly on exchange houses. The owners of exchange houses usually are more focused on business and profit than compliance, because there are no adequate penalties for noncompliance. This reflects on the correspondent's decision in dealing with exchange houses. As such, the auditors of the correspondent should ensure that the exchange sector in the country is adequately regulated and has a specific regulation for anti-money laundering and counter- terrorist financing. Additionally, they should ensure that the regulations are at least in line with the FATF recommendations and the correspondent AML/CFT policy; that these regulations are applied by the exchange house, including all employees and concerned departments; and that the policy should be approved by the top management/board of directors. The auditors also have to ensure that penalties/fines are enforced to guarantee the application of AML/CFT policies and procedures.

- *Hawaladar*

The legitimacy of transfer channels used by exchange houses is very important to the auditor of the correspondent. Furthermore, some of the transfer services might be legal in one country and illegal in other countries, such as the HAWALA system. The HAWALA is an Arabic word, which literally means ‘‘transfer”. The HAWALA is a traditional trust-based system used to transfer funds across countries, and it is an easy way to transfer money from one country to another without banking trail or money processing formalities. This system is identified by the U.S. State Department and law enforcement agencies as a potential way for criminals to launder money and may play an important role in international terrorism financing.

Recently, as a result of the application of HAWALA, the concept of Hawaladar has appeared. Hawaladars refer to the individuals who make the HAWALA. The HAWALA is considered legal in some countries, such as the United Arab Emirates. The Hawaladar has to be registered and licensed, and has to follow the Central Bank of UAE special instructions, ‘‘The HAWALA Regulations System in the UAE”. However, this kind of transfer is riskier than other types of transfers, as it relies deeply on individuals to do these transfers (World Bank, 2009).

Normally, Hawaladars make their transfers by using an exchange house without any permission, so the auditors of the correspondent should make sure that the exchange houses do not have any deals with Hawaladars, and, if so, that the deal is approved by the regulator and the EDD is in place to mitigate the generated risks. However, some exchange houses use HAWALADAR to move money for their customers to certain places where there are no exchange houses, such as sanctioned countries, or to further benefit from a competitive cost of making this type of transfer through them.

The idea of presenting Hawaladars is to realize the risks behind this type of transfer, as the Hawaladars are known for little formal record keeping, lack of government controls, and settling transactions that do not go through formal financial channels. Moreover, the auditors may check some important points when they are auditing the HAWALADARS: firstly, the suitability of the regulations and conditions applicable to HAWALADAR transfers; secondly, the relationship between the cost of normal transfers and HAWALADAR transfers; thirdly, the currently used procedures and conditions to deal with these kinds of transfers and how the exchange house can improve them in the future.

- *Payment methods*

The customers can pay for the transaction in a multitude of ways, such as credit/debit card, deposit in the account, cash, etc. Therefore, the exchange houses should ensure the legitimacy of the source of funds, and ensure that they belong to the ultimate beneficial owner of the transfer. It is required that the auditors of the correspondent test the procedures applied by the exchange house for each payment method, to test whether it is appropriate, and to see if improvements are needed. If the WIRE transfer that was sent by the customer through the exchange house has been paid in cash and sent through the bank based on corresponded relationship transfer, then the auditors should ensure that the exchange house has informed the bank of the payment method for each transfer. Also, if the exchange house wants to exchange currencies from the bank, then the auditor should ensure that the exchange company is not changing currencies for an unknown customer and that all exchange operations that are done in the exchange house are complying with the regulations.

- *Customers*

Different kinds of customers can use the exchange houses to make their transactions, so the auditors should test whether there are tools and a system in place to monitor customer activities behavior, and whether there is a classified risk rating depending on the customer type (resident/ non- resident, politically exposed persons, or PEPs), etc.

After that, the auditors of the correspondent should have a proper understanding to classify the risk associated with the exchange houses and provide recommendations to the banks on whether to deal with the exchange houses. On one hand, both banks and exchange houses will benefit when banks deal with good and regulated exchange houses and make profit without the fear of getting penalties from the regulators. On the other hand, good exchange houses will not suffer from the de-risking approach followed by the banks.

