



# **How Much Anti-Money Laundering Effort is Enough?**

**The Jamaican Experience**

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## Abstract<sup>1</sup>

The worldwide fight against money laundering is escalating. Individuals and businesses that conduct and depend on legitimate international financial transactions are feeling the impact of measures meant to counter illegitimate ones. Countries flagged as having weak AML regulations encounter substantial challenges maintaining correspondent banking relations. However, recent experiences have shown that fulfilling the AML standards, albeit necessary, is not sufficient to persuade financial institutions to keep international financial relations. This is particularly the case with international fund transfers via correspondent banks. Jurisdictions such as Jamaica—even if generally complying with AML standards—face challenges to use banks for correspondent services. Reasons to avoid having correspondent banking relations with certain financial institutions include the following: First, correspondent banking is risky in itself, given the difficulty the respondent faces to effectively supervise the AML capacity of the correspondent. In addition, the risk of a transaction depends on country-specific factors, most notably the strength and enforcement of a sound AML system and the type of clients. Money services businesses constitute one category that is perceived as more vulnerable to money laundering. Given these elements, respondent banks may simply decide to sever correspondent banking relations to avoid risks—real or perceived—altogether. This tendency to avoid perceived risks makes finding a potential solution challenging. Not only would countries have to attain the highest possible level of compliance with AML standards, they would also need to develop a communication strategy that effectively conveys that the government and private sector recognize and embrace the money laundering issue and are committed to the implementation of AML efforts.

**JEL codes:** K4, F550, F24

**Key words:** Anti-Money Laundering, Compliance, Regulation, Remittances, correspondent banking

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## I. Introduction

The worldwide fight against money laundering is escalating with negative consequences for international transactions. The willingness of correspondent bank networks to support this infrastructure is decreasing because of (a) the pressure to demonstrate compliance to avoid money laundering and terrorist financing and (b) the risk of sanctions by regulators (KPMG 2014). Regulation has tightened, putting more responsibility on correspondent banks. In addition, sanctions have increased over the past few years as reflected in record fines.<sup>2</sup> As a result, some banks are avoiding customers who are seen as high risk because of a perceived regulatory risk rather than an assessment of the actual risk of illicit activity, a behavior which has been referred to as de-risking. (World Council 2014, FT 2014a and FT 2014b).<sup>3</sup> Countries that are flagged as having deficient anti-money laundering (AML) regulation or as being uncooperative could face challenges maintaining correspondent banking relations (The Economist 2013).<sup>4</sup> However, the AML framework in the jurisdiction in which financial institutions operate is only one aspect of the dynamic, as even in the United Kingdom two of its major banks, HSBC and Barclays, ended correspondent bank relations for both domestic and international money services businesses<sup>5</sup> (MSBs) as clients (Coyle 2013).

However, private individuals, companies, and countries depend on international financial transactions. If international payments cannot be made or compliance substantially increases their cost, global trade (FT 2014c) is threatened and the lives of millions are negatively impacted, most notably families of migrants who depend on remittances. According to The Economist (2014), the cost of doing business for exporters in Indonesia and cotton farmers in Mali has increased steeply as has the cost to receive remittances in Africa (see also FT 2014a).

Jamaica is no exception with MSBs, where they are seen as presenting higher risks and as such face challenges that make it difficult for them to use banks for correspondent services. MSBs provide different services, including money transfer for private and commercial customers; they can range from small corner shops to worldwide brands such as Western Union. Compared to banks, MSB customers use more cash and transactions are less regular.

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<sup>2</sup> For a list of recent monetary penalties and C&D orders for deficiencies in BSA/AML programs in the United States, see <http://www.bankersonline.com/security/bsapenaltylist.html>

<sup>3</sup> <http://blogs.wsj.com/riskandcompliance/2014/11/11/the-morning-risk-report-regulators-try-to-curb-bank-de-risking/>

<sup>4</sup> See for instance CFATF call for action for Guyana <http://www.fatf-gafi.org/topics/high-riskandnon-cooperativejurisdictions/documents/cfatf-may2014-public-statement.html>

<sup>5</sup> The US Treasury defines MSBs to include the U.S. Postal Service and six distinct types of financial services providers: (1) dealers in foreign exchange; (2) check cashers; (3) issuers and sellers of traveler's checks or money orders; (4) providers of prepaid access; (5) money transmitters; and (6) sellers of prepaid access.

