

Potential Risks Associated with Providing Banking Services to Money Service Businesses

Background

This Advisory outlines the potential risks associated with providing banking services to member-owned Money Service Businesses (MSBs). It also sets out DICO's expectations for those credit unions and caisses populaires that are providing banking and wire transfer services to member-owned MSBs or are considering entering into this line of business.

The current low interest rate environment has motivated some credit unions to improve profitability by seeking non-traditional sources of revenues. In particular, a number of credit unions have entered into arrangements to provide banking and wire transfer services to member-owned Money Service Businesses (MSBs) which are generating fee income for related cash handling, wire transfer and foreign exchange services.

MSBs are defined by the Financial Transactions and Reports Analysis Centre of Canada (FINTRAC) as "non-bank" entities which provide transfer and exchange mechanisms. Individuals and entities generally use MSBs to exchange or transfer value, or to purchase or redeem negotiable instruments. In Canada, an MSB is defined as an individual or an entity that is engaged in the business of any of the following activities:

- foreign exchange dealing;
- remitting or transmitting funds by any means or through any individual, entity or electronic funds transfer network;
- issuing or redeeming money orders, traveler's cheques or other similar negotiable instruments

FINTRAC describes MSBs as generally higher risk customers from a money laundering and /or terrorist financing perspective as criminal elements seek to exploit MSB businesses to transfer and launder funds. For further information please consult FINTRAC's report "Money Laundering and Terrorist Financing Typologies and Trends for Canadian Money Service Businesses, which is available on FINTRAC's website at www.fintrac.gc.ca.

While every MSB in Canada must be registered with FINTRAC in a similar fashion to financial institutions, there are a number of MSBs operating outside of the FINTRAC framework. The number and relative size of MSBs make it challenging for regulatory authorities to monitor them effectively.

Major banks have typically refused to provide banking services for MSBs owing to the risks associated with providing them services. For this reason any credit union that has chosen to provide services to MSBs must have a comprehensive and robust compliance regime in place.

Risks to the Credit Union

Credit unions or caisses populaires entering into the servicing of MSBs are receiving significant fees for the services being provided. This level of revenues may unduly influence the credit union's rationale for entering into the MSB business by placing an inappropriately high weighting on potential returns versus the associated risks. In addition, once a financial institution begins taking on MSB clients, it is very likely that other MSBs will seek to open accounts with the credit union thus resulting in ever increasing risk.

The risks to the credit union are both financial and reputational. Financial losses (and in extreme cases, criminal penalties which may include up to 5 years imprisonment) can arise and have arisen from penalties levied by FINTRAC or law enforcement for non-compliance with the Proceeds of Crime (Money Laundering) and Terrorist Financing Act ("PCMLTFA") or from lost recourse on deposited cheques that may potentially be so severe as to result in the failure of the institution. It should also be noted that amendments to the PCMLTFA have been proposed by the Department of Finance to include business relationships in addition to account openings and prescribed financial transactions. Reputational risk may arise from association with fraudulent activities of an MSB, its Principals, employees or its business activities.

Some credit unions have attempted to mitigate the potential risk of non-compliance with PCMLTFA legislation by contracting with third parties to screen MSB applicants and provide anti-money laundering (AML) monitoring. However, third parties do not assume the risk of non-compliance with PCMLTFA and the credit union retains both the financial and reputational risks. Where those third parties are receiving fees from MSB providers to confirm their AML Compliance Programs meet PCMLTFA requirements and monitoring ongoing AML compliance on behalf of the credit union on a fee basis, once the MSB becomes a member, a serious potential conflict of interest may arise.

DICO's Expectations

DICO has the following expectations of credit unions or caisses populaires that engage in this type of business:

- The Board of Directors should authorize entry into this line of business based on a thorough analysis by management of the potential benefits and risks.
- All MSB member accounts should be subject to Board approval.
- A comprehensive risk assessment process should be in place to identify and monitor high risk clients.
- Increased scrutiny is required over MSB accounts as they are considered extremely high risk.

- Annually, the credit union shall verify that the MSBs are in good standing with FINTRAC, provide confirmation to the credit union's Board of Directors and retain record of the verification and report to the Board for DICO examiners.

Credit unions should not accept MSBs as members unless the accounts meet the highest business standards, are professionally managed, operate in full compliance with FINTRAC requirements and are subject to robust internal and external audit procedures.

