

WHITE PAPER
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Correspondent Banking : Know Your Customer's Customer

In 2018, the US Financial Crimes Enforcement Network (FinCEN) established the CDD Rule¹ to clarify and strengthen customer due diligence requirements for US banks, mutual funds, brokers or dealers in securities, futures commission merchants, and introducing brokers in commodities.

The CDD Rule requires that the financial institutions to which it applies establish and maintain written policies and procedures that are reasonably designed to:

1. Identify and verify the identity of customers
2. Identify and verify the identity of the beneficial owners of companies opening accounts
3. Understand the nature and purpose of customer relationships to develop customer risk profiles
4. Continuously monitor for suspicious transactions and report them and maintain and update customer information on a risk basis

Regulators have been clear in their expectations regarding the management of risks associated with banking relationships. Customer due diligence is generally mandated and enforced by regulatory bodies. Know your customer (KYC) is a critical component of the due diligence process; know your customer's customer (KYCC) goes further. As part of KYCC, financial institutions must identify, verify, and investigate their customer's customer.

In correspondent banking relationships, one financial institution conducts business on behalf of another financial institution's customers. This indirect relationship means the correspondent bank provides business to third parties, the identities of which it has not verified itself. The large volume of transactions between respondent and correspondent bank can make it difficult to identify suspicious activity.

According to the Guidance on Correspondent Banking Services² published by the US Financial Action Task Force (FATF): "There is no expectation, intention or requirement for the correspondent institution to conduct customer due diligence on its respondent institution'[s] customers."

¹ www.fincen.gov/resources/statutes-and-regulations/cdd-final-rule

² www.fatf-gafi.org/publications/fatfrecommendations/documents/correspondent-banking-services.html

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Yet the FATF requires financial institutions to monitor their customers continuously in order to flag up transactions that could signal unusual activity. If unusual activity is detected, the correspondent institution should have internal processes in place to review it further. This may involve requesting transaction information from the respondent institution. Depending on the risk level of the transaction, it could include a request to access information about the respondent institution's customer.

Understanding the risks posed by your customer's customer is one of the cornerstones of an investigation process between correspondent and respondent banks. Using analytics across the customer lifecycle, Moody's Analytics can help uncover hidden risk and reveal new, unexpected opportunities.

1. Risks and challenges in correspondent banking relationships

Per FATF guidance, if a correspondent bank notices any suspicious or unusual activity, it should contact the respondent bank using the request for information process. However, there can be obstacles to finding out more about a customer's customer. Data privacy rules differ around the world, as do KYC regulations. Transferring data across borders may not be permitted in some instances. Some correspondent banks may not fully understand the extent of the correspondent facilities the respondent bank offers to other institutions. This can hamper their ability see the full extent of their customer's customer relationships. Furthermore, a respondent bank might be reluctant to share their customers' information.

To a large extent, the correspondent bank relies on the respondent bank doing its own customer due diligence. Banks should pay attention to the effectiveness of the respondent bank's anti-money laundering (AML) controls subject to the AML governance and supervisory environments in the jurisdiction in which it operates.

In view of these challenges, it is imperative that financial institutions have the means to investigate and run their own due diligence on respondent banks' clients. Without appropriate due diligence, they could face fines and enforcement actions. Having access to the right data and insights is key to run successful KYC and KYCC programs. Moody's Analytics is committed to promoting transparency by helping organizations better understand the individuals and entities they are doing business with. Our data, analytics, and solutions help financial institutions to counter global challenges.

2. Emerging money laundering typologies and red flags

Criminals and terrorists continuously adapt to changing regulation and new technologies to find new ways to raise and move funds while avoiding detection.

Regulatory bodies such as the FATF, the Egmont Group of Financial Intelligence Units, FinCEN, and the Wolfsberg Group, among others, have issued money laundering typologies and identified trends to help financial institutions address money laundering, terrorist financing, and other financial crime risks. Three areas have been flagged up as particularly significant: misuse of legal persons, trade-based money laundering (TBML), and virtual assets, including cryptocurrencies.

2.1 Misuse of legal persons

Legal persons are significantly misused for money laundering, terrorist financing, and other financial crimes. FATF Mutual Evaluations³ show a generally insufficient level of effectiveness in combating the misuse of legal persons for money laundering and terrorist financing globally. Adequate, accurate and up-to-date information on beneficial ownership and control of legal persons is an integral part of a financial institution's AML and countering the financing of terrorism (CFT) program.

