Wilson Center
CANADA INSTITUTE

January 2018

DE-RISKING OF CORRESPONDENT BANKING RELATIONSHIPS: THREATS, CHALLENGES AND OPPORTUNITIES

By: James A. Haley[1]

Introduction

Many countries are threatened by the potential loss of their connection to the global financial system as large international banks terminate long-standing relationships and close correspondent accounts.[2] This de-risking phenomenon reflects several factors and has potential far-reaching consequences. Some of these effects are of obvious importance to the countries affected; others could have adverse consequences on shared goals, including financial inclusion, the pursuit of broad development objectives, and efforts to safeguard the integrity of the international payments system and financial stability generally.

This note provides an overview of the causes and potential consequence of de-risking as well as possible approaches that could be pursued to mitigate its effects. It also identifies key stakeholders who can assist in the resolution of the problem. Bringing these actors together to mobilize concerted action could be a useful first step towards resolving the problem. Such efforts are justified by the fact that de-risking poses a threat both to the individual countries adversely affected by it and to the wider international community. Given these potential costs, there is a clear public policy rationale for coordinated efforts to address the challenges de-risking poses.

---

[1] Canada Institute Global Fellow, Woodrow Wilson International Center for Scholars, Washington, D.C. Helpful comments from Antoine Brunelle-Côté, Gustavo De Rosa, Ian MacDonald, Mat Shannon and José Luis Stern are gratefully acknowledged. The author thanks participants at an informal Chatham House rule discussion of de-risking hosted by the Canada Institute of the Wilson Center, June 27, 2017, and Paul Jenkins for allowing him to draw on unpublished research. Acknowledgment and thanks to Roberto de Michele (Inter American Development Bank) for assistance. The views expressed are those of the author and should not be attributed to the Wilson Center. For further information, please contact the author at James.Haley@wilsoncenter.org or Laura Dawson, Director of the Canada Institute, Laura.Dawson@wilsoncenter.org.

[2] The Committee on Payment and Market Infrastructure (CPMI) at the Bank for International Settlements quotes a 2003 CPMI glossary, which defines correspondent banking as "an arrangement under which one bank (correspondent) holds deposits owned by other banks (respondents) and provides payment and other services to those respondent banks" (2016).

Characteristics of De-risking

De-risking may take many forms; not all need be present simultaneously. Three elements are particularly problematic:

First, the *closure of (or refusal to open) bank accounts* for certain individuals and firms, and other restrictions on access to financial services;[3]

Second, the *withdrawal or restriction of banking services from money transfer organizations* (MTOs) and other remittances facilities; and

Third, the *severing of correspondent banking relationships* (CBRs), which can entail the loss of access to the international payments clearing system.

The first element of de-risking is largely borne by individuals. To the extent domestic banks can provide services for non-cross-border transactions, the costs are largely in terms of limiting financial integration. The loss of remittance services, meanwhile, is particularly damaging to poorer countries heavily dependent on such flows, and has the potential to set back efforts to reduce poverty and meet key development goals. The third manifestation of de-risking—loss of CBRs—is potentially highly destructive as it entails possible systemic effects within the affected economy and could lead to a less efficient international payments system.[4]

Extent of the problem

The causes and extent of de-risking have been assessed by the international financial institutions (IFIs).[5] These reports indicate that the problem is global in nature, but that countries highly-dependent on remittance payments and small countries with low cross-border transaction volumes are at most risk. Among regions, the Latin America and the Caribbean (LAC) region appears to be the hardest hit. The situation is particularly severe for jurisdictions with offshore financial centers and those perceived at greatest risk of non-compliance with anti-money laundering (AML) and combatting the financing of terrorism (CFT) regulations.[6] It should be noted in this regard, however, that even smaller jurisdictions that are highly compliant with AML/CFT regulations may be at risk of de-risking because of the low volume/low margin of transactions.

---

[3] Some studies refer to this problem as "de-banking." See, for example, CGD, 2015, *Unintended Consequences of Anti-Mony Laundering Polocies on Poor Countries.*

[4] Christine Lagarde (2016), Managing Director of the International Monetary Fund (IMF), notes: "Correspondent banking is like the blood that delivers nutrients to different parts of the body. It is core to the business of 3,700 banking groups in 200 countries."

[5] The World Bank published two surveys *Withdrawal from Correspondent Banking—Where, Why and What to Do About It* and *Report on the G20 Surveys on De-risking Activities in the Remittance Market*, both in November 2015. The IMF published a staff discussion note, " The Withdrawal of Correspondent Banking Relationships: A Case for Policy Action" in June 2016. Meanwhile, the Caribbean Development Bank has focused on the effects of de-risking on Caribbean countries (Boyce and Kendall 2016).

[6] That said, some communities in the U.S. southwest have reportedly lost access to financial services as local banks tainted by deposit inflows of unknown provenance are "de-risked."

Costs and unintended consequences

In the first instance, the effects of de-risking are economic. For countries that are heavily reliant on trade, the loss of CBRs could have significant direct costs. These costs include lower exports and imports as bank customers are unable to send or receive foreign payments and maintain business relationships with foreign customers and suppliers. These direct effects have indirect costs, however, as domestic businesses lose revenues and experience difficulties servicing bank loans. Weakened banks are less able to provide loans and other financial services meanwhile, which would have a negative impact on growth. Moreover, a domestic banking system that is less effective in servicing clients could represent a significant deterrent to foreign direct investment (FDI). The loss of FDI can seriously impair growth prospects in these countries through several channels.[7]

For countries dependent on remittances the loss of MTO services can be particularly debilitating (CDG 2015). Higher costs for transferring money have a direct impact on the poorest households for whom remittances are a critical source of income. This effect can setback efforts to alleviate poverty. At the same time, de-risking resulting in the loss of remittances can have serious unintended consequences, including driving licit transactions into the shadows, possibly making it more difficult to achieve AML and CFT goals, and setting back development objectives by the loss of remittances. One expert, in testimony before Congress, argued: "From a national security perspective, current AML/CFT policies may be self-defeating to the extent that they catalyze finance moving from the formal financial system to more opaque parts of the system" (Lowery 2016).

