De-Risking 101

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De-Risking 101

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Stanley Foodman, CPA, CFE, CFF, CAMS, CGMA is CEO of Foodman CPAs & Advisors. Mr. Foodman has extensive experience representing U.S. and non-U.S. taxpayers with U.S. and cross border tax reporting and governmental controversies. Mr. Foodman uses his law enforcement background, extensive experience as a forensic accountant and expert witness to represent clients in resolving their tax disputes. He has represented numerous U.S. taxpayers through the U.S. Offshore Voluntary Disclosure Programs. Mr. Foodman along with his team of CPA's also represent clients with a full range of accounting and tax services including corporate and individual taxation, estate and trust taxation, wealth planning and banking regulatory compliance. Foodman CPAs & Advisors consistently rank as one of the top accounting firms in South Florida with offices also in the Caribbean, Central and Latin America. Foodman CPAs & Advisors represent individuals and businesses from around the world including the United States, the Caribbean region, Latin America, Europe and the Middle East.

Stanley Foodman
CEO & Founder
Foodman CPAs & Advisors
www.foodmanpa.com
Tel: 1(305) 365-1111
Email: stanley@foodmanpa.com

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Some History

Bank Secrecy Act of 1970

- Requires U.S. financial institutions to assist U.S. government agencies to detect and prevent money laundering by keeping records of cash purchases of negotiable instruments, and file reports of cash purchases of these negotiable instruments of more than $10,000 (daily aggregate amount), and to report suspicious activity that might signify money laundering, tax evasion, or other criminal activities.
  - Amended several times since, including provisions in title III of the USA PATRIOT Act. (See 31 USC 5311–5330 and 31 CFR Chapter X.)
  - The BSA is sometimes referred to as an "anti-money laundering" law ("AML") or jointly as "BSA/AML".

- Require all financial institutions to submit five types of reports to the government.
  - FinCEN Form 112 (formerly Form 104) Currency Transaction Report (CTR): A CTR must be filed for each deposit, withdrawal, exchange of currency, or other payment or transfer, by, through or to a financial institution, which involves a transaction in currency of more than $10,000.
    - Multiple currency transactions must be treated as a single transaction if the financial institution has knowledge that: (a) they are conducted by or on behalf of the same person; and, (b) they result in cash received or disbursed by the financial institution of more than $10,000.
  - FinCEN Form 105 Report of International Transportation of Currency or Monetary Instruments (CMIR): Each person (including a bank) who physically transports, mails or ships, or causes to be physically transported, mailed, shipped or received, currency, traveler's checks, and certain other monetary instruments in an aggregate amount exceeding $10,000 into or out of the United States must file a CMIR.
  - FinCEN Form 114 (formerly Treasury Department Form 90-22.1) Report of Foreign Bank and Financial Accounts (FBAR): Each person (including a bank) subject to the jurisdiction of the United States having an interest in, signature or other authority over, one or more bank, securities, or other financial accounts in a foreign country must file an FBAR if the aggregate value of such accounts at any point in a calendar year exceeds $10,000

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Some History

- A recent District Court case in the 10th Circuit has significantly expanded the definition of "interest in" and "other Authority".

  - Treasury Department Form 90-22.47 and OCC Form 8010-9, 8010-1 Suspicious Activity Report (SAR): Banks must file a SAR for any suspicious transaction relevant to a possible violation of law or regulation.
  - FinCEN Form 110 Designation of Exempt Person: Banks must file this form to designate an exempt customer for the purpose of CTR reporting under the BSA. In addition, banks use this form biennially (every two years) to renew exemptions for eligible non-listed business and payroll customers.

- It also requires any business receiving one or more related cash payments totaling more than $10,000 to file IRS/FinCEN Form 8300.

