FINANCIAL SERVICES VOLUNTEER CORPS

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Addressing the "De-Risking" Challenge

This note proposes a broad strategy for addressing one of the most significant recent failings of the international financial system, namely, the reluctance of large international banks to maintain correspondent accounts with banks in numerous emerging market countries. This phenomenon, known as "de-risking", can effectively sever some countries' linkages to the global financial system. The result can damage a country's ability to make trade-related and other payments, and can also place considerable strain on remittance flows, often a vital underpinning of emerging market economies. Another negative consequence of de-risking is its detrimental impact on financial inclusion, as respondent banks in emerging market countries have fewer resources to allocate to underserved local regions and populations.

The IMF, World Bank and other bodies have extensively analyzed the causes and consequences of de-risking. A recent IMF analysis, for example, identified a range of causes that included large international banks' negative assessments of the profitability and risk associated with the correspondent banking business; changes in the regulatory and enforcement landscape, including expanded use of financial sanctions and more rigorous anti-money laundering/combating the financing of terrorism (AML/CFT) requirements; and a general increase in banks' regulatory compliance costs. While much has been written, little progress has been made in identifying potential solutions to the de-risking challenge, which threatens the economic well-being and fundamental stability of scores of emerging market countries. The countries, institutions and businesses hurt by de-risking are often reluctant to talk about it, but the problem does not appear to be receding in importance.

From FSVC's vantage point, several causal factors loom especially large. Multi-billion dollar fines levied by U.S. authorities against internationally-active banks for violations of AML/CFT regulations and financial sanctions have played a critical role in prompting banks to pull back from international correspondent activities. For many banks, the financial returns are too meager to justify the heightened perceived risk. Although U.S. regulators have issued statements implicitly encouraging banks to maintain their international correspondent ties, the banks themselves have remained fearful of being found in violation of U.S.-imposed AML/CFT requirements and sanctions. A further problem has been a lack of capacity in emerging market countries to develop and maintain bank supervisory and AML/CFT regimes that comply with international standards and best practice.

Any effective solution to the de-risking challenge needs to adopt a multi-pronged approach to address various aspects of the problem. The multiple factors involved, combined with the fact that no one party is responsible for all of them, have complicated the development of a solution. A multi-faceted approach should focus concurrently on 1) seeking clarification from U.S. policymakers and financial regulators regarding the substance and intent of relevant regulatory policies; 2) encouraging large international banks to weigh more carefully, and in a broader context, the social consequences of their correspondent account decisions; 3) capacity-building in the emerging market countries themselves; 4) developing new institutions and/or consortia to facilitate international payments flows; and 5) pursuing new financial technologies (fintech) that may reduce emerging market countries' reliance on correspondent bank accounts. A brief elaboration of each of these components is offered here, in the hope that this will generate further discussion.

1. <u>Actions by U.S. Policymakers and Regulators</u>

With regard to U.S. regulatory actions, any path forward must factor in the commitment of the U.S. government to maintaining strong AML/CFT regimes, its legal authority and capacity to impose financial sanctions (at least in certain circumstances), and its established policy of taking strong actions against financial institutions that willfully or egregiously violate the law. That said, there appears to be a gap between what U.S. and other regulators intend and the way large international banks perceive those intentions. The August 2016 Joint Fact Sheet issued by the U.S. Treasury and federal banking agencies on foreign correspondent banking sought to address this misunderstanding. The Fact Sheet noted, for example, that "the vast majority (about 95 percent) of…compliance deficiencies identified by the [federal banking agencies, U.S. Treasury Financial Crimes Enforcement Network (FinCEN) and Office of Foreign Assets Control (OFAC)] are corrected by the institution's management without the need for any enforcement action or penalty." However, the managements of many large banks, and perhaps more importantly their compliance officers, do not appear to accept the veracity of such official statements. Moreover, actions speak louder than words, even written words.

It is possible that some bank examiners send a different, and tougher, message to the banks they supervise. As the CEO of one large American bank recently observed to an FSVC team, "We believe the policy of U.S. regulators is zero tolerance." Further efforts to address the de-risking challenge should engage the U.S. Treasury, federal banking regulators, and other official agencies such as the U.S. Justice Department and New York State Department of Financial Services to seek agreement on a common policy position that would encourage the maintenance of correspondent banking activities. At a minimum, the need exists for these agencies to clarify further their intentions, including their level of tolerance for minor and unintended AML/CFT regulatory violations.

A number of specific supervisory actions might help address the de-risking challenge. The supervisory concept of "proportionality", for example, may facilitate a way forward in crafting a more accommodating approach to the oversight of correspondent banking accounts that meet certain requirements. Financial regulatory agencies need to ensure that examiners understand the risk-based framework and principles that ought to govern the supervision of correspondent accounts. Proportionality is also not just a supervisory concept. It is a foundational concept embedded in the rule of law, one relevant as well to the penalties that

U.S. regulators levy against large banks for compliance violations. Regulators have often argued that penalties should be proportionate to volumes or revenue. But a strong case could also be made that penalties should be proportionate to harm caused or profits earned.