The withdrawal of international banks from markets reduces the quality of information available to law enforcement. Moreover, the larger that informal mechanisms for facilitating financial transactions become, the easier it would be to hide criminal or terrorist activities in the "shadows." This effect creates the possibility of pathways opening in jurisdictions subject to de-risking through which illicit transactions are transmitted. While financial flows from criminal networks likely account for the bulk of transactions, potential threats to national security from such pathways should not be discounted. In this regard, the report of the Task Force to Investigate Terrorism Financing, Committee of Financial Services, and the U.S. House of Representatives (2016) notes a disturbing increase in the activities of deemed terrorist organizations in Latin America, particularly Venezuela. This finding underscores the fact that de-risking has broader implications. These threats are not limited to source jurisdictions. Neighbouring countries, which may likewise be subject to de-risking, may be exposed to increased levels of illicit activity; as noted above, Caribbean countries are among the countries

[7] FDI can be an important source of new technology as well as capital. As a result, lower FDI could have a serious long-term, dynamic cost. In addition, for many small jurisdictions facing the greatest threat of de-risking, increased financial and trade autarky would impose a dynamic cost through reduced competition and increased "rent-seeking" behaviors. For these countries, the competition provided by potential imports may serve as a useful check on monopoly pricing and as a source of growth. Haley (2017) discusses the costs of de-risking in more detail and examines the underlying economics of the problem.

most-severely affected by the threat of de-risking.

De-risking is still an emerging issue and more time must pass before reliable estimates of these costs are available. Nevertheless, in cases in which there is a complete loss of banking relationships, the impact would be severe. Where there is a partial loss of CBRs, foreign correspondent banks may impose higher costs on local respondent banks to keep accounts active. Such costs could include minimum activity thresholds and the passing on of the higher costs of AML/CFT due diligence (IMF 2016b). The Fund staff has provided hypothetical estimates of such costs using scenario analysis (see box below).

IMF Scenario Analysis

Belize has been particularly affected by the loss of CBRs. Only two banks, representing roughly a quarter of the banking system's assets, of nine domestic and international banks that had CBRs have managed to retain at least one CBR with full banking services. In view of the systemic nature of the problem, the IMF's 2016 Article IV consultation for Belize evaluated a hypothetical "high risk" scenario in which 30 percent of affected transactions find workarounds (IMF 2016b). While the results of this analysis are only illustrative, the effects are striking. In this scenario, real GDP drops by 5-6 percentage points annually over the 2016 to 2021 period. The value of annual exports of bank customers drops by about 23-25 percentage points of GDP, and the value of annual imports by 25-28 percentage points of GDP during the same period. Annual FDIs drop by about 2-3 percentage points of GDP and the banking system's capital adequacy ratio falls by close to 9 percentage points.

At the same time, the costs of de-risking are not limited to cases in which CBRs have been withdrawn. The potential loss of access to the international payments system associated with increased regulatory risk can have indirect costs. A recent working paper by Collin, Cook and Soramäki (2016) that examines this effect concludes that countries on an internationally-recognized list of high-risk jurisdictions face a 10 percent decline in the number of cross-border payments received from other jurisdictions. It is not surprising therefore that, given its prominence, the Financial Action Task Force (FATF) list of jurisdictions under review has been a matter of considerable concern to affected countries.[8]

Causes

De-risking reflects several factors, including increased capital requirements for global banks following the global financial crisis, heightened standards for anti-money laundering, countering the financing of terrorism and efforts to increase the transparency of tax regimes; the small size of many affected jurisdictions (and correspondingly low-return product lines) is also a driver.

[8] A critical concern voiced by affected jurisdictions is that, in the past, countries have been identified as being non-compliant with international standards without the opportunity to present their case, contrary to the precepts of natural justice.

Cost Drivers

Higher post-crisis bank capital requirements have a direct effect. This is because capital must be allocated over different risks—credit, market and operational. *Credit risk* is the potential loss the bank incurs from borrowers failing to repay their loan commitments on time and in full. *Market risk* arises when asset prices, interest rates and exchange rates move in a manner that adversely affects the bank's balance sheet. *Operational risk* reflects potential losses from myriad causes; these can include information and technology problems (i.e., "hacking"), reputation loss, or litigation costs.

Capital allocation decisions with respect to operational risk are typically based on simple rules of thumb. These heuristics reflect the difficulty of accurately assessing such "lumpy" risks and the desire to avoid falling into the pitfall of false precision. While that approach makes intuitive sense if operational risks are relatively small, unrelated to other variables, and difficult to anticipate, these conditions might not hold with respect to operational risks associated with de-risking. Recent widely cited fines and other financial penalties imposed on large international banks for non-compliance with various AML/CFT requirements have undoubtedly influenced de-risking (table 1).[9]

Table 1. Selected fines and other penalties for AML/CFT non-compliance

Bank	($ billions)	Date
HSBC	1.9	December 2012
J.P. Morgan Chase	1.7	January 2014
BNP Paribas	8.9	July 2014
Commerzbank	1.5	March 2015

Sources: Author, compiled from media reports

Meanwhile, the costs of complying with AML/CFT legal requirements have grown significantly over the past decade, with regulatory and compliance expenses in the billions of dollars annually (Noonan 2015). One industry group estimates governance, risk and compliance (GRC) costs now account for between 15 and 20 percent of operating expenses (Memminger et al. 2016). Particularly onerous is the Suspicious Activity Report (SAR), which requires banks and other businesses handling money to flag any questionable transaction of $5,000 or more by identifying the parties in a report submitted to the U.S. Treasury Department's Financial Crimes Enforcement Network (FinCEN).

Compliance costs are additionally increased by uncertainty with respect to some regulatory expectations, which may lead to an unintended over-investment in reporting activities to minimize legal risks but do not serve a useful purpose. A recent report issued by The Clearing House (2017), a trade association of large banks, notes:

> *"The largest firms collectively spend billions of dollars each year…Yet the conclusion of the vast majority of participants in the process is that many if not most of the*

---

[9] See CGD (2015) for more information on the evolution of fines and penalties resulting from prosecutions for AML/CFT non-compliance in the U.S. and the U.K.

resources devoted to AML/CFT by the financial sector have limited law enforcement or national security benefit, and in some cases cause collateral damage to other vital U.S. interests – everything from U.S. strategic influence in developing markets to financial inclusion."[10]

Such effects are magnified with respect to transactions originating in jurisdictions with weak AML/CFT and other regulatory compliance regimes and with smaller, less well capitalized banks that may lack the resources to establish and maintain compliance protocols to FATF-sanctioned standards.