Exchange houses must be able to demonstrate to the correspondent bank that they have the required resources to apply the sufficient AML/CTF program, and that there is no need for additional resources to maintain the robust AML/CTF program.

- *Speed of transfer*

The speed of transfer for international and local remittances, and the low commission associated with local Money Value Transfer (MVT) services, makes it an attractive option for anyone wishing to remit money (Altaf Shaikh, page 12).

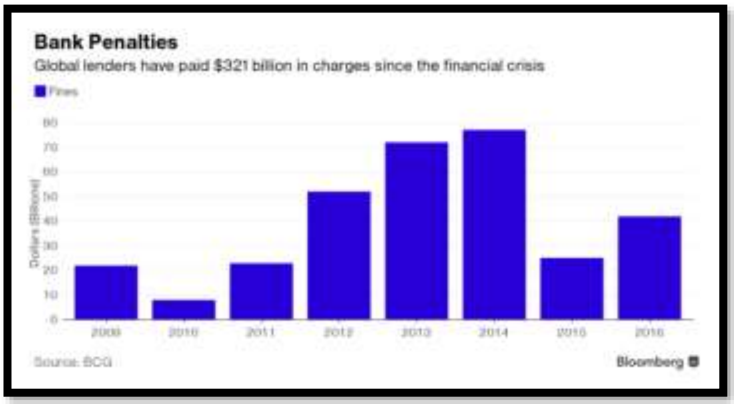
For validation purposes the researcher, as stated in the methodology, formed a focus group that is composed of six experts to discuss the scope of answers available in the literature and international experiences. Their input was as follows:

Bankers agreed on the following topics presented in the above first questions (dealing with cash, dealing with walk-in customers, lack of regulations, Hawaladar, payment methods, customers, speed of transfer), while exchange houses refused the logic simply because all of these points are the main characteristics of their services.

<u>Question no. 2: What are the drives of CBR terminations?</u>

- *<u>Growing consequences of compliance failure (large fines and penalties).</u>*

According to data from Boston Consulting Group, banks globally have paid fines of $321 billion from the financial crisis in 2008 until 2017 for an abundance of regulatory failures, from money laundering to market manipulation and terrorist financing. In 2016, banks paid fines of $42 billion. The data showed a 68 percent rise in fines in 2016 compared with the previous year.



https://www.bloomberg.com/news/articles/2017-03-02/world-s-biggest-banks-fined-321-billion-since-financial-crisis.

Although banks' objectives are to maximize profit generated from banking operations, and the more profitable deal with correspondents and exchange houses, huge penalties from AML/CTF violations were imposed when banks decided to expand their business.

- *<u>Insufficient profit to compensate for identified risk</u>*

Compliance cost is the expenditure of time or money in conforming to government requirements, such as legislation and regulation. Correspondent banks should deal with exchange houses with respect to the RBA as not all exchange houses represent the same level of risk. Not all of them require the same level of control, so proper AML/CTF evaluation is required before and during the relationships. Correspondent banks should implement AML/CTF audit on exchange houses, including all products and services, and frequently provide regular reports to senior management in order to ensure that no violations have been committed regarding AML/CTF requirements.

Implementing an RBA when dealing with exchange houses costs the correspondent bank a substantial amount of money in evaluating, monitoring, executing transfers, making reports, improving human resources, implementing AML/CTF monitoring system, overall time, and providing training to raise compliance culture.

For validation purposes, the researcher, as stated in the methodology, formed a focus group composed of six experts to discuss the scope of answers available in the literature and international experiences. Their input was as follows:

Bankers and exchange houses agreed on all topics presented in the above question.

Question No. 3: What is the impact of CBRs terminations?