In addition, financial institutions could be encouraged in certain instances to share information among themselves about suspicious account activities, thereby strengthening the banks' AML/CFT regimes while reducing costly duplicative compliance efforts. And banks should not be held accountable for knowing in detail the business of their customers' customers, an approach which effectively makes banks the regulators of businesses far beyond their own. Many large banks are operating as if regulators do hold them accountable for the misdeeds of their customers' customers, and this has further impeded the banks' willingness to engage in correspondent activities with emerging market countries.

2. Actions by Large Banks

Large and medium-sized international banks should be encouraged to review once again their correspondent banking policies, in coordination with their regulators and perhaps the IMF. While regulators will be understandably loath to intervene in decisions by banks regarding their choice of customers, the social and economic impact of banks' international correspondent account decisions can be enormous as well as highly detrimental. There is anecdotal evidence that the analytical basis for these decisions is not consistently rigorous or thorough. FSVC knows of one case, for example, where staff at a large international bank informed a major Hawaiian bank that it might lose its correspondent accounts because it was based "on an island in the Pacific." In addition, notices received by respondent banks terminating their correspondent relationships rarely give reasons or indicate what remedial actions might lead to a restoration of accounts. At a minimum, the IMF and regulators should encourage large international banks to give respondent banks a more detailed explanation when account relationships are terminated, as well as some indication of steps that could be taken to restore those relationships over time.

3. Capacity-Building in Emerging Market Countries

Emerging market countries must engage in AML/CFT capacity-building in order to strengthen their own international credibility. Respondent banks in these countries must demonstrate that they have effective customer due diligence processes and procedures that meet international standards. Local regulatory authorities must similarly demonstrate that they are effectively supervising the financial institutions within their jurisdictions, applying risk-based principles and meeting international standards. The Financial Action Task Force (FATF) conducts peer reviews of each member country to assess compliance with FATF Recommendations and the effectiveness of its AML/CFT systems. These periodic reviews, the results of which are made public, provide a mechanism for certifying emerging market countries' progress toward meeting international AML/CFT standards. If a country has achieved a satisfactory level of AML/CFT effectiveness, and that achievement is documented in a periodic

FATF Mutual Evaluation, this process might be harnessed to help that country maintain its international correspondent banking linkages.

4. Developing New Institutions

International efforts should concurrently focus on developing new channels for facilitating trade transactions, remittance flows and other international payments to and from fragile emerging market countries. One possibility is the development of a new "class" of international commercial bank that would engage in correspondent financial activities with emerging market countries as a core business. There is evidence that a small number of banks based in Europe are already developing this capability, and that the correspondent business is potentially profitable for them. Banks in this class would need to maintain strong relationships with larger international banks that can provide dollar clearing, but the latter institutions might be much more willing to deal with a reputable, well-regulated institution in a major jurisdiction than with a small respondent bank in a remote, little understood location. In some regions of the world, such as the Pacific Islands, Sub-Saharan Africa, parts of Asia or the Caribbean, a regional payments clearing house might be able to play an important role in strengthening correspondent bank linkages. Such a clearing house, provided it met international standards for customer due diligence, might ease larger international banks' concerns about counterparty risk. International regulators or other authorities might also provide some sort of accreditation to a regional clearing house, making it easier for large international banks to engage in correspondent transactions with them.

5. Fintech

Last but not least, new financial technologies offer a potential major channel for addressing the de-risking challenge. Blockchain, or distributed ledger technology, may offer new means of facilitating remittance flows, trade-related payments and other funds transfers to and from emerging market countries in a traceable, cost-effective way, and without the need for correspondent bank accounts. Digital currencies, using blockchain technology, may offer innovative possibilities as well. Mobile payments, which rely on widely-available cell phone technology and networks, may provide another avenue for transferring funds internationally with minimal reliance on correspondent banking relationships. Other new technologies could potentially provide attractive alternatives to credit cards and more traditional international funds transfer networks such as SWIFT. All of these digital technologies pose risks as well as opportunities to users, and only the mobile payments model benefits in many countries at present from a basic supervisory framework with agreed general rules and principles. Much more work needs to be done in this area, focused on identifying the most viable, cost-effective funds transfer mechanisms and a supervisory framework for overseeing their use. It remains unclear how long this work will take, but policymakers and financial regulators should give it high priority and seek early implementation of results.

In conclusion, an important focus must now be on identifying near-term solutions to de-risking that can facilitate reliable, cost-effective funds transfers to/from countries facing the specter of losing their correspondent banking linkages to the rest of the world. A more vigorous dialogue is needed among key agencies of the U.S. government, U.S. federal and other financial regulators, large international banks and respondent banks in the affected countries. Capacity-building in the emerging market countries themselves, aimed at strengthening bank supervision and private sector AML/CFT compliance, is another essential component of any effective solution. Greater international attention and resources need to be focused on this global problem. Given the IMF's expertise on these issues as well as its international credibility, there may be no institution with a more powerful "bully pulpit" for seeking to promote workable solutions to the de-risking challenge. While the IMF has done much already, much more needs to be done. This note is intended to facilitate further discussion and action.