Customer due diligence requirements are viewed as particularly problematic. In May 2016 FinCEN issued regulations strengthening rules regarding customer due diligence which required banks to identify and verify the beneficial owners of legal entity customers. Prior to these requirements, banks in the U.S. were not required to know the identity of beneficial owners that own or control their legal entity customers. Under the strengthened rules, banks are now required to collect and verify identification documentation for beneficial owners of legal entity customers.[11] FinCEN guidance indicates that it is the responsibility of the legal entity customer to identify its ultimate beneficial owners, and that the bank may rely on that information unless there is reason to question its accuracy.

Nevertheless, financial institutions questioned whether they could rely on the information provided by the legal entity customer and these concerns have led to questions regarding the appropriate standard banks should adopt.[12]

Information asymmetries

Analytically, the de-risking problem is exacerbated by potential information asymmetries that impede efficient decision-making. From the perspective of international banks providing CBRs, the challenge is to distinguish between respondent banks that pose significant operational risks and those that do not. Their efforts are hampered by the fact that they do not directly observe the transactions conducted by respondent banks. Faced with the threat of large fines and uncertain regulatory expectations, international banks may treat all banks in a

---

[10] See The Clearning House report, *A New Paradigm: Redesigning the U.S. AML/CFT Framework to Protect National Security and Aid Law Enforcement*, February 2017.

[11] The most significant change is that banks must establish protocols designed to identify and verify beneficial ownership of new accounts on or after May 11, 2018.

[12] The issue with respect to CBRs is whether banks should apply the "know-your-customer" (KYC) rule or, in view of the uncertainty associated with the compliance regime, the "know-your-customer's-customer" (KYCC) standard.

jurisdiction as potential source of risk and terminate their relationships with them.[13] In some jurisdictions facing the loss of CBRs, this problem could be aggravated by legal impediments to sharing information under bank secrecy laws. Some international banks argue they cannot carry out adequate due diligence of their foreign respondent banks given prohibitions in local regulations to the sharing of information among financial institutions.

Putting these various elements together, it should be clear that in evaluating capital allocation decisions banks will balance the expected returns from a business line against the potential costs. This suggests that, from a purely business perspective, smaller jurisdictions entail higher costs which disadvantages them relative to larger countries: With a fixed cost of maintaining a business relationship with a particular jurisdiction (reflecting monitoring and reporting costs) and a smaller market (fewer transactions), the average cost of maintaining the business line will be higher in smaller countries. To this effect, add the expected cost of fines and other financial penalties, which on an expected value basis may be higher given weaknesses in monitoring and regulatory compliance regimes.

Possible mitigation

As de-risking entails costs to the individual countries directly affected and to the wider international community, efforts to mitigate its effects must involve a range of stakeholders. The underlying goal is to identify effective measures to mitigate costs and avoid unintended consequences. This is a formidable assignment. Fortunately, a consensus already exists that de-risking is a shared problem, and that there is a shared responsibility to respond to its challenges.[14] And while work remains to be done to develop concrete proposals, important progress has already been achieved.

Going forward, meeting the challenge will require a focus on technology to reduce compliance costs. The development of KYC and legal entity identifier database platforms that facilitate compliance is a starting point. Such utilities could be jointly owned and shared, analogous to the SWIFT payments-clearing system. And, already, private sector suppliers are filling the void.[15] But development of effective information-sharing platforms would not guarantee success. An environment that allows technology to be used most effectively must be fostered through better coordination and collective policy-making. Creating such conditions requires

---

[13] This situation is analogous to the "market for lemons" problem (Ackerloff 1970). More generally, Rothschild and Stiglitz (1976) demonstrated that the inability to discriminate based on unobserved qualitative differences can lead to a pooling equilibrium and a possible market failure. The challenge in such circumstances is to design a contract that incentivizes individuals to reveal the hidden information, resulting in a separating equilibrium in which the resulting prices reflect differences in quality.

[14] The International Monetary and Finance Committee (2016) notes: "We support the IMF's work with other international organizations to address the decline in correspondent banking relationships and preserve access to financial services. This would include intensifying AML/CFT and supervisory capacity development support in respondent banks' jurisdictions, clarifying regulatory expectations, and promoting industry solutions; promoting greater financial inclusion; and helping countries strengthen their institutions to tackle illicit financial flows."

[15] Thomson Reuters, for example, is marketing a proprietary transactions monitoring utility.

work to overcome the complexities associated with different regulatory regimes, data privacy provisions, and determining beneficial ownership. These efforts can be divided into those undertaken by the countries directly implicated in de-risking and measures that the international community can adopt to maintain the integrity of the global financial system and the efficiency of international capital markets.

Affected jurisdictions

Primary responsibility for better coordination and collective policy-making lies with the countries affected. Their interests are most at stake and they have the most to gain from the successful mitigation of de-risking. Efforts to strengthen their AML/CFT regimes would have a direct effect on the de-risking problem. Beyond such targeted measures, a menu of actions national authorities could pursue should address two key issues:

- The small size of fragmented banking markets which results in higher costs spread over fewer transactions and banks of lower profitability;[16]

- The problem of information asymmetries, which raises the costs of compliance with international standards and distorts decision-making on the part of correspondent banks.

Addressing these issues may require measures that affect sensitive areas and raise potential political concerns, particularly where possible efforts to mitigate de-risking impinge on sovereign decision-making. Accordingly, the suggestions below are not offered as fully articulated policy proposals, but as potential options for consideration intended to stimulate further discussion. Some undoubtedly must be tailored to fit individual country circumstances; others may be discarded as unworkable.

