Information paper

Addressing the unintended consequences of de-risking

Contents

Key takeaways

Banks around the world are reducing their correspondent banking relationships, focusing in particular on high-risk jurisdictions.

De-risking is not necessarily just about minimising risk – the cost of maintaining relationships is a significant consideration.

De-risking may result in difficulties which could affect a wide range of transactions, including remittances sent by individuals to their relatives at home, purchases of consumables, payments for medical care and education fees.

Without access to traditional banking channels, people may seek alternative channels which are less well regulated and which may bring additional risks.

By implementing the appropriate controls and providing information to correspondents and to the market in a more consistent and transparent way, banks may be able to reduce the likelihood that they will be de-risked.

Data utilities such as The KYC Registry can be used to share information in an efficient and standardised way.

Introduction

It’s no secret that many banks around the world are reassessing their correspondent banking relationships. The phenomenon, known as de-risking, has seen many large international banks responding to concerns about money laundering and terrorist financing – as well as cost and regulatory pressures – by withdrawing from certain relationships, products or even jurisdictions.

While such decisions may make business sense for the individual banks concerned, it is becoming increasingly clear that there are wider consequences for the industry as a whole. People still need to make payments – and if traditional banking channels are no longer available, transactions are likely to be forced into alternative channels, which may be less well regulated. This paper explores the impact of de-risking on banks and their end customers, and asks what the industry can do to overcome these issues.

Background

Correspondent banking is an arrangement whereby one bank (the correspondent) provides services to another (the respondent), often as a means of gaining access to overseas products and enabling cross-border transactions. As such, correspondent banking services are an important part of the global payments landscape.

In the last couple of years, however, some banks have begun rationalising their correspondent banking relationships – often focusing their attention on high-risk jurisdictions. This trend, known as de-risking, is increasingly widespread: a report published by The World Bank in November 2015 found that 75% of the large international banks surveyed had reported a decline in their correspondent banking relationships, with the Caribbean most significantly affected.[1]

Reasons for de-risking

It is becoming increasingly clear that de-risking is not only about managing risk. In some cases, de-risking is the result of international banks becoming concerned about risks relating to Anti-Money Laundering / Counter Terrorist Financing (AML/CTF) compliance in specific relationships or even whole countries – particularly where there is a lack of transparency over local banks' activities and compliance strategies. However, cost is also a significant catalyst.

"One driver is a straight business reason, where you have banks with thousands of corresponding relationships around the world," says Steve Beck, Head of Trade Finance at the Asian Development Bank (ADB). "There is a cost to maintaining those relationships, and in some countries it may not make economic sense for users to maintain a relationship with so many banks. So there may be a business decision to exit some of those relationships."

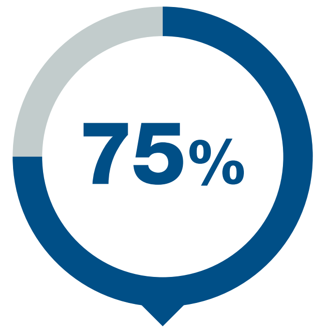
Beck adds, "What is arguably a more dominant reason for banks to sever relationships is the costly, onerous and overlapping set of requirements they may need to fulfil. These may include regulations not only in their home countries, but also in many different jurisdictions. These rules may lack clarity, and the goalposts may move."

This trend may be exacerbated in some cases by the need for banks to take additional regulatory factors into account. "Some banks have deferred prosecution agreements with the US government, which mitigates their risk of further prosecution provided they fulfil certain criteria," says Gary Bishop, Chief Operations Officer at Bank Sepah International. "This results in these banks applying not only their local regulation, but also US regulation in their de-risking policies."

While de-risking is often seen as an activity carried out by international banks, local banks may also engage in de-risking exercises of their own. Pattison Boleigha, Chief Conduct and Compliance Officer at Access Bank, notes that while banks in Nigeria, Sierra Leone and Gambia have been de-risked in the last two years, "We do a lot of de-risking too. In Nigeria, there has been wholesale closure of bureau de change businesses."

"Correspondent banking relationships play a vital role in the economic development and trade of African countries. A strong correspondent banking network can help local banks in the Caribbean and Africa bridge the knowledge, technology, product and risk management gaps.

Pattison Boleigha
Chief Conduct and Compliance Officer, Access Bank



75% of the large international banks surveyed had reported a decline in their correspondent banking relationships.

[1]The World Bank, *Withdrawal from Correspondent Banking: Where, Why, and What to Do About it*, November 2015.

De-risking in practice

A consultative report published by the BIS in October 2015 notes that types of correspondent banking services which are perceived to have higher associated risks are being scaled back, while cutbacks in the number of relationships "have resulted in a significant concentration of relationships in a relatively smaller number of service-providing institutions, which increasingly dominate the market."