It is important to note that when a bank decides to terminate a Money Services Business (MSB) bank account, the MSB has to shut down. As a result, the community that is served by the MSB will experience a gap in the availability of financial services including, but not limited to, check cashing, money transfer, money orders, wires, and foreign currency exchange. Therefore, a CBR termination affects not only the MSB, but also the served community, as well (NCC, 2016).

Creating black market

While CBRs can take place for different reasons, it has become apparent that measures originally intended to combat the risk of money laundering and terrorist financing have contributed to the termination of some exchange houses. This, in turn, makes it more difficult for payments to be made through legitimate channels—ultimately increasing the risk of illegal transactions. As the industry seeks to overcome these issues, financial inclusion must remain front and center, not only because it is essential to society, but also as a means of minimizing unlawful money flows.

Bankers and exchange houses agreed on all topics presented in the above question.

Question No. 4

What alternatives may-be adopted for CBR terminations?

- *Coordination between private and public sector*

The solution to CBRs needs a coordinated effort among regulators, correspondent banks, and exchange houses; and a deep analysis regarding the benefits and drawbacks of each alternative in each jurisdiction or region. Also, regulators need to be supportive of correspondent banks that evaluate exchange houses' accounts by applying the requirements of BSA based on risks.

- Correspondent banks should develop techniques to differentiate risk with one particular class of customers they are obliged by law to treat as high risk; namely, Money Service Providers. Perhaps similar approaches could be applied to other commonly accepted money laundering/terrorist financing high or higher risk sector (for example, if certain MSBs operating in certain markets are regarded as high risk, then what characteristic, if any, might identify the ''good'' from the ''bad'' within that category) .

- *Implement RBA instead of CBR terminations*

This means that correspondent banks need to assess the risks associated with exchange houses, and specifically address the following four areas:

- Products, services, and delivery channels.
- Geography.
- Clients and business relationships.
- Other relevant factors.

To do so, correspondent banks need to consider the types of exchange house they deal with, the products and services they provide, how they deliver their products or services, and the locations of their businesses.

If the correspondent banks identify situations that represent a high risk for ML/TF activities, they need to control these risks by implementing mitigation measures, including conducting enhanced ongoing monitoring and keeping client information up to date. In other words, they should adhere to the following:

- Understanding and recording the inherent risk posed by the exchange house.
- Applying controls tailored to mitigate the specific risk(s) of the exchange house.
- Documenting the controls in policies, procedures, and processes.
- Understanding and explaining to regulators and management the BSA risk posed by exchange houses after the application of mitigating controls (residual risk).

By adopting an RBA, the correspondent bank will be able to identify the area of higher risk. Once the area of higher risk is identified, then proper controls can be implemented to determine the reliability and genuine nature of the information obtained, and to mitigate the risks.

Based on the analyses performed in the various parameters, a risk rating is assigned to each factor depending on the residual risk obtained after the implementation of mitigation controls.

- *Implement EDD procedures for exchange houses*

Exchange houses should have an automated BSA monitoring system, which allows them to track and analyze customer activities, and a comprehensive sanctions system to be adopted that permits up-to-date checks on all customers.

Bankers and exchange houses agreed on all topics presented in the above question.

RECOMMENDATIONS

Exchange houses should be a reputable, highly regulated industry to support financial stability and ensure that cash flow across borders is not driven into the hands of criminals and restricted to the black market. This could be done by mutual effort from all counterparties (regulators, correspondent banks, and exchange houses).

Regulators should be more proactive in supporting the exchange houses, and establishing clear guidelines on the due diligence requirements of exchange houses; then the correspondent banks will be more confident and comfortable when starting a new relationship with exchange houses.

A correspondent bank should manage these accounts correctly. Not terminating could depend on high quality of an AML/CTF audit, so they could have a detailed audit to demonstrate and cover all areas of the AML/CTF program.

Exchange houses should recruit trained and educated compliance personnel, with internationally recognized certifications, to be able to run their compliance programs.

Finally, strong exchange houses with good compliance programs should differ from those that don’t follow the AML/CTF requirements. Regulators, correspondent banks and official bodies should work together in line with the exchange houses to support financial stability.

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