Dealing with the small size of fragmented banking markets is perhaps the most difficult task. Given its role in the efficient intermediation of savings into investment and supporting the payments system, every country seeks to retain control over its own banking system. But for small states, particularly those heavily dependent on a few key industries, this may result in banking systems that are insufficiently diversified and too small to achieve efficient cost economies. Reducing the number of banks licenced in a particular jurisdiction could help in terms of achieving minimum optimal scale of operations, but only by incurring higher welfare

[16] Less-profitable banks may lack the resources to invest in the data-processing technology needed to reduce the costs of compliance with AML and CFT requirements. At the same time, banks operating with very low profit margins may be incentivized to exercise less rigor in evaluating transactions that entail greater risk of non-compliance. While it would be necessary to balance the efficiency losses from reduced competition on price and volume of services, a regulatory regime that targets some modicum of monopoly profits through consolidation and entry might advance the goal system stability and provide benefits in terms of an increased range of financial services; the threat of losing potential monopoly profits would enhance the efficacy of the regulatory framework. Calomieris and Haber (2014) discuss the relationship between profitability and systemic stability.

costs as competition is curtailed.[17] The question is how to achieve a felicitous trade-off between the need for size and competition.

One way to achieve such a balance is to enlarge the size of the banking market by joining with neighbouring jurisdictions to encourage a regional banking market. Driven by the potential risks posed by de-risking, members of the Eastern Caribbean Currency Union (ECCU) are promoting the consolidation of banks within their countries. The objective is to achieve the minimum operating scale to make investments in technology profitable. While this process is obviously facilitated by membership in the ECCU, which increases the return of enhanced coordination of financial policies under a banking union, membership in a currency union is not a necessary condition for the enlargement of banking markets.

Introducing a system of regulatory "passports" under which banks licensed in one jurisdiction would be permitted to operate in other jurisdictions that recognize the regulatory regime might suffice. This would require a significant degree of cooperation among countries that agree to mutually-recognize the regulatory regimes of the others. Moreover, this regime would still entail inefficiencies in that the outcome might be the same number of regulatory/supervisory bodies each regulating fewer banks; to the extent that the costs of regulation are levied on the regulated banks, the result may be higher regulatory costs that defeats the purpose of the initiative. A more effective approach might be to harmonize regulatory regimes around a single regulatory body. This presents a significant political challenge.[18]

Still to be assessed is the question of how technological developments that allow for on-line payments ("Fintech") might be mobilized to replace banking relationships lost to de-risking. While such technologies offer an alluring means to mitigate losses, there are many challenges that must be addressed before new technologies can be considered a viable solution. Two issues stand out. First, the regulatory regime for Fintech is nascent; there is enormous work to be done before regulatory regimes are established that balance the need for financial stability and consumer protection with the provision of services.[19] Second, by potentially facilitating transactions outside formal banking systems, Fintech could exacerbate unintended consequences of facilitating illicit transactions.

---

[17] One "solution" might be to limit the number of banks to one, enforcing tight controls over prices and services to reduce welfare losses analogous to a regulated public utility. This approach is very likely unworkable, however, since the regulated public utility would be very effective in lobbying governments to relax controls; or would have little incentive to be efficient, allowing costs to rise without effective controls.

[18] One challenge that would have to be addressed is the effects of consolidation on banks that are forced to "exit." The outcome of the process would be fewer, stronger banks and the failure of weaker, less-well-managed banks. In this regard, a political economy dynamic would be set in motion in which weaker banks seek protection through government intervention. This underscores the need for a transparent regulatory framework administered by a quasi-independent supervisory authority.

[19] In December 2016, the U.S. Office of the Comptroller of the Currency issued a background paper for discussion on special purpose charters for Fintech companies.

Addressing the problem of information asymmetries is, conceptually at least, much easier, but no less challenging. The goal is to reduce the costs of adhering to the KYC standard. Here, too, smaller states face higher hurdles because of diseconomies of scale in adapting KYC technologies to individual jurisdictions. But such obstacles are not insurmountable. A plan to bridge the informational divide between correspondent and responding banks would entail two elements:

First, the *coordination and standardization of regulatory requirements* across different jurisdictions, both within the region (where a bank may be operating in any number of countries, as above) and with key countries promulgating international AML/CFT standards; such efforts would include a common standard on customer identification and definition of beneficial ownership;[20]

Second, adopting or revising legal frameworks on data privacy that are transparent and consistent with the goals of AML/CFT.

The second of these two elements is likely to prove particularly contentious, particularly as, in the past, some jurisdictions have been, in their view, unfairly labelled as promoting opacity in order to facilitate tax avoidance. However, to the extent that is not the case, the remedy is to ensure that international bodies enforcing international tax transparency accurately reflect the nature of their data privy frameworks. The Mexican Secretariat of Finance—the Secretaría de Hacienda y Crédito Público (SHCP)—has developed a simple data-sharing protocol between domestic and foreign banks that could serve as a useful template for other jurisdictions.

The final responsibility of affected jurisdictions is governance. They must ensure that sufficient resources are allocated to their regulatory and supervisory bodies to ensure a high degree of professionalism and that they operate within a framework of constrained independence; as such, there would be a degree of continuity in institutional capacity.

Affected countries have already taken responsibility for mitigation of the adverse effects of de-risking. In their February 2017 meeting, the Heads of Government of the Caribbean Community (CARICOM) "recognized the need for a regional approach and concerted action to address effectively the challenge posed by the de-risking strategies of the global banks which result in the withdrawal of correspondent banking services" and "…the need for continued urgent action to strengthen the integrity of the financial system in CARICOM Members States and to attenuate the perception of the Caribbean as a high risk Region."[21] CARICOM heads also noted the need to strengthen member states' compliance with AML/CFT and tax transparency standards.

---

[20] As publication of the Panama Papers highlights, such standards and definitions must be applied generically to financial transactions, including trust and other agreements effected by law firms, and not just financial services provided by regulated financial institutions.

[21] For example, Prime Minister Browne of Antigua and Barbuda convened a conference on de-risking in October 2016; the subject was also discussed at the Caribbean Forum meeting organized by the Government of Trinidad and Tobago and the IMF in November 2016.

International stakeholders

At the same time, and as noted above, given the potential threats posed to broad development and security objectives, the international community more broadly also has an interest in minimizing the unintended consequences of de-risking. This perspective reflects the public good nature of the global financial system—all members of the international community benefit from the system; all members have a shared responsibility to maintain the integrity of the system.