- Requires every U.S. FI to maintain Monetary Instrument Log (MIL) that indicate cash purchases of monetary instruments, such as money orders, cashier's checks and traveler's checks, in value totaling $3,000 to $10,000, inclusive.
  - This form is required to be kept on record at the FI and produced at the request of examiners or audit to verify compliance.
  - A FI must maintain a Monetary Instrument Log for five years.

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Sanctions

- Heavy penalties exist for individuals and FIs that fail to file CTRs, MILs, or SARs. There are also penalties for a bank which discloses to its client that it has filed a SAR about the client. Penalties include heavy fines and prison sentences.

- IRC § 6038D requires that all U.S. persons, individuals, corporations (FIs are both U.S. persons and corporations) partnerships, LLC's and trusts, provide timely information regarding their foreign accounts, otherwise a $10,000 penalty will result for every month it is late (subject to a certain maximum penalty).

Money Laundering Control Act of 1986

- Consists of two sections, 18 U.S.C. § 1956 and 18 U.S.C. § 1957.
  - The first time in the United States criminalized money laundering.
    - Section 1956 prohibits individuals from engaging in a financial transaction with proceeds that were generated from certain specific crimes, known as “specified unlawful activities” (SUAs).
    - Requires that an individual specifically intends in making the transaction to conceal the source, ownership or control of the funds.
    - No minimum threshold of money, nor is there the requirement that the transaction succeed in actually disguising the money.
    - Broadly defined a “financial transaction”.
    - Need not involve a financial institution, or even a business.
    - **Merely passing money from one person to another, so long as it is done with the intent to disguise the source, ownership, location or control of the money, has been deemed a financial transaction under the law.**
    - Section 1957 prohibits spending in excess of $10,000 derived from an SUA, regardless of whether the individual wishes to disguise it. This carries a lesser penalty than money laundering, and unlike the money laundering statute, requires that the money pass through a financial institution.

The USA PATRIOT Act

The USA PATRIOT Act

- Signed into law by President George W. Bush on October 26, 2001.
  - Full title is "Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001".
- President Barack Obama signed the PATRIOT Sunsets Extension Act of 2011 on May 26, 2011 a four-year extension of three key provisions in the USA PATRIOT Act:
  - roving wiretaps,
  - searches of business records, and
  - conducting surveillance of "lone wolves"—individuals suspected of terrorist-related activities not linked to terrorist groups.

Title I: Enhancing domestic security against terrorism

- Established a fund for counter-terrorist activities and increased funding for the Terrorist Screening Center which is administered by the FBI.
- Authorized the military was to provide assistance in some situations that involve weapons of mass destruction when so requested by the Attorney General.
- Expanded National Electronic Crime Task Force was expanded and President's authority and abilities in cases of terrorism.
- Condemned the discrimination against Arab and Muslim Americans that happened soon after the September 11 terrorist attacks

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The USA PATRIOT Act

Title II: Surveillance procedures

- Allows government agencies to gather "foreign intelligence information" from both U.S. and non-U.S. citizens, and
- Changed FISA to make gaining foreign intelligence information the significant purpose of FISA-based surveillance, where previously it had been the primary purpose.
- Expanded scope and availability of wiretapping and surveillance orders.
  - Wiretaps were expanded to include addressing and routing information to allow surveillance of packet switched networks.
- Established three controversial provisions:
  - "Sneak and Peek" warrants,
  - Roving wiretaps, and
  - Ability of the FBI to gain access to documents that reveal the patterns of U.S. citizens.

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The USA PATRIOT Act

Title III: Anti-money-laundering to prevent terrorism

- Intended to facilitate prevention, detection and prosecution of international money laundering and the financing of terrorism.
  - Primarily amends portions of the Money Laundering Control Act of 1986 (MLCA) and the Bank Secrecy Act of 1970 (BSA).
    - Divided into three subtitles,
      - The first dealing primarily with strengthening banking rules against money laundering, especially on the international stage.
      - The second attempts to improve communication between law enforcement agencies and financial institutions, as well as expanding record keeping and reporting requirements.
      - The third subtitle deals with currency smuggling and counterfeiting, including quadrupling the maximum penalty for counterfeiting foreign currency.

