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Foreign Correspondent Banking - Regulators Encourage U.S. Banks to Keep Doing It, But Their Regulations Have Been Discouraging

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Once again, banks seem to be caught between a regulatory rock and a hard place. After years of additional regulations and civil money penalties hindering the foreign correspondent banking industry, the U.S. Department of the Treasury (Treasury) and various federal banking agencies (the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, and Office of the Comptroller of the Currency (OCC)) (collectively, the Federal Banking Agencies) are encouraging banks to continue offering foreign correspondent accounts. On August 30, 2016 the Treasury and the Federal Banking Agencies issued a Joint Fact Sheet on Foreign Correspondent Banking aimed at mitigating banks' concerns regarding the regulatory risks related to foreign correspondent accounts.

Foreign financial institutions open foreign correspondent accounts at U.S. banks so that such U.S. banks can accept deposits and handle other financial transactions, including payments, on behalf of the foreign financial institution. It is a way for a foreign financial institution and its customers to transact business in the U.S. without formally establishing a presence in the U.S. Foreign correspondent banking plays a vital role in international trade and finance.

These foreign correspondent accounts are subject to the same account-opening regulations as any other customer account of a U.S. bank, including the bank's BSA/AML and OFAC compliance procedures. However, with foreign correspondent accounts the account opening procedures must also include an assessment of the particular risks posed by the foreign financial institution, including an analysis of the foreign financial institution's business and markets, the purpose of and activity in the account, the nature and duration of the relationship with the foreign financial institution, the supervisory regime of the jurisdiction in which the foreign financial institution is licensed, and information known or reasonably available about the foreign financial institution's AML record.

Over the past decade, U.S. banks have been subject to severe civil money penalties and other public enforcement measures for BSA/AML and OFAC violations that have made them leery of opening accounts from foreign sources. U.S. banks are finding that they are vulnerable to money laundering, terrorist financing and other illicit transactions when they accept deposits from foreign banks that oftentimes are not subject to the same strict legal standards as the U.S. bank. U.S. banks recognize that civil money penalties in the hundreds of millions, or even billions, of dollars, as well as other forms of punishment, are a very real possibility for BSA/AML and OFAC program-related lapses in controls and compliance. Bankers electing to participate in foreign correspondent banking can expect a very thorough regulatory examination of the adequacy of controls and risk management processes should they choose to engage in those activities, and boards will be expected to ascertain that appropriate controls are in place and being monitored and enforced.

With such hefty penalties as a concern, it can be difficult for a bank to see how the benefits of opening and maintaining foreign correspondent bank accounts outweigh the risks. There is little doubt that correspondent banking relationships are valuable to foreign financial institutions and their customers. But in this regulatory environment, U.S. banks are less sure how valuable such correspondent banking relationship are to their own interests, and are considering whether it is in their best interest to "de-risk" by terminating these relationships.

Recent statements from the Federal Banking Agencies indicate that they are growing concerned about the effect their regulations are having on the strength of the global financial market, and they have tried to provide clarity to U.S. banks regarding the banks' BSA/AML compliance obligations in order to reduce impediments to legal international transactions. Likewise, numerous legislators and international organizations have also expressed concern with U.S. banks exiting the foreign correspondent banking line of business. And in December, the Financial Stability Board (FSB), which is an international body that monitors and makes recommendations about the global financial system, published an action plan to address the decline in correspondent banking.

One of the primary concerns U.S. banks have regarding opening foreign correspondent accounts has been a lack of clarity on whether banks are required to conduct due diligence on the customers of the foreign financial institutions (i.e. their customer's customers). In their Joint Fact Sheet the Treasury and Federal Banking Agencies tried to alleviate this concern by stating that "there is no general requirement for U.S. depository institutions to conduct due diligence on a [foreign financial institution's] customers." However, in the very next sentence of the Joint Fact Sheet the Treasury and Federal Banking Agencies seemed to claw-back the apparent clarity of that statement by stating that in determining the appropriate level of due diligence necessary, U.S. banks should consider the "types of customers" the foreign financial institution serves, which they say may require the U.S. banks to request additional information regarding the foreign financial institution's underlying transactions. So, in short, while the regulators' may have attempted to provide clarity, there is still ambiguity regarding a U.S. bank's due diligence obligations concerning the customers of the foreign financial institution.

So long as the burden of preventing money laundering and other illicit activity is placed on banks, foreign correspondent banking will likely continue to provide many compliance headaches for U.S. banks. The issues are too complex and the potential consequences are too great, that clear, black-and-white tests may not be feasible.

In order to make sure they are properly evaluating the risks, U.S. banks engaged in foreign correspondent banking are advised by the OCC to do the following:

- Ensure that periodic risk reevaluations are conducted and decisions regarding the treatment of foreign correspondent accounts are based on the periodic risk reevaluations;

- Confirm that procedures for reevaluating foreign correspondent account risks and making account-related decisions are implemented;

- Ensure that decisions to terminate foreign correspondent accounts resulting from risk reevaluation are based on analysis of the risks presented by individual foreign financial institutions and the bank's ability to manage those risks;

- Establish and maintain an effective governance function to review the method for risk reevaluation and to monitor the appropriateness of recommendations regarding foreign correspondent account retention or termination;

- Communicate foreign correspondent account termination decisions regularly to senior management;

- Communicate with foreign financial institutions, considering specific mitigating information these institutions may provide, and providing sufficient time to establish alternative banking relationships before terminating accounts, unless doing so would be contrary to law or pose an additional risk to the bank, national security, or reveal law enforcement activity; and

- Ensure a clear audit trail of the reasons and method used for account closure.

Ultimately, despite strong encouragement by federal banking regulators to engage in foreign correspondent banking, institutions that intend to do so in the current regulatory environment do so at some peril, realizing that the risk involved will require careful analysis, the imposition of controls that are adequate to mitigate that risk, and the recognition that the activities will likely continue to generate special regulatory interest and concern.