According to the report by The World Bank, "The products and services identified as being most affected by the withdrawal of correspondent banking are: (check) clearing and settlement, cash management services, international wire transfers and, for banking authorities and local/regional banks, trade finance."

For local and regional banks at the receiving end of a de-risking exercise, the consequences can be considerable. At the milder end of the spectrum, banks may be forced to find alternative partners – an exercise which takes time and money, and which may result in less favourable terms and conditions than previous arrangements. The World Bank report notes, "The ability of financial institutions in affected jurisdictions to find alternative correspondent banks varied, but the majority indicated they were able so far to find replacements."

> **"Some of the biggest banks have halved, or more than halved, their relationships, particularly in emerging markets. In some cases, they have exited countries completely.**
>
> **Steve Beck**
> **Head of Trade Finance, ADB**

This has been the case for some banks in the Caribbean, a region which is experiencing significant levels of de-risking. Trevor Brathwaite, Deputy Governor of the Eastern Caribbean Central Bank (ECCB), says that a number of local banks have seen their transaction fees increase, while others have received notice that their relationships with correspondent banks would be terminated. So far, these banks are applying to other partners prepared to offer correspondent banking services.

Brathwaite notes that some second-tier banks in the US have indicated a willingness to provide services, although these arrangements have yet to be finalised. In other cases, banks may find themselves cut off entirely – with potentially dire consequences.

[2] Bank for International Settlements, Committee on Payments and Market Infrastructures, *Consultative report: Correspondent banking*, October 2015.

Unintended consequences

While the impact of de-risking can be serious for individual financial institutions, the potential impact on the affected countries – and indeed the wider financial system – may be even more significant. The scale of this issue was not immediately obvious when de-risking measures first began to take effect.

"Initially, when some larger banks started retrenching from some of their markets, de-risking created the potential for second and third tier banks to step in," explains Bishop. "However, de-risking has become much more widespread – to the point where larger banks have been de-risking European and UK banks, as well as some corporates. At that stage, de-risking became much more onerous to the industry as a whole, and instead of potentially being an opportunity for second and third tier banks, became an impediment to free access to the financial markets."

Different regions are being affected in different ways. Notable developments include the following:

- After sizeable fines in recent years in relation to transactions between Mexico and the US, a number of banks have withdrawn from their correspondent banking relationships in the country.
- In Africa, Bleming Nekati, Chief Trade Finance Officer at the African Development Bank, says that de-risking is being manifested in a number of ways, including the introduction of restrictive financial and non-financial covenants, an increase in the cost of funds, a reduction in facility tenors and sizes and the intensifying of sanctions in certain markets such as Zimbabwe and Sudan.
- Research has shown that in the Eastern Caribbean, one correspondent bank terminated all accounts involved with downstream correspondent or third party intermediary activities, as well as closing accounts of several legal professionals and local charities. Another bank has closed its entire operation in the Eastern Caribbean.
- In the last year, 14 de-risking events have occurred in relation to local general banks and international banks in Curacao and Sint Maarten, according to information from Centrale Bank van Curaçao en Sint Maarten (CBCS).

> **"De-risking has the potential to destabilise our economies, promote financial exclusion and increase poverty levels.**
>
> **Centrale Bank van Curaçao en Sint Maarten (CBCS)**

Unintended consequences

Social impact

De-risking can have a significant impact not only on banks, but also on their end customers. If countries are completely cut off, the consequences for individuals could range from inconvenient to life-threatening.

"For several Latin American countries, an important percentage of our GDP comes from remittances sent to families from working members of the family in the United States and other countries," says Fabiola Herrera, Payment Systems Department Director at the Central Bank of the Dominican Republic. "This money goes through money transfer operators and remittance companies. Many of these are global companies; some are local companies with accounts in correspondent banks. These accounts are also at risk of being closed."

Latin America is not the only region to be affected in this way. Brathwaite reports that in the Caribbean, the impact of de-risking could include making it difficult for people to pay for consumables imported from the US. "In addition, a number of our citizens send their children to universities in the United States," he says. "If fees and accommodation costs cannot be paid, children will not be able to advance their education."

For some, the consequences of this type of disruption could be even more severe. People seeking medical attention in the US could suffer – or, indeed, die – if they are unable to pay for the services they need.

Political impact

In other cases, difficulties in accessing correspondent banking services could have significant political consequences – as noted by Bishop.

"Bank Sepah, in conjunction with other UK Iranian banks, came out of sanctions on 16 January" 2016, he explains. "However, none of us have yet got a clearer who is prepared to accept commercial banking payments business. In fact, smaller banks who would be willing to operate services for us are being advised by their clearer that this would not be acceptable."