- Tightened the record keeping requirements for FIs
  - Must record aggregate amounts of transactions processed from areas of the world where money laundering is a concern to the U.S. government.
  - Made FIs institutions put reasonable steps in place to identify beneficial owners of bank accounts and those who are authorized to use or route funds through payable-through accounts.
  - The U.S. Treasury was charged with formulating regulations intended to foster information sharing between financial institutions to prevent money-laundering.
  - Put new regulations into place to make it easier for authorities to identify money laundering activities and to make it harder for money launderers to mask their identities.
- If money laundering was uncovered, the subtitle legislated for the forfeiture of assets of those suspected of doing the money laundering.

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The USA PATRIOT Act

Title III: Anti-money-laundering to prevent terrorism

- U.S. Treasury authorized to block mergers of bank holding companies and banks with other banks and bank holding companies that had a bad history of preventing money laundering.
  - – Similarly, mergers between insured depository institutions and non-insured depository institutions that have a bad track record in combating money-laundering could be blocked.

- Placed restrictions on accounts and foreign banks.
- Prohibits shell banks that are not an affiliate of a bank that has a physical presence in the U.S. or that are not subject to supervision by a banking authority in a non-U.S. country.
  - Prohibits or restricts the use of certain accounts held at financial institutions.
  - Financial institutions must now undertake steps to identify the owners of any privately owned bank outside the U.S. who have a correspondent account with them, along with the interests of each of the owners in the bank.
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  - Banks must identify all the nominal and beneficial owners of any private bank account opened and maintained in the U.S. by non-U.S. citizens.
    - – Expected that they must undertake enhanced scrutiny of an account owned by, or being maintained on behalf of, any senior political figure where there is reasonable suspicion of corruption.
  - Deposits made from within the U.S. into foreign banks deemed deposited into any interbank account the foreign bank may have in the U.S.
    - – Thus any restraining order, seizure warrant or arrest warrant may be made against the funds in the interbank account held at a U.S. financial institution, up to the amount deposited in the account at the foreign bank.

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The USA PATRIOT Act

Title III: Anti-money-laundering to prevent terrorism

- Restrictions placed use of internal bank concentration accounts because such accounts do not provide an effective audit trail for transactions, and this may be used to facilitate money laundering.
  - FIs prohibited from allowing clients to specifically direct them to move funds into, out of, or through a concentration account, and they are also prohibited from informing their clients about the existence of such accounts. Financial institutions are not allowed to provide any information to clients that may identify such internal accounts.
  - FIs required to document and follow methods of identifying where the funds are for each customer in a concentration account that co-mingles funds belonging to one or more customers.

- Definition of money laundering expanded to include;
- Financial transactions in the U.S. to commit a violent crime,
- Bribery of public officials and fraudulent dealing with public funds,
- Smuggling or illegal export of controlled munitions, and the importation or bringing in of any firearm or ammunition not authorized by the U.S. Attorney General,
- Smuggling of any item controlled under the Export Administration Regulations,
- Any offense where the U.S. would be obligated under a mutual treaty with a foreign nation to extradite a person, or where the U.S. would need to submit a case against a person for prosecution because of the treaty,
- Import of falsely classified goods,
- Computer crime, and
- Felony violation of the Foreign Agents Registration Act of 1938.