Given the importance of combatting money laundering and the financing of terrorism, the obvious consequence for countries with challenges to remain connected to international financial markets is to improve their AML legal and regulatory framework. However, it seems that compliance with international standards alone may not be sufficient. Indeed, Jamaica has seen issues with correspondent banking emerge at the same time the country was making important strides in improving its AML legal and regulatory framework. As such, other important factors have to be taken into account.

The remainder of this policy brief will provide a short overview of AML regulation, discuss the Jamaican AML framework, present an overview of challenges for correspondent banking, explore potential reasons for cutting correspondent banking relations, and conclude with a discussion of potential solutions for countries such as Jamaica to continue being integrated into international financial markets through the correspondent banking network.

## II. Background

In a world of financial interconnection, measures against money laundering--Anti-Money Laundering/Combatting the Financing of Terrorism (AML/CFT)--have been extended to international relationships and transactions. The principles and standards that guide AML frameworks are set by the Financial Action Task Force<sup>6</sup> (FATF), which has defined a set of recommendations, the FATF Recommendations<sup>7</sup>, to promote effective implementation of legal, regulatory, and operational measures for combating money laundering, terrorist financing, financing of proliferation of weapons of mass destruction, and other threats to the integrity of the international financial system.

The FATF Recommendations set out an expansive framework and measures that countries should implement in order to combat money laundering and terrorist financing, as well as the financing of proliferation of weapons of mass destruction. Given the varying legal, administrative, and operational frameworks and diverse financial systems, the FATF Recommendations set an international standard that countries implement through measures adapted to their particular circumstances with the aim of (a) identifying risks and developing policies and domestic coordination; (b) combating money laundering, terrorist financing, and the financing of proliferation of weapons of mass destruction; (c) applying preventive measures for the financial sector and other designated sectors; (d) establishing powers and responsibilities for the competent authorities (e.g., investigative, law enforcement and

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<sup>6</sup> FATF is an intergovernmental body that develops international standards to combat money laundering and terrorist financing. It also produces lists of countries that do not have sufficient legal and regulatory standards to combat money laundering and terrorist financing. The FATF Recommendations are recognized as the global AML/CFT standard.

<sup>7</sup> See International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation, The FATF Recommendations, February 2012.

supervisory authorities) and other institutional measures; (e) enhancing the transparency and availability of beneficial ownership information of legal persons and arrangements; and (f) facilitating international cooperation. The original FATF Recommendations were drawn up in 1990 but have undergone several revisions. In addition, nine Special Recommendations on terrorist financing were added subsequently. These Recommendations have been endorsed by more than 180 countries and are universally recognized as the international standard for AML/CFT.

The United States and other major financial centers have been at the forefront of implementing a stronger and more effective AML/CFT framework. These AML requirements extend to countries and financial institutions that intend to engage with the United States financial sector. Scrutiny increased especially when the negligence of HSBC United States, with its subsidiary in Mexico, was unveiled. HSBC's weak compliance has probably led to hundreds of millions of United States dollars related to organized crime and drug trafficking to be laundered through the U.S. financial system.<sup>8</sup> The case has led not only to severe fines for the financial institutions that were involved but also to demands for stronger compliance measures for U.S. financial institutions that act as correspondent banks for foreign institutions.<sup>9</sup>

### III. Jamaican AML Framework

It is costly for countries to be cut off from international financial markets. Because of this, nations have been strengthening their AML/CFT frameworks to align with the closer attention paid to the issue over the past decade. Jamaica is no exception, and it has achieved important strides in strengthening its AML/CFT framework in a short period of time. At the time of the third round of the Mutual Evaluation Report of Jamaica, which was adopted by the Caribbean Financial Action Task Force (CFATF) Council of Ministers in October 2005, Jamaica received ratings of partial compliance on seven out of the sixteen Core and Key Recommendations. In addition, Jamaica was rated partially compliant or noncompliant on several non-Core or Key Recommendations. As a consequence, Jamaica was put on enhanced follow-up and was to report regularly to the CFATF Plenary on progress made to address its AML deficiencies.

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<sup>8</sup> For details on the HSBC case, see United States Senate Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs: U.S. Vulnerabilities to Money Laundering, Drugs, and Terrorist Financing: HSBC Case History. July 17, 2012 Hearing.

<sup>9</sup> Correspondent banking is the provision of a current or other liability account, and related services, to another financial institution, including own affiliates, used for the execution of third-party payments and trade finance, as well as its own cash clearing, liquidity management, and short-term borrowing or investment needs in a particular currency. A correspondent bank is effectively acting as its correspondent's agent or conduit, executing and/or processing payments or other transactions for the correspondent's customers. These customers may be individuals, legal entities or even other financial institutions. A correspondent relationship is characterized by its ongoing, repetitive nature and does not generally exist in the context of one-off transactions.