As the global leader of AML/CFT standard setters, the U.S. has a critical role to play. Until recently it would have been politically infeasible to consider a review of existing U.S. regulations given the overriding importance attached to their underlying objectives. However, the regulatory burden initiative embodied in the executive order signed by President Trump (2017), which requires federal departments and agencies to eliminate two regulations for every new regulation they wish to implement, may provide a political imprimatur for consideration of possible ways to reduce the compliance costs associated with AML/CFT regulations.

A key starting point is to reduce uncertainty surrounding the application and enforcement of AML/CFT regulations. Greater clarity with respect to the compliance expectations would provide a "safe harbour" for banks offering CBRs with foreign entities.[22] Important progress has been made. In August 2016, the U.S. authorities issued a joint fact sheet on foreign correspondent banking with respect to civil and criminal penalties banks could face for noncompliance (Board of Governors of the Federal Reserve System et al.).[23] The fact sheet notes the "vast majority" of cases involving compliance deficiencies were resolved by the institutions' management without the need for any enforcement action or penalty. And, the joint agency statement helpfully stressed that the egregious cases that did result in fines and/or other penalties reflected instances of wilful neglect or disregard of legislative requirements. In October 2016, FATF provided guidance on its code of international "best practice" for compliance. It stressed that the relevant standard for due diligence is KYC; not KYCC. In practical terms, this implies that banks providing CBRs must monitor the respondent institutions to detect changes in risk profile. However, there is no expectation that the correspondent institution must conduct due diligence with respect to the respondent's own customers.

---

[22] New York State regulators have recently moved to provide such clarity with respect to requirements on transactions monitoring and board resolutions on regulatory compliance (3 N.Y.C.R.R. § 504). The guidance specifies the required attributes that an institution's monitoring and filtering of transactions must display. Industry representatives expressed concerns, however, that the proposed measures would lead to costly duplication of and possible confusion with existing federal requirements.

[23] See also Office of the Comptroller of the Currency, 2016, "Risk Management Guidance on Periodic Risk Reevaluation of Foreign Correspondent Banking," which establishes the expectation that decisions to close CBRs on the basis of risk evaluations are based on "analysis of the risks presented by individual foreign financial institutions and the bank's ability to manage those risks."

Such clarifications are useful and welcome. But, by themselves, they are unlikely to resolve the problem of de-risking. This is because, while safe harbors reduce some of the uncertainty associated with providing CBRs, they do not address the issue of costs of compliance. In this respect, a recent Center for Global Development study argued that banks' perceptions of regulatory risk are unlikely to change if those perceptions are driven by the incidence of AML/CFT-related enforcement actions and the rate of enforcement action does not change (CGD 2015).[24] These considerations put smaller jurisdictions at risk; it is these countries that are also most susceptible to the threat of failure and which may, therefore, pose security issues to the broader international community.

More broadly, the question is whether the security and legal objectives of the existing AML/CFT regime can be achieved in a manner that reduces the costs to banks and mitigates the threat of de-risking. As the Clearing House (2017) report cited above notes, the existing system is one in which compliance is assessed primarily by bank examiners whose objective is to limit the bank's exposure to loss or reputational damage by "ensuring that there is rigorous adherence to all written policies and procedures." The result is the inefficient expenditure of resources, generating poor results in terms of the fundamental objectives of preventing criminal or terrorist activities. Moreover, the widely-cited but poorly articulated purpose for AML/CFT regulations of "preserving the integrity of the financial system" has been operationalized as keeping money out of the system, rather than "tracking of money once it is in the financial system and providing financial services to developing nations and underserved U.S. communities." According to the Clearing House report, the misdirected focus of the existing regime has led to de-risking. This view is shared by Sharon Cohen Levin (2016) who argues:

> *"The use of financial intelligence provided by banks might lead one to conclude that the AML regime has achieved some success. But continued success depends upon banks' continuing involvement in markets where money laundering and other financial crimes occur. The current enforcement-heavy approach of the government, however, often discourages banks from this kind of involvement…This punitive approach to enforcement has made banks risk averse, causing them to close accounts and exit relationships that would otherwise be profitable, provide financial intelligence for law enforcement, or serve a social good. To protect themselves from penalties and in response to the high cost of compliance, banks are de-risking."*

One particularly pernicious effect of the status quo is that financial institutions do not have an incentive to adopt innovative techniques or practices that might enhance the quality of information needed by law enforcement officials. Meanwhile, approaches to potential efficiencies are barred by barriers to the sharing of information between institution and law

---

[24] The CGD report notes that the rate of AML-related enforcement actions and fines did not substantially abate following earlier clarifications of regulatory policy. The key analytical point is that *uncertainty* over the prospect of future fines may be affecting bank behavior, despite clarifying statements from regulators.

enforcement.[25] In addition, options for reducing costs through the collective provision of monitoring and other activities would free up resources for more sophisticated analysis of data that would better promote the fundamental goals of AML/CFT. Given these considerations, it would be helpful to identify areas in which new technologies in data collection, analysis and sharing could mitigate the risk of de-risking.

Possible measures to reduce AML/CFT compliance costs are identified in table 2. These proposals reflect the recommendations made by the banking sector, the international community, as well as a working group established by a leading development think tank to assess the impact of de-risking on key development objectives.

While some progress has been made, or can be expected with proposed legislative changes, there are two areas in which more can be done. The first area is in use of technology. Efforts to promote the use of KYC utilities, the adoption of Legal Entity Identifiers, and the creation of a public utility that allows institutions to share information for analysis with, for example, FinCEN could be explored, subject to appropriate privacy safeguards.[26]

---

[25] Legislation was introduced to address this problem in the 114th Congress; it is expected that it will be re-introduced in the 115th session. See Anti- Terrorism Information Sharing is Strength Act, H.R. 5606, 114th Cong. (2016).

[26] As Klein (2017) argues, however, effective enforcement of U.S. AML/CFT regulations is handicapped by state laws permitting the incorporation of anonymous shell entities that are not required to provide information regarding beneficial ownership. Such entities may account for the FATF December 2016 evaluation report which cited the U.S. as "non-compliant" with recommendations pertaining to access to "adequate, accurate and updated information on beneficial ownership."

Table 2. Possible measures to reduce AML/CFT compliance costs†

Challenge/Problem	Measure	Status
Absence of prioritization and clarification of regulatory expectations	1) Address disconnects between information collected on the basis of SARs requirements and actionable prosecutions. 2) Clarification of due diligence with respect to KYCC.	1) Unclear. 2)Progress made.
Barriers to information sharing	1) Provide safe harbor for the sharing of information by changing Section 314(b) of the U.S. Patriot Act to allow financial institutions to fill in missing "gaps" on AML/CFT risk profiles. 2) Allow U.S. depository institutions to share SARs with foreign branches or affiliates in FATF member countries. 3) Promote the use of KYC utilities by respondent and correspondent banks, with standardized minimum set of information and data.	1) Draft legislation H.R. 5606 introduced in 114th Congress; expected to be reintroduced. 2) See above. 3) Unclear.
More efficient information gathering and minitoring	1) Information on beneficial ownership recorded at time of incorporation and whenever such information changes. Protocols for sharing information with financial institutions. 2) Adopt Legal Entity Identifier in correspondent banking.	1) Draft legislation H.R. 4450 introduced in 114th Congress; expected to be reintroduced. 2) Unclear.
Centralization of data evaluation	1) Utility allowing banks to share bulk data (with privacy safeguards) for analysis.	1) Evolution of technology allows for the evaluation of big data by central agency.

Sources: Haley 2017 based on The Clearing House 2017, CPMI 2016, and CDG 2015.

Work could also be undertaken to coordinate and prioritize the myriad regulations across the different agencies responsible for AML/CFT reporting requirements. This may be an especially useful exercise in the U.S., where there are 31 different public and private agencies involved in the monitoring and enforcement of AML/CFT provisions (table 3). And, while not all of these agencies are directly responsible for the implementation of compliance requirements, given the number of players involved, there may be scope for possible changes to the regulatory framework that simultaneously better promote the fundamental national security and legal objectives and reduce compliance costs.[27] A possible starting point would be to compile a comprehensive concordance of existing regulations enforced by the various agencies to identify how the underlying purpose of the regulation could be severed at lower cost by improved coordination and reduced overlap. Judged by recent efforts to address the costs of compliance, it is clear that the banking industry hopes to achieve significant changes to the existing regime. And, while it is too early to assess the likely effectiveness of the range of proposals that have been advanced, the current Congress and administration is open to considering reforms. Presumably, a key selling point of such efforts is their resonance with the president's initiative to reduce regulatory burdens.

Any regulatory change in the U.S. AML/CFT regime would have important consequences for other jurisdictions. And, given that its financial system is highly integrated with that of the U.S., Canada is especially implicated. Canadian banks are also major players in Latin America and the Caribbean, which as noted above has become a region of greater interest to U.S. national security officials. There is an incentive, therefore, for Canadian banks whose franchise value may be potentially affected by de-risking to work closely with Canadian and U.S. officials on efforts to meet the twin goals of mitigating the threat of de-risking and promoting the objectives of AML/CFT safeguards.[28]

International Institutions

Other global players also have an interest; these partners include the IFIs, the Financial Stability Board (FSB), the FATF, and the Basel Committee on Banking Supervision (BCBS). Here, too, progress has been made. The IMF has identified de-risking as a key priority, consistent with its mandate to promote international financial stability and as its role in helping to facilitate orderly international trade and payments. In this regard, the Fund staff have provided key analytical support to members grappling with the consequences of de-risking and senior officials have used the convening power of the IMF to bring interested stakeholders together to identify possible solutions. The Managing Director and senior officials, meanwhile, have used their offices to mobilize international efforts. As discussed above, the World Bank has already conducted surveys of the problem and is collaborating with other institutions and with the G20 on the issue. The Caribbean Development Bank approved a $250,000 pilot program

[27] An issue of concern is the extent to which possible inconsistencies between provisions increase compliance costs and unintentionally undermine the integrity of the financial system.

[28] Canada represents English-speaking Caribbean members of the IMF and World Bank.

Table 3. U.S. regulatory agencies of relevance for AML/CFT enforcement

Federal banking regulators
The Board of Governors of the Federal Reserve System (FRB)
The Federal Deposit Insurance Corporation (FDIC)
The Office of the Comptroller of the Currency (OCC)
The National Credit Union Administration (NCUA)
Nonbanking regulatory agencies
Securities and Exchange Commission (SEC)
Commodity Futures Trading Commission (CFTC)
Financial Industry Regulatory Authority (FINRA)
Consumer Financial Protection Bureau (CFPB)
National Futures Association (NFA)
New York Stock Exchange (NYSE)
National Indian Gaming Commission (NIGC)
IRS Tax Exempt and Government Entities Division (IRS-TEGE)
IRS Small Business and Self-Employment Division (IRS-SBSE)
Law Enforcement Agencies
Federal Bureau of Investigation (FBI)
Drug Enforcement Administration (DEA)
Department of Homeland Security, Immigration and Customs Enforcement (ICE)
Department of Homeland Security, Customs and Border Protection (CBP)
Internal Revenue Service Criminal Investigation (IRS-CI)

Table continued on next page...

US Department of the Treasury

Office of Terrorism and Financial Intelligence (TFI)

Office of Terrorist Financing and Financial Crime (TFFC)

Office of Intelligence and Analysis (OIA-T)

Financial Crimes Enforcement Network (FinCEN)

Office of Foreign Assets Control (OFAC)

Treasury Executive Office for Asset Forfeiture (TEOAF)

US Department of Justice (DOJ)

Asset Forfeiture and Money Laundering Section, Criminal Division (AFMLS)

Counterterrorism Section, Criminal Division (CTS)

National Drug Intelligence Center (NDIC)

Office of International Affairs, Criminal Division (OIA)

US State Department

Bureau of Economic and Business Affairs (EB)

Bureau of International Narcotics and Law Enforcement Affairs (INL)

State's Office of the Coordinator for Counterterrorism (S/CT)

Source: CDG 2015.

to strengthen implementation of and compliance with international standards, increase the technical capacity of banks and credit unions to conduct customer due diligence, including staff training, and improve public-private sector coordination with regulators. The CDB will partner with the Multilateral Investment Fund of the Inter-American Development Bank and the Office of the Secretary of the Association of Supervisors of Banks of the Americas. Meanwhile, the FSB is following a four-point action plan to assess and address the problem of de-risking and has created a Correspondent Banking Coordination Group to coordinate and sustain efforts on the action plan.[29] The FATF has clarified expectations with respect to due diligence and ancillary information needed to implement a risk-based approach.[30]

---

[29] The action plan includes: (1) examination of implications, including collection of data on scale of withdrawal, its causes and effects; (2) clarification of regulatory expectations, including through guidance by the FATF; (3) expansion of domestic capacity-building in affected jurisdictions; and (4) strengthening tools for customer due diligence by correspondent banks.

[30] Such information requirements include knowledge of the respondent bank's business model, reputation and quality of its supervision, particularly whether it is subject to a money laundering or terrorist financing investigation or regulatory action, and an assessment of its AML/CFT controls.

Shared responsibilities

Given the public good nature of the twin goals of safeguarding the integrity of the global payments system while preserving access to CBRs by smaller jurisdictions and MTOs, there is a clear case for concerted efforts on the part of the international community. Four areas stand out. First, many smaller jurisdictions must build the technical capacity to effectively monitor and enforce AML/CFT standards. This implies a multi-year program of technical assistance and capacity building. The international community can facilitate this knowledge transfer; the IFIs clearly have a role through regional technical assistance programs, but so too do the larger members of the international community that drive international standards. Second, consideration should be given to a multilateral response to the challenges of facilitating the sharing and analysis of information through new utilities. The World Bank, regional development banks as well as national governments and central banks all have a role to play. Third, the international community could evaluate the possible design of insurance or indemnity arrangements that would provide some degree of protection to correspondent banks. Any such arrangement would need to be incentive-compatible, creating incentives for jurisdictions to strengthen AML/CFT regimes to contain risks.[31] Fourth, to the extent that the application of innovative financial technology could be mobilized to support financial inclusion, there is a policy imperative for governments to work closely to establish a sound regulatory framework for new financial-based applications that balances stability and innovation. The need to cooperate on a regulatory framework for Fintech is especially relevant in the context of the potential unintended consequence of driving licit transactions into the shadows.

Conclusions: Shared stakes and a possible approach forward

As a complex issue involving several elements, there is no single solution to the problem of de-risking. That said, analysis of the problem should aid in the identification of a package of concrete, *implementable* actions to mitigate its effects. This note is a preliminary contribution towards that goal. It reviews the extent of the de-risking problem, identifies and evaluates the key drivers, and provides a framework for developing possible measures. The note also

---

[31] The problem of *Knightian uncertainty* may pose an insurmountable obstacle to such contracts. This is because the premium for such protection must reflect the intrinsic uncertainty associated with the expected value of possible fines; these would very likely be sufficiently high as to make insurance unprofitable. Similarly, absent some external support, smaller jurisdictions most threatened by de-risking would lack the financial resources required to make a credible commitment to indemnify a bank successfully prosecuted for AML/CFT noncompliance. At the same time, a moral hazard problem exists; banks with insurance or an indemnity would have reduced incentives to exercise oversight of transactions, increasing the expected costs to insurer or jurisdiction providing the indemnity. Notwithstanding these challenges, however, with support from the international community, it may be possible to structure an intervention that provides an indemnity with strict oversight of AML/CFT and other policy actions to address weaknesses in regulatory frameworks and other areas.

highlights that important progress has already been made.

But more needs to be done. The need for action is particularly acute with respect to smaller jurisdictions that face potentially large negative effects through a loss of tourist or remittance receipts. Such effects would be felt on impact. Yet, as discussed above, there are several adverse consequences of de-risking that could imperil long-term growth. These dynamic effects would be particularly damaging for countries with high debt burdens that have persevered with painful adjustment programs and which now hope to reap the gains of sustainable growth. The unwelcome combination of debt, de-risking and dismal growth could setback development and erode domestic political support for sound policies.

A return of policy heterodoxy would not be helpful either to the countries themselves or to regional partners. Sadly, the inevitable result would likely be increased unemployment and with it higher crime. In this environment, it would be more difficult for the authorities to prevent the corrosive effects from spilling over to neighbours and friends tied by geography and history. Such effects could potentially be extremely harmful if de-risking leads to an expansion of unregulated, unsupervised and hidden pathways for the financing of criminal or terrorist networks as licit transactions are driven into the shadows. This risk should not be minimized.

Table 4. Mitigation measures/action plan for mitigation

	Problem	Measure/Consideration
Affected jurisdictions	Fragmented market	Increase the size of banking markets to reduce operating costs. Consolidation where appropriate and feasible and/or "regulatory passports." Regional regulatory body.
	Information asymmetries	Coordination and standardization of regulatory requirements across jurisdictions. Transparent and consistent legal frameworks on data privacy.
	Loss of MTO facilities	Explore Fintech options under an appropriate regulatory regime in conjunction with remittances source country regulators.
International stakeholders	Regulatory uncertainty	"Safe Harbor" clarification and assurance
	AML/CFT compliance costs	See table 2
International institutions	Threats to international payments system	Insurance/indemnity model with risk-based premiums.
Shared responsibilities		Building and maintaining state of the art compliance regime. Multi-year program of capacity building technical assistance.

Source: Haley (2017).

Given these potential costs, there is a clear public policy rationale for coordinated efforts to mitigate de-risking and preserve the integrity of the international payments system. A program for mitigation is summarized in table 4. The roadmap for action it outlines includes policy actions on the part of all key players. It is encouraging that some of the actions identified, such as clarification of regulatory expectations, are already being implemented.

Going forward, there is a range of measures to mitigate the effects of de-risking. Most important, perhaps, are structural measures to expand the size of banking markets, protocols for the sharing of information and the development of regulatory frameworks for Fintech. These measures also entail the greatest potential encroachment on national policy-making and must be approached with considerable care; addressing them will take time. More immediate returns might be obtained from a detailed analysis of the web of AML/CFT monitoring and reporting requirements. The objective would be to minimize the regulatory burden on financial institutions subject to meeting the national security and criminal enforcement priorities. As the member of the international community with the largest financial system and the leader of AML/CFT standard setters, the U.S. has an interest and responsibility in undertaking such an exercise. The president's Executive Order mandating a review of all the regulatory environment provides a political *imprimatur* and policy rationale.

The U.S. is not alone, however. Today, large global banks operate across a range of jurisdictions, regardless of the country in which they are licensed. An effective strategy for addressing the challenge of de-risking requires the international cooperation. In this regard, the purpose of this note is to solicit comments and suggestions on measures to achieve the key objectives that all members of international community seek—mitigating the threat of de-risking and securing the integrity of the global payments system.

References

Akerlof, George. 1970. "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism." The Quarterly Journal of Economics 84 (3): 488-500.

Anti-terrorism Information Sharing is Strength Act, H.R. 5606, 114th Cong. (2016).

Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, and U.S. Department of the Treasury. 2016. "U.S. Department of the Treasury and Federal Banking Agencies Joint Fact Sheet on Foreign Correspondent Banking: Approach to BSA/AML and OFAC sanctions supervision and enforcement." Office of the Comptroller of the Currency, U.S. Department of the Treasury, August 30.

Boyce, Toussant, and Patrick Kendall. 2016. Decline in Correspondent Banking Relationships: Economic and Social Impact on the Caribbean and Possible Solutions. Caribbean Development Bank, May.

Calomiris, Charles W., and Stephen H. Haber. 2014. Fragile by Design: The Political Origins of Banking Crises and Scarce Credit. Princeton, NJ: Princeton University Press.

CARICOM Heads of Government. 2017. "Communiqué – 28th Inter-Sessional Meeting of CARICOM Heads of Government." Caribbean Community, February 18.

Center for Global Development [CGD]. 2015. Unintended Consequences of Anti-Money Laundering Policies on Poor Countries. Center for Global Development.

Collin, Matthew, Samantha Cook, and Kimmo Soramäki. 2016. The Impact of Anti-Money Laundering Regulation on Payment Flows: Evidence from SWIFT data. Center for Global Development Working paper 445, December.

Committee on Payments and Market Infrastructures [CPMI]. 2016. Correspondent Banking. Bank for International Settlements.

Financial Action Task Force [FATF]. 2016. Anti-Money Laundering and Counter-Terrorist Financing Measures: United States. Mutual Evaluation Report. Financial Action Task Force, December.

Haley, James A. 2017. "De-Risking: Effects, Drivers and Mitigation." CIGI Papers No. 138, July.

International Monetary Fund [IMF]. 2016a. "The Withdrawal of Correspondent Banking Relationships: A Case for Policy Action." IMF Staff Discussion Note SDN/16/07, June.

———. 2016b. "Towards a Better Understanding of Macro-Financial Linkages." Belize: Selected Issues, June.

International Monetary and Finance Committee. 2016. "Communiqué of the Thirty-Fourth Meeting of the International Monetary and Finance Committee (IMFC)." International Monetary Fund, October 8.

Klein, Aaron. 2017. "State Incorporation Laws: Good for Crooks, Bad for Banks." American Banker, April 9.

Lagarde, Christine. 2016. "Relationships in Banking—Making it Work for Everyone." Address at the Federal Reserve Bank of New York, July 18.

Levin, Sharon Cohen. 2016. "AML Sanctions Reform: A Safe Harbor Proposal." Banking Perspective, Quarter 3.

Lowery, Clay. 2016. "Statement of the Honorable Clay Lowery, Vice President, Rock Creek Global Advisors LLC, Before the U.S. House Committee on Financial Services' Task Force to Investigate Terrorism Finance." Financial Services Committee, March 1.

Memminger, Matthias, Mike Baxter, and Edmund Lin. 2016. "You've Heard of Fintech, Get Ready for 'Regtech.'" American Banker, September 7.

Noonan, Laura. 2015. "Banks Face Pushback over Surging Compliance and Regulatory Costs." Financial Times, May 28.

Office of the Comptroller of the Currency. 2016. "Risk Management Guidance on Periodic Risk Reevaluation of Foreign Correspondent Banking." OCC Bulletin 2016-32, October 5. Office of the Comptroller of the Currency, U.S. Department of the Treasury.

Rothschild, Michael, and Joseph Stiglitz. 1976. "Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information." The Quarterly Journal of Economics 90 (4): 629-649.

Task Force to Investigate Terrorism Financing, Committee on Financial Services, and U.S. House of Representatives. 2016. Stopping Terror Finance: Securing the U.S. Financial Sector. 114th Congress, Second Session, December 20.

The Clearing House. 2017. A New Paradigm: Redesigning the U.S. AML/CFT framework to protect national security and aid law enforcement. The Clearing House, February.

3 N.Y.C.R.R. § 504.

Trump, Donald J. 2017. "Presidential Executive Order 13771: Reducing Regulation and Controlling Regulatory Costs." The White House, January 30.

World Bank. 2015a. Withdrawal from Correspondent Banking—Where, Why and What to Do About It. World Bank, November.

———. 2015b. Report on the G20 Survey on De-risking Activities in the Remittance Market. World Bank, November.

World Bank (2015a), "Withdrawal from Correspondent Banking—Where, Why and What to Do About It."

World Bank (2015b), "Report on the G20 Survey on De-risking Activities in the Remittance Market."

James A. Haley is a Global Fellow of the Wilson Center's Canada Institute in Washington, DC. He has served as Executive Director for Canada, Ireland and the Caribbean at the International Monetary Fund (IMF) and as Executive Director for Canada, Inter-American Development Bank (IDB). Prior to his appointment to the Board of the IDB, he was Director of the Global Economy Program at CIGI. Mr. Haley held a series of senior appointments in the Canadian Treasury and was Research Director, Bank of Canada. He previously served on the staff of the Research Department of the IMF, contributing to the Fund's flagship publication, World Economic Outlook. In addition to his professional duties, Mr. Haley has also taught at the Norman Patterson School of International Affairs, Carleton University and the McCourt School of Public Policy, Georgetown University.

The Canada Institute

wilsoncenter.org/canada
canada@wilsoncenter.org
facebook.com/Canada.Institute
@CanadaInstitute
202.691.4301

Woodrow Wilson International Center for Scholars
One Woodrow Wilson Plaza
1300 Pennsylvania Avenue NW
Washington, DC 20004-3027

Wilson Center
CANADA INSTITUTE