> **One issue is that even if you remove one correspondent banking relationship, you can't be sure that the correspondent bank isn't going to find a new relationship elsewhere, and that the money will still end up coming through your institution.**
>
> **Dr Inês Sofia de Oliveira, Research Fellow, Centre for Financial Crime & Security Studies, RUSI**

Payments between the US and Mexico are now dependent on one USD clearer

Finding alternative channels

"cheaper, easier and more efficient for banks around the world to access the information they require to gain comfort with their counterparties..."

The KYC Registry

The KYC Registry delivers a central repository of up-to-date due diligence documents and data of banks on the SWIFT platform, providing users with a fast and cost-effective KYC solution that enables them to monitor, manage and grow their correspondent banking network.

When access to traditional banking channels is cut off, there is a risk that people will be forced to find other methods of making and receiving payments – whether that means using money remittance services or even physically transporting suitcases of cash across borders. Ironically, the adoption of less well-regulated channels may bring additional risks.

"If people are not able to receive money and transfer money through the financial system, then they will try to find other ways of doing it – whether that means using money remittance companies or asking someone to transfer it for them," says Dr Inês Sofia de Oliveira, Research Fellow, Centre for Financial Crime & Security Studies at the Royal United Services Institute (RUSI). "This always leaves people more vulnerable to criminals."

"The danger is that in pushing out certain customers – and whole countries in some instances – banks will push those entities to alternative, less regulated providers," adds Bishop. "This will undermine the regulators' aims in getting banks to be more risk-aware and more careful, by driving business underground, or into the arms of less regulated providers, potentially creating openings for money laundering and terrorist financing."

Overcoming the challenges

Awareness of the problems associated with de-risking is growing – and in some cases, actions are being put in place to mitigate the challenges.

For example, Banco de México has stepped in with the creation of SPID, a domestic electronic system which will operate as a clearing house, enabling the transfer of US dollar payments. The system is also intended to impose enhanced AML obligations.

Other actions include the introduction of closed user groups to help address de-risking. "In the Dominican Republic we have built a closed user group (CUG) using SWIFT, with the central bank as the central hub," says Herrera. "All of the banks in the Dominican Republic are part of this. Local payments are executed using this private network, which is in real time, very safe and with low cost."

Herrera says that this concept has been extended to central America to create a closed user group of six central banks – meaning that clients from participating countries can exchange USD payments.

Herrera adds that there are some theoretical scenarios when it comes to addressing the issue of de-risking (if there are no changes in this policy). "One would be to keep doing business at a regional level, using networks of banks as described above," she explains. "But that's easier said than done. Another would be to create a 'global private club' that only the banks with the strongest AML measures can join. And a third one could be a scenario where central banks become part of the solution (see the recent case of Banco de México) but this one poses important risks for central banks and would require careful analysis. In these utopic scenarios – and in any other case – central banks might need to take a more active role."

Meanwhile, the BIS report published in October made a number of recommendations, including the use of KYC utilities as a means of reducing the compliance burden for some KYC procedures. In addition, the report recommended that stakeholders consider the use of the Legal Entity Identifier (LEI) "as a means of identification which should be provided in KYC utilities and information-sharing arrangements".

To de-risk or not to de-risk?

One further possible solution is for correspondent banks to reconsider whether de-risking is really necessary. Mary Popo, General Manager of the Caribbean Association of Banks (CAB), says that correspondent banks should be considering other options.

"We would like correspondent banks to implement measures to mitigate risk, rather than de-risking," she explains. "They should also provide timely communication of compliance gaps, enabling the respondent bank to address the issues, while working with respondent banks to enhance collaboration, trust and transparency. In addition, when risk-rating jurisdictions, correspondent banks should consider the country's rating with respect to independent international authorities such as FATF, OECD et cetera."

How to avoid being de-risked

While there is a clear need for industry-level solutions, many local and regional banks are asking how they can avoid being de-risked at the individual bank level. While nothing is fool-proof, there are a number of steps that banks can take to reduce the likelihood that this will happen to them – or, indeed, to increase their chances of securing successful alternative arrangements if they are de-risked.

One of the key catalysts for de-risking is a lack of transparency over a particular bank's activities, business lines or behaviour. All too often, banks share information with counterparties and with the market in a way that is not adequate or consistent.

Guy Sheppard, Head of Compliance Initiatives, Americas, Nordics and UKI at SWIFT, notes that best practice in this area is to have a single individual or department tasked with creating and maintaining a gold standard data set. This data set can then be shared with the market in different ways – from sophisticated data utilities to basic press releases and information on the bank's external website.

Data utilities

A number of different utilities are available in the market place which aim to address this issue by acting as a repository of reliable, up-to-date information. One such utility is SWIFT's KYC Registry, a shared platform for managing and exchanging standardised KYC data. With over 2,500 financial institutions already signed up, the Registry gives banks a means of sourcing and providing validated information from correspondents.