According to the May 2014 Tenth Follow-Up Report, Jamaica is currently fully compliant in all Core and Key recommendations. In addition, Jamaica met most of the non-Core or Key Recommendations. However, deficiencies remained, especially with regard to the AML/CFT framework for Designated Non-Financial Businesses and Persons (DNFBPs)<sup>10</sup>, which has a negative effect on several recommendations. Changes relating to DNFBPs are ongoing, but the designation at the time of the 10th Follow-Up Report did not yet cover all the DNFBPs as defined by the FATF Recommendations. As such, the recommendations related to DNFBPs remained only partially met even though work is ongoing to close the remaining gaps.<sup>11</sup>

#### **IV. Correspondent Banking<sup>12</sup>**

Correspondent banking includes inherent risks associated with processing transactions for other financial institutions or their clients. The correspondent bank often has no direct relationship with the underlying parties to any transaction routed through it and may not be in a position to verify identity or to understand fully the nature of the specific transaction, particularly when processing electronic payments (wire transfers) or clearing checks. The interrelationships built up over decades between institutions within correspondent banking networks have produced a highly efficient mechanism which is of fundamental importance to the global economy. This network facilitates the movement of money from one person or entity to another and from one country to another. However, the efficiency of this important mechanism may also unintentionally facilitate the laundering of criminal proceeds or finance terrorism and other unlawful activities. Recent law enforcement and regulatory actions have resulted in record-breaking financial penalties and have highlighted the vulnerabilities to which financial institutions are exposed when there are failures in the risk management framework, particularly in the areas of governance, client due diligence, risk assessment, and transaction monitoring.

Correspondent bank accounts have been used to move the proceeds of drug trafficking, unlawful Internet gambling and other crimes, to finance terrorism and to facilitate business with entities and individuals subject to economic sanctions. This misuse of the financial system highlights the need for proactive vigilance in maintaining an effective AML program for correspondent banking and will surely result in continued heavy focus by regulators and law enforcement. In this respect, Recommendation 17 on the “Reliance on

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<sup>10</sup> Designated Non-Financial Businesses and Professions (DNFBPs) are defined by FATF as Lawyers, Accountants, Trust and Company Service Providers, real estate agents, dealers in precious metals/stones and casinos.

<sup>11</sup> DNFBP Requirements for real estate dealers, casinos, gaming operators and accountants came into effect in April 2014. The requirements for lawyers came into effect in June 2014.

<sup>12</sup> This section draws heavily on The Wolfsberg Group, Wolfsberg Anti-Money Laundering Principles for Correspondent Banking, 2014.



Third Parties” states that “the ultimate responsibility for [customer due diligence (CDD)] measures remains with the financial institution relying on the third party” and does not allow the bank to rely on the third party’s “ongoing due diligence on the business relationship and scrutiny of transactions undertaken throughout the course of that relationship” with the third party’s customer.

This pressure is felt by financial institutions all around the world who themselves have to implement more stringent controls in order to avoid losing the relationship with U.S. correspondent banks. These controls are costly and intense, complicated not only by physical distance but also by different legal and regulatory frameworks and enforcement as well as information asymmetries. While an AML compliance officer of a U.S. bank has a good idea of the quality and enforcement of the U.S. AML/CFT framework, the same is not necessarily true for her knowledge of the AML/CFT framework of a small country thousands of miles away. This lack of information implies that U.S. banks have to conduct their own stringent controls and have to stop providing services that are deemed risky or hard to monitor or that risk reputational and financial losses if they are found to be involved in money-laundering activities. A further complication arises from the strong desire of criminal organizations to launder illegal proceeds. Therefore, it is reasonable to assume that criminal organizations continuously search for weaknesses in the AML/CFT framework to “legalize” their profits.<sup>13</sup>

Maintaining a correspondent banking relationship is further complicated when the correspondent banking client extends the correspondent banking services to their own clients, who might present additional risks. Provision of such banking services include facilitating transactions in certain business segments and providing certain products or services generally recognized as being vulnerable to money laundering, including operating in high-risk jurisdictions, Money Services Businesses (MSB), private banking, and cross-border wire transactions.