"Concealment of Beneficial Ownership,"⁴ a 2018 report issued by both the FATF and the Egmont Group of Financial Intelligence Units, addressed the red flags and vulnerabilities of legal persons. Below, we highlight some, but not all, of the red flags:

- » Companies registered overseas, particularly those in tax havens
- » The use of newly incorporated companies
- » A change in directors or authorized signatories after an account has been opened

³ <https://www.fatf-gafi.org/faq/mutualevaluations/>

⁴ <https://www.fatf-gafi.org/media/fatf/documents/reports/FATF-Egmont-Concealment-beneficial-ownership.pdf>

- » A change of directors or authorized signatories at a long-established organization, or a change in such an organization's business activities
- » The use of nominee shareholders
- » A complex organizational structure without reasonable explanation
- » The use of shell companies without reasonable explanation
- » Hidden or overly complex relationships
- » Use of legal persons with names similar to established legal persons

2.2 Trade-based money laundering

Using international trade to move and disguise the proceeds of crime is one of the ways criminals launder their illicit gains. TBML exploits the international trade system. It allows criminals to disguise their illicit proceeds and move them between countries through the use of legitimate international trade. This makes it extremely hard for authorities to detect. In 2020, the FATF published a report⁵ on TBML. It flagged up the infiltration of legitimate supply chains by criminals and the exploitation of surrogate shopper networks as two areas financial institutions should be aware of in their KYC procedures. In 2021, the FATF and the Egmont Group of Financial Intelligence Units published a list of TBML risk indicators⁶, for example:

- » Misuse of legal persons
- » Trade activity is inconsistent with the stated line of business of the entities involved
- » Owners or senior managers of a trade entity appear to be nominees acting to conceal the actual beneficial owners
- » A trade entity engages in transactions and shipping routes or methods that are inconsistent with standard business practices
- » A trade entity engages in complex trade deals involving numerous third-party intermediaries in incongruent lines of business
- » A trade entity consistently displays unreasonably low profit margins in its trade transactions
- » A trade entity makes unconventional or overly complex use of financial products

2.3 Virtual assets including cryptocurrencies

The Covid-19 pandemic accelerated financial services' move to digital technologies. This trend has created new opportunities for criminals to infiltrate the financial system.

Virtual assets including cryptocurrencies have anonymous structures and no physical presence or location characteristics. This therefore increases the risk that they will be used for money laundering, terrorist financing, or other financial crimes. Virtual assets reduce transparency and increase obfuscation of financial flows.

The FATF reminded both the public and private sectors to pay more attention to the new illicit financing typologies regarding virtual assets. In its updated guidance for virtual asset service providers (VASPs)⁷, the FATF flagged up the areas of the virtual asset ecosystem that can reduce transparency and can pose fraud and market manipulation risks:

- » Anonymity-enhanced cryptocurrencies.
- » Mixers and tumblers.
- » Decentralized platforms and exchanges.
- » Privacy wallets.
- » Initial coin offerings.
- » Virtual-to-virtual layering systems.

⁵ www.fatf-gafi.org/media/fatf/content/Trade-Based-Money-Laundering-Trends-and-Developments.pdf

⁶ www.fatf-gafi.org/publications/methodsandtrends/documents/trade-based-money-laundering-indicators.html

⁷ www.fatf-gafi.org/publications/fatfrecommendations/documents/guidance-rba-virtual-assets-2021.html

To mitigate the risk attached to VASPs, the EU's draft Risk Factors Guidelines⁸ have been strengthened and extended. They now require banks to conduct an enhanced due diligence process when dealing with VASPs.

Moody's Analytics brings together extensive data, adverse media, source documentation and workflow tools to enable customers to move the needle on KYC.

3. New technologies and best practice in AML and CFT

Financial institutions should build a robust AML and CFT compliance framework to protect themselves from money laundering, terrorist financing, and other financial crimes. Technology is a critical component; the FATF encourages financial institutions to use new technologies to improve the efficiency and effectiveness of their AML and CFT processes. In a 2021 report⁹, the FATF said that new technologies refer to:

- » Innovative skills, methods, and processes that are used to achieve goals relating to the effective implementation of AML and CFT requirements
- » Innovative ways of using established technology-based processes to comply with AML and CFT obligations

To promote technological innovation and uptake, the taskforce recommended:

- » Government and the private sector create an environment that enables responsible innovation to enhance AML and CFT effectiveness
- » Privacy and data protection be built into new technologies
- » The promotion of AML and CFT innovation that supports financial inclusion by design
- » The development and communication of policies and regulatory approaches to innovation that are flexible, technology-neutral, outcomes-based, and in line with the risk-based approach
- » Informed oversight of regulated entities to help to improve supervision
- » Communication and cooperation between supervisors should be facilitated by supervised entities

3.1 Digital customer lifecycle risk management

In 2022,¹⁰ the Wolfsberg Group issued guidance on the financial crime risks associated with digital engagement. The group recommended that financial institutions:

- » Build a more holistic customer profile in line with customer consent and data protection regulation
- » Map the variables behind the holistic customer profile to data that can alert the financial institute to a possible change or deviation from the expected value of any data point or attribute
- » Move to a more effective trigger-based approach by better detecting changes and deviations in the customer profile
- » Recognize that local conditions may warrant distinct approaches to identification, verification, and authentication for some relationships
- » Collaborate with governments on digital initiatives

⁸ <https://www.eba.europa.eu/regulation-and-policy/anti-money-laundering-and-e-money/guidelines-on-risk-factors-and-simplified-and-enhanced-customer-due-diligence>

⁹ www.fatf-gafi.org/publications/fatfrecommendations/documents/opportunities-challenges-new-technologies-for-aml-cft.html

¹⁰ [wolfsberg-principles.com/articles/publication-guidance-digital-customer-lifecycle-risk-management](https://www.wolfsberg-principles.com/articles/publication-guidance-digital-customer-lifecycle-risk-management)

3.2 Internal control framework and procedures

Financial institutions should set clear risk tolerance thresholds and adopt a risk-based approach. They should also continuously enhance their internal frameworks and procedures so that they can adapt to changing technologies and financial crime methods. The AML and CFT controls related to detecting and mitigating shell company risks should be continually strengthened.

VASPs should establish their control framework by defining and assessing the characteristics of their counterparty VASP relationships and whether they are undertaking activities similar to correspondent banking. This should include considering their competent authorities' views on any identified high-risk counterparty VASP relationships.¹¹

3.3 Next generation KYC: perpetual KYC

[Perpetual KYC](#) is the process of continually monitoring clients for potential KYC issues. Client data is updated in near real-time, based on triggers that can be set according to risk level. Perpetual KYC uses automation to reduce the need for human input, and to enable more constant monitoring of vast data sources.

Moody's Analytics supports perpetual KYC by helping you to monitor customers from onboarding and throughout the customer lifecycle.

4. How Moody's Analytics can help

Moody's Analytics has the tools to enable perpetual monitoring of all relevant stakeholders in near-real time consistent with the principles of perpetual KYC. From monitoring company ownership and ultimate beneficial owners, to adverse media related to shareholders, directors, and owners, our suite of KYC solutions helps organizations to monitor and assess the impact of changes.

[Moody's Analytics Orbis](#) database has information on more than 425 million companies. You can define your thresholds for beneficial ownership, filter results by jurisdiction, decipher circular and indirect ownership, and quickly assess a group linked to politically exposed persons (PEPs) and sanctions. A searched name is matched with consideration given to variables including linguistic culture, spelling alternatives and word order, resulting in fewer false positives and more relevant screening results.

[Moody's Analytics Grid](#) is the world's largest curated risk-relevant database, comprising sanctions lists, PEPs, watchlists, and more than 50 risk types. Risk intelligence is organized into detailed, entity-resolved profiles so you can see all risk-relevant data on an organization or individuals in structured, easy-to-consume reports. Grid combines comprehensive data and categorization to allow filtering by risk type, risk stage and risk age, based on relevance and your own risk appetite. This results in fewer false positives, more efficiency, and greater speed.

[Moody's Analytics PassFort](#) enables financial services companies to rapidly onboard customers, then manage risk and compliance standards throughout the customer lifecycle. You can dynamically orchestrate customer due diligence, enhanced due diligence, KYC, know your business, and AML workflows. These are designed according to your risk policies and the regulations you need to follow.

For more information about [Moody's Analytics KYC solutions](#), please contact us to [schedule a demo](#).

¹¹ The FATF Updated Guidance for a Risk-Based Approach to Virtual Assets and Virtual Asset Service Providers <https://www.fatf-gafi.org/publications/fatfrecommendations/documents/guidance-rba-virtual-assets-2021.html>

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