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The USA PATRIOT Act

Title III: Anti-money-laundering to prevent terrorism

- Allows forfeiture of any property within the jurisdiction of the United States gained as the result of an offense against a foreign nation involving manufacture, importation, sale, or distribution of a controlled substance.
- Foreign nations may now seek to have a forfeiture or judgment notification enforced by a district court of the United States.
- The Act also requires the Secretary of Treasury to take all reasonable steps to encourage foreign governments make it a requirement to include the name of the originator in wire transfer instructions sent to the United States and other countries, with the information to remain with the transfer from its origination until the point of disbursement.
- The Secretary ordered to encourage international cooperation in investigations of money laundering, financial crimes, and the finances of terrorist groups.
- The Act also introduced criminal penalties for corrupt officialdom.
- Penalties apply to financial institutions who do not comply with an order to terminate any corresponding accounts within 10 days of being so ordered by the Attorney General or the Secretary of Treasury.
- The financial institution can be fined $10,000 for each day the account remains open after the 10-day limit has expired.
- Money Services Businesses (MSBs) included in the definition of a FI.
- FinCEN made a bureau of the United States Department of Treasury.
- ***Financial institutions were ordered to establish anti-money laundering programs.***

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The De-Risking Puzzle

- The 2008 financial crisis prompted a significant change in the relationship between regulatory authorities and the FIs.
- US Regulators have increased scrutiny and enforcement actions against FIs from a perception that financial institutions had ineffective AML/CFT processes in place during the financial crisis. Flow of monies derived from terrorist activity, tax evaders and drug lords was circulating through the banking system.
- The crackdown on illicit activities during the crisis changed the worldwide banking regulatory landscape; leading to the current state of heightened regulatory scrutiny.
- Regulation and Legislation to counter Money Laundering, Corruption and Tax Evasion continues to be at the forefront of the US Department of Treasury.
- Increased attention from US Regulators to AML/CFT has coincided with the world wide focus on "financial inclusion" – meaning, accessible, usable and affordable banking services to the "underserved" and "underbanked".
  - According to World Bank Data, the "underbanked" are estimated to be 2.5 Billion individuals residing primarily in the developing the countries.
  - The "underserved" in the US alone are approximately 50 Million individuals.
- FIs play defense against the current regulatory environment by "**de-risking**" (or "de-banking") clients and relationships thereby reducing FI risk exposure (or appetite).
  - FIs make the decision to close out an account/relationship due to the perception that the client/relationship is "high risk".

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The De-Risking Puzzle

  - FIs make the decision to close out an account/relationship due to account unprofitability.
    - Rising compliance costs,
    - Hard to understand complex corporate client structures,
    - Fines and penalties,
    - Shift from corporate responsibility to individual liability, and
    - reputational concerns.
  - Instead of “managing the risk” and related costs, FIs end customer relationships.
- The consequence of these account closures is that many clients/relationships are now “bank-less”.
- Entire regional economies suffer and move back into cash economies (less transparency).
- According to the Global Center on Cooperative Security (GCCS), Global AML/CFT scrutiny and a decline in risk appetite by the financial institutions are the 2 main reasons why de-risking is occurring.
- Other de-risking drivers are:
  - Financial institutions have not been transparent as to their reasons and criteria for exiting relationships.
    - Some of the industry benchmarks that lead to the termination and closure of bank relationships are:
      - 1) The size of the bank,
      - 2) The risk capacity of the bank given the regulatory climate, and
      - 3) Account profitability.

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The De-Risking Puzzle

- The sectors mostly affected by de-risking are:
  - Money service businesses,
  - Foreign embassies,
  - Politically exposed persons (PEPs),
  - International charities, and
  - Correspondent banks.
- De-risking is controversial.
  - The perception is that it leads “high – risk” clients to smaller financial institutions that might not have an adequate AML/CFT processes in place.
  - Moreover, some of these entities are being pushed to less regulated or “shadow banking” systems with no regulatory oversight.
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- According to **The Financial Action Task Force (FATF)**: “De-risking can be the result of various drivers, such as concerns about profitability, prudential requirements, anxiety after the global financial crisis, and reputational risk. It is a misconception to characterize de-risking exclusively as an anti-money laundering issue. This issue is of crucial importance to the FATF for the two following overriding reasons:
- 1. De-risking can introduce risk and opacity into the global financial system, as the termination of account relationships has the potential to force entities, and persons into less regulated or unregulated channels. Moving funds through regulated, traceable channels facilitates the implementation of anti-money laundering / countering the financing of terrorism (AML/CFT) measures.

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The De-Risking Puzzle

- 2. It is central to our mandate to ensure that the global AML/CFT standard is well understood and accurately implemented and that countries and their financial institutions are provided with support in designing AML/CFT measures that meet the goal of financial inclusion".

- "De-risking" should never be an excuse for a bank to avoid implementing a risk-based approach, in line with the FATF standards. The FATF Recommendations only require financial institutions to terminate customer relationships, on a case-by-case basis, where the money laundering and terrorist financing risks cannot be mitigated. This is fully in line with AML/CFT objectives. What is not in line with the FATF standards is the wholesale cutting loose of entire classes of customer, without taking into account, seriously and comprehensively, their level of risk or risk mitigation measures for individual customers within a particular sector.

- The risk-based approach should be the cornerstone of an effective AML/CFT system, and is essential to properly managing risks. The FATF expects financial institutions to identify, assess and understand their money laundering and terrorist financing risks and take commensurate measures in order to mitigate them. This does not imply a "zero failure" approach.

- The FATF is committed to financial inclusion, and effective implementation of AML/CFT measures through proper implementation of the risk-based approach".

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The De-Risking Puzzle

- There are a variety of challenges facing FIs that are not being supported through the agency regulatory environment – the conundrum of safely navigating the meaning of the term of art "risk-based approach".

- Regulatory supervision is not uniform throughout the regulatory system.
  - FIs do not know what to expect from one regulator visit to another.
  - Compliance quality is in the eye of the regulator.

- Regulatory education and field supervision is not uniform throughout the regulatory system.
  - Leads to inconsistent regulatory supervision.

- There are no bright lines for FI compliance departments to use as bench marks for compliance.

- The regulatory environment does not fully encourage "end-to-end" KYC-CDD standards.
  - The definition of legal entity customers only includes statutory trusts created by a filing with the Secretary of State or similar office. Otherwise, it does not include trusts.
  - This is because a trust is a contractual arrangement between the person who provides the funds or other assets and specifies the terms (i.e., the grantor/settlor) and the person with control over the assets (i.e., the trustee), for the benefit of those named in the trust deed (i.e., the beneficiaries).
  - Formation of a trust does not generally require any action by the state.

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What is happening today?

- Major money centers are shedding correspondent account and “high risk” customer account relationships,

- Smaller FIs are expanding their correspondent relationship networks.
  - Requiring the complete elimination of shell company customers unless UBOs are disclosed
  - Requiring disclosure of the UBOs of the FFI.
  - Requiring establishment of a trust in the P&P of the correspondent.

    - Based on an in-depth review of the day-to-day activities of the FFI
    - How do day-to-day activities comport with the P&P?

- A further prerequisite is a co-participation (control of) by the FI in the treasury activities of the offshore correspondent.

- Some jurisdiction central banks are using their U.S. Federal Reserve Accounts to process the wire activity of local FIs without U.S. correspondent relationships.

- Consolidation of banks is occurring in some jurisdictions in order to centralize risk and heighten profitability for U.S. FIs.
  - Does this necessarily increase confidence by U.S. FIs in jurisdiction FIs?
  - Does this automatically eliminate UBO questions?

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The Economic Effects?

- Turning back the clock at least 50 years,
  - No access to credit card services outside of a de –risked jurisdiction.
  - No ability to engage in wire transfer activity.
  - Vendors and buyers unable to receive and make international payments.
  - Slow down/ elimination of international movement of good and services.
  - Transportation of large amounts of actual cash.
- Increases in unemployment.
- Local jurisdiction economic recessions.
- Public unrest.
- Deteriorating international relations.

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Questions

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Thank you.

BSA News Now and Global RADAR wish to thank you

for your participation in today's webinar.