"The KYC Registry makes it cheaper, easier and more efficient for banks around the world to access the information they require to gain comfort with their counterparties," says Beck. "We think it will be important to addressing this issue and have been actively encouraging the commercial banks we work with to submit their information and ensure it is kept up to

The need for transparency has created a large number of data exchange utilities that cater for different core segments, such as correspondent banking, broker dealers, trusts, et cetera. It has become very clear that the market is moving towards more efficient and standardised approaches to data and document transparency and availability which go above and beyond traditional incumbent databases. Banks will also need to include their data in any government-run data registries that might be relevant to their individual markets. In many cases, the best option for banks may be to 'slice and dice' their master data as needed and to register their data with multiple utilities – while ensuring that the data used in each case is accurate, consistent and fully up to date.

"As a respondent bank, it's important to understand that if correspondents are unable to find your data, this equates to an increased cost of doing business with you," notes Sheppard. "There is a very real need to get your data out there – in line with your own level of comfort around how secure that data is going to be, and the level of disclosure required."

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Moving forward

De-risking is having a significant impact on correspondent banking relationships around the world. In light of these challenges, there is a need for the industry to address this issue proactively, putting in place measures to keep the wheels moving and to avoid the risk of financial exclusion in affected markets.

At the same time, banks in high-risk jurisdictions should be taking appropriate steps to demonstrate greater transparency over their activities and compliance measures, in order to reduce the likelihood that they will be de-risked.

Of course, there are no guarantees that a bank will be able to avoid being de-risked, even when best practice is followed. "You can go to your correspondents and say you are putting in better procedures and improving your risk awareness," says Bishop. "But ultimately, if they have got you on the list of high-risk entities or countries, and they don't think you are within their risk appetite, then you're out."

However, banks can take steps to mitigate the potential impact of de-risking on their businesses. As Sheppard concludes, "Even if you are de-risked by some banks, if you can address the concerns in a logical, rational and defensible way, you become a very attractive prospect to the next tranche of banks, which may have a different level of risk appetite. If you can become the most attractive option in a potentially high-risk jurisdiction, you may even command a premium."

Best practices

Luc Meurant, head of SWIFT's Compliance Services division, highlights a number of steps for banks to consider to try and avoid being on the receiving end of a de-risking exercise:

- **Put the right controls in place.** Use compliance controls such as transaction screening – and make sure you can demonstrate them to your correspondent.
- **Be transparent.** Large banks increasingly need to understand their correspondents' clients (Know Your Customer's Customers). Smaller banks should be transparent with their larger clearers about the clients, industries and geographies they serve.
- **Communicate proactively.** Smaller banks should actively communicate what they are doing to increase their level of compliance.
- **Reduce your clearer's due diligence cost.** For a large bank, the due diligence costs for a high-risk counterparty can be as much as $50,000 per year. If this is higher than the fees earned from that counterparty, large banks may conclude the relationship does not make sense financially. Smaller banks should take any steps possible – such as joining The KYC Registry – to help reduce due diligence costs for their counterparties.

How SWIFT can help

In addition to The KYC Registry, SWIFT offers a number of solutions which can help banks achieve greater transparency over their operations, standardise compliance processes and mitigate the relevant risks. These include:

Sanctions Screening

A SWIFT-hosted solution that provides an easy to use, cost effective tool for banks, central banks and other institutions to screen all types of financial transactions in a standardised way.

Traffic Profile

A low cost tool giving an aggregate view of a bank's exposure to sanctioned countries.

Compliance Analytics

An enterprise level solution which enables banks to examine their payment flows and share of payment corridors, as well as explicitly identify and query nesting behaviour.

By providing these tools, SWIFT is able to help banks understand their own behaviour as well as identifying any hidden exposures.

About SWIFT

For more than 40 years, SWIFT has helped the industry address many of its biggest challenges. As a global member-owned cooperative and the world's leading provider of secure financial messaging services, we enable more than 11,000 banking and securities organisations, market infrastructures and corporate customers in more than 200 countries and territories to communicate securely and exchange standardised financial messages in a reliable way.

As their trusted provider, we facilitate global and local financial flows, relentlessly pursue operational excellence, and continually seek ways to lower costs, reduce risks and eliminate operational inefficiencies. We also bring the financial community together to work collaboratively to shape market practice, define standards and debate issues of mutual interest.

SWIFT users face unprecedented pressure to comply with regulatory obligations, particularly in relation to the detection and prevention of financial crime. In response, we have developed community-based solutions that address effectiveness and efficiency and reduce the effort and cost of compliance activities. Our Compliance Services unit manages a growing portfolio of financial crime compliance services in the areas of Sanctions, KYC and CTF/AML.

Financial crime compliance is also a major theme at Sibos, the world's premier financial services event, organised by SWIFT for the financial industry.

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