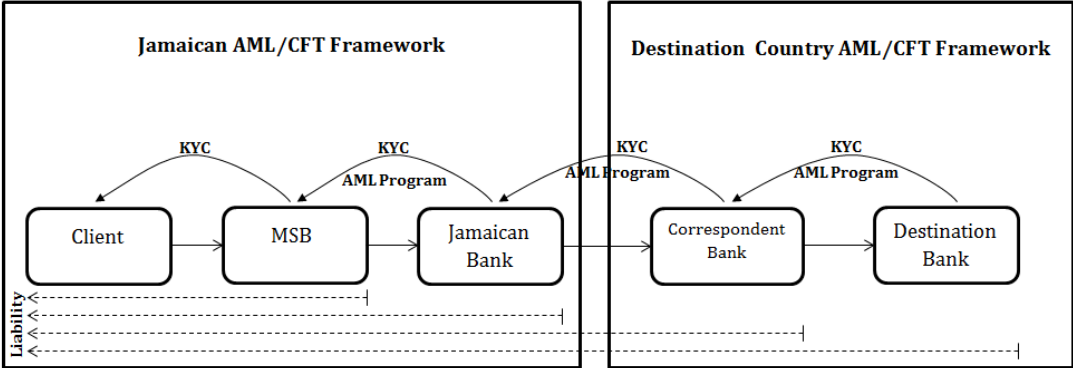
Figure 1 outlines the inherent problem and complexity of the correspondent relationship. In theory, the AML framework requires each financial institution to monitor its customers. In that example, the Jamaican MSB would be responsible for monitoring the person conducting a transaction. The Jamaican respondent bank is, in turn, responsible for monitoring their client, which is the MSB. However, this would not only include a thorough understanding of the MSB’s anti-money laundering program but also the type of services that the MSB offers in addition to the type of clients that the MSB serves. Besides the initial

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<sup>13</sup> See, for example, a discussion on Mexican money-laundering efforts at [blog.thomsonreuters.com/index.php/less-drug-money-traffic-at-hsbc-may-mean-more-risk-for-other-banks-in-u-s](http://blog.thomsonreuters.com/index.php/less-drug-money-traffic-at-hsbc-may-mean-more-risk-for-other-banks-in-u-s)

assessment of the AML program, the respondent bank would also monitor the transactions from the MSB, including deviations from the expected pattern. The chain continues, as the foreign correspondent bank has to be confident about the money-laundering risk arising from the relationship with the respondent bank. To establish a business relationship, the bank will need to assess the AML program of the Jamaican bank, including the AML program of their clients and the specific risks that could arise from regulatory weaknesses in the country. In this simple example, the funds would reach a client of another bank, which is again responsible for monitoring their counterpart. The example illustrates the complexity of correspondent relationships and the resulting challenge to properly monitor transactions, especially if the respondent bank offers these services to other financial institutions. As such, “Know Your Customer” has become “know your customers’ customers” (The Economist 2014). Correspondent banks open themselves up to legal and reputational risks, while the implementation of monitoring is challenged by the multiple intermediaries between the source and destination of the transaction. Add to this a lesser degree of familiarity and a potential lack of trust in the legal framework and supervisory capacity of foreign jurisdiction and it will probably explain the reason correspondent banks prefer to avoid certain kinds of transactions altogether.

**Figure 1. Chain for International Transactions**



**V. Risks With Correspondent Banking Services to Jamaica<sup>14</sup>**

Thanks to recent efforts, Jamaica is close to being fully compliant with all core Financial Action Task Force recommendations. However, banks have become risk averse as a consequence of reputational and financial risks associated with the enhanced regulatory

<sup>14</sup> This section uses information that has been collected in interviews with compliance managers of foreign banks that act as correspondent banks. To allow for open discussion, it was agreed that the bank names would not be disclosed.

scrutiny and as a result choose to preventatively de-risk<sup>15</sup> to avoid some of the major risks related to acting as correspondent banks. The risk for correspondent banks is further increased if clients of Jamaican banks include MSBs, which are perceived as more vulnerable to money laundering. Foreign banks will provide correspondent services only if they trust the AML system of their Jamaican counterparts. In addition, they will want to restrict the types of businesses to which the Jamaican bank offers services. For example, foreign banks would not offer correspondent services to respondent banks that have unregistered or unregulated MSBs as their clients, which is not the case in Jamaica, or if they suspect that the regulation and supervision of the MSBs is deficient.

In addition, even though monitoring of transactions coming from respondent banks is possible, it is costly and requires specialized skills depending on the nature of businesses involved. For example, if a Jamaican respondent bank wanted to provide services to a local MSB, it would need to be able to demonstrate that it has done sufficient due diligence over the MSB to see that it had adequate AML programs. Also, the respondent bank would have to show that they monitor the activity of the MSB. Moreover, even though the entire correspondent banking network is structured such that each bank is responsible for monitoring its own customers, the correspondent bank could still be liable if the correspondent network is being used for illegal funds. As such, a sound due diligence program does not necessarily provide a complete defense as regulators can take the view that the bank should have been able to identify and report the suspicious activity earlier. In those cases, the regulator or enforcement agency can conclude that the bank's AML program was deficient. Because relying on third parties is not sufficient, the correspondent bank also has to monitor transactions and investigate when they observe a suspicious transaction, such as a substantial increase in funds from a specific entity. In these cases, not only would the correspondent bank ask the Jamaican bank to explain the transactions, it would also examine individual transactions. It is clear that the degree of monitoring is complex and costly, implying that some correspondent banks may not be willing to incur these costs and therefore would restrict their services to certain clients.

## VI. Conclusions

The worldwide anti-money laundering fight is escalating. Individuals and businesses that conduct and depend on legitimate international financial transactions are feeling the impact of measures meant to counter illegitimate ones. In Jamaica, one major bank has begun to offer fewer services to Money Services Businesses.

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<sup>15</sup> The term is used for banks that terminate or restrict business relationships simply to avoid perceived regulatory risk, not in response to an assessment of the actual risk of illicit activity (See Wall Street Journal 2014).

However, the issue is not restricted to Jamaica. Recently, two major United Kingdom banks dropped MSBs as clients and anecdotal evidence suggests a similar pattern worldwide (The Economist 2014). There are different reasons for this trend, including increased scrutiny and regulatory pressure, record fines for noncompliance, asymmetric information and a lack of incentives to act as correspondent banks. In addition, international improvements in due diligence and AML regulation probably result in more sophisticated schemes to use financial institutions to clear proceeds from illegal activity, leading to a continuous cat-and-mouse game between the ones who try to launder money and the ones who try to arrest it. Given those circumstances, it could be a simple business decision for banks to abstain from certain transactions that are not the core of their business. The issue also has gained international attention as the media, policy makers and regulators urge banks to abstain from de-risking as opposed to using a risk based approach to manage client relations (see e.g. American Banker 2014, US Treasury 2014 and FATF 2014).

However, due diligence and monitoring of clients is costly, and the incentives for banks to simply refuse certain kinds of clients is strong, especially when dealing with small countries. This makes addressing the problem challenging as there are dozens of factors that determine the cost and risk involved with correspondent banking. There are clear factors that would stop them, for instance banks would not want to have correspondent relationships with institutions in a country that have serious flaws in their AML/CFT framework such as allowing unregulated MSBs. However, with these clear cases apart, it is hard to offer simple suggestions as the case of Jamaica shows. The country strongly improved their AML/CFT framework and the correspondent banks we interviewed were not able to pinpoint a flaw in Jamaica's regulation of MSBs or any other specific issue that would make business with Jamaica more risky.

As such, a country that faces restrictions of domestic financial institutions with correspondent networks needs to address two issues: (a) potential weaknesses in the domestic AML/CFT framework and (b) information deficiencies about these frameworks at potential correspondent banks abroad.

Knowing country-specific characteristics and regulation is costly and time-intensive and proper supervision of transactions requires specialized skills and knowledge, both of which might not be cost effective to obtain for correspondent banks dealing with smaller jurisdictions. As a result, it is probably beneficial for small countries to have regulation and supervision in place that go beyond the minimum to meet the FATF Recommendations. This is especially true for certain types of businesses, for instance MSBs, for which the regulator might need to increase regulation and monitoring to facilitate access to the correspondent

bank network. This is even more evident, considering that U.S. and U.K. banks have ceased correspondent relationships with MSBs in their own country.

But having a strong regulation alone might not be sufficient given the lack of knowledge of foreign financial institutions of the country-specific regulations and a possible lack of trust in proper enforcement. However, the national regulator could directly seek contact with compliance managers of potential correspondent banks abroad to support their due diligence. Similar to a road show, which provides country-specific information and discusses potential risks to investors in government bonds, regulators could explain their respective domestic measures to avoid money laundering and address concerns.

Another approach would be to have an independent institution—such as a domestic MSB or bankers' association—develop and implement stringent standards for its members. They could develop a standard of excellence that is monitored and grant recognition only to institutions that fulfill certain criteria. Again, it would be this institution's decision to convince foreign banks that institutions who fulfill those standards do not pose substantial risks.

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