Sibos 2016 in Review

Banking low-risk clients in high-risk jurisdictions

The trend of de-risking continues to be an issue across correspondent banking. With the closing of business lines only being an initial ramification, a panel discussion at Sibos 2016 explored the implications of de-risking, the possible solutions – and whether it is still possible to bank low-risk clients in high-risk jurisdictions in the current climate.

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Executive Summary

Panelists

John Cusack
Global Head, Financial Crime Compliance, Standard Chartered

One of the world's longest serving Heads of Money Laundering Prevention, John is a member and former Chair of the Wolfsberg Group.

Julie T. Katzman
Executive Vice President/COO, Inter-American Development Bank (IDB)

Julie is responsible for driving change throughout the organisation, while leveraging her background in investment banking to craft the next generation of capital and risk policies.

Richard A. Lalonde
Senior Financial Sector Expert, International Monetary Fund (IMF)

Richard is also the former chairman of the Financial Action Task Force (FATF) working group on the revision of the FATF recommendations.

Jochen Metzger
Director General of Payments and Settlement Systems, Deutsche Bundesbank

Jochen also served as senior staff member and member of the secretariat in the Financial Stability Forum at the Bank for International Settlements (BIS).

Session highlights

- Many institutions around the world have seen de-risking trends, though several regions have been affected more significantly than others.
- If it is difficult to get money into a particular country through legitimate channels, people may have to find alternative channels.
- While the pace of de-risking may be slowing down, there is concern that some banks are carrying out 'additional de-risking' by applying restrictions to particular products or clients.
- Banks are entitled to choose where they operate, but the consequences for economies need to be addressed.
- Possible solutions include ensuring that local banks comply with international standards, as well as fostering greater engagement with regulators.
- Recently, regulators have started to add some clarity around what they expect from banks and how they see enforcement which could have an impact and mitigate overall de-risking.

The rise of de-risking

The issue of de-risking is highly topical. With more banks opting to 'de-risk' by terminating their correspondent banking relationships in certain markets, concerns are mounting about the impact on the global financial industry – and particularly on the risk of financial exclusion among certain customers. A panel discussion between industry experts at Sibos 2016 explored why de-risking is happening, what the wider implications are – and what steps the industry should be taking to address these issues.

The panel highlighted the fact that the last few years have seen a significant reduction in the number of correspondent banking relationships. The effects of this trend have been seen in different countries and regions around the world, including the Caribbean, some of the small South Pacific islands, Africa, MENA and Central America. However, this trend is developing unevenly: the panel noted that in markets such as North America, Western Europe and Asia, there has been little impact.

One of the experts pointed out that while the number of correspondent banking *relationships* has dropped, the number of correspondent bank *payments* has actually increased, adding to the concentration of correspondent banking relationships on fewer banks.

Why is this happening? The experts explained that a number of factors are contributing to this trend. Despite the terminology, a bank's decision to terminate correspondent banking relationships is not necessarily just about risk. One of the panellists noted that the term 'de-risking' implies that assessments are being carried out to evaluate the risk of a relationship – but that in reality, some banks are de-risking their relationships without carrying out such an evaluation.

"People are operating in an environment where they are not quite sure what the regulators are going to do. That creates fear."

Julie T. Katzman, Executive Vice President/ COO, Inter American Development Bank (IADB)

The panellists pointed out that concerns about profit margins are also contributing to this trend: in