At a minimum, for each potential MSB account, credit unions are expected to:

- Conduct background checks of account principals (financial and criminal/terrorist);
- Obtain business and financial references;
- Determine the scope and size of operations, including client base and nature of material transactions;
- Review the experience and suitability of the external auditors;
- Review the qualifications of the internal auditors and the internal audit plan;
- Review the business plan and Audited Financial Statements (2 years);
- Confirm that MSB membership meets membership criteria;
- Develop and submit a business case for Board approval where MSB membership is recommended.

Any MSB membership account should have a robust membership agreement including specific operating and reporting criteria to ensure that the MSB continues to operate in full compliance with FINTRAC requirements.

Where a credit union is already involved in offering services to, or is planning to offer services to MSBs, DICO will require the credit union to provide evidence of sufficient due diligence in considering the risks in accordance with By-law #5 requirements.

DICO's examination process will include a review of all new lines of business to confirm that sufficient due diligence has been conducted and that appropriate risk management policies and controls are in place.

Examiners will also review:

- Business case and Board approvals for all MSB accounts
- MSB client information and any outsourcing arrangements or contracts
- the level and quality of internal controls
- the nature and extent of on-going monitoring and compliance practices
- the nature and extent of internal audit procedures
- the form and content of board reports

In cases where increased risk is evident, DICO may place the credit union on its Watchlist and / or require the credit union to maintain additional capital.

If you have any questions, please contact your Regional Manager. For your convenience extracts from part 5 of the PCMLTFA regarding penalties have been included as Appendix A to this document.

APPENDIX A

Extract from the Proceeds of Crime (Money Laundering) and Terrorist Financing Act

PART 5 - OFFENCES AND PUNISHMENT

General offences

74. Every person or entity that knowingly contravenes any of sections 6, 6.1 or 9.1 to 9.3, subsection 9.4(2), sections 9.5 to 9.7 or 11.1, subsection 12(1) or (4) or 36(1), section 37, subsection 55(1) or (2), section 57 or subsection 62(2), 63.1(2) or 64(3) or the regulations is guilty of an offence and liable

- (a) on summary conviction, to a fine of not more than \$50,000 or to imprisonment for a term of not more than six months, or to both; or
- (b) on conviction on indictment, to a fine of not more than \$500,000 or to imprisonment for a term of not more than five years, or to both.

Reporting — sections 7 and 7.1

75. (1) Every person or entity that knowingly contravenes section 7 or 7.1 is guilty of an offence and liable

- (a) on summary conviction,
 - (i) for a first offence, to a fine of not more than \$500,000 or to imprisonment for a term of not more than six months, or to both, and
 - (ii) for a subsequent offence, to a fine of not more than \$1,000,000 or to imprisonment for a term of not more than one year, or to both; or
- (b) on conviction on indictment, to a fine of not more than \$2,000,000 or to imprisonment for a term of not more than five years, or to both.

Defence for employees

(2) No employee of a person or an entity shall be convicted of an offence under subsection (1) in respect of a transaction or proposed transaction that they reported to their superior or in respect of property whose existence they reported to their superior.

Disclosure

76. Every person or entity that contravenes section 8

- (a) is guilty of an offence punishable on summary conviction; or
- (b) is guilty of an indictable offence and liable to imprisonment for a term of not more than two years.

Reporting — section 9

77. (1) Every person or entity that contravenes subsection 9(1) or (3) is guilty of an offence and liable on summary conviction to a fine of not more than \$500,000 for a first offence and of not more than \$1,000,000 for each subsequent offence.

Due diligence defence

(2) No person or entity shall be convicted of an offence under subsection (1) if they exercised due diligence to prevent its commission.

Registry

77.1 Every person or entity that provides information to the Centre under section 11.12, 11.13, 11.14 or 11.3 and that knowingly makes any false or misleading statement or knowingly provides false or misleading information to a person responsible for carrying out functions under this Act is guilty of an offence and liable

- (a) on summary conviction, to a fine of not more than \$50,000 or to imprisonment for a term of not more than six months, or to both; or
- (b) on conviction on indictment, to a fine of not more than \$500,000 or to imprisonment for a term of not more than five years, or to both.

Liability of officers and directors

78. If a person or an entity commits an offence under this Act, any officer, director or agent of the person or entity who directed, authorized, assented to, acquiesced in or participated in its commission is a party to and guilty of the offence and liable on conviction to the punishment provided for the offence, whether or not the person or entity has been prosecuted or convicted.

Offence by employee, agent or mandatory

79. In a prosecution for an offence under section 75, 77 or 77.1,

- (a) it is sufficient proof of the offence to establish that it was committed by an employee, agent or mandatory of the accused, whether or not the employee, agent or mandatory is identified or has been prosecuted for the offence; and
- (b) no person shall be found guilty of the offence if they establish that they exercised due diligence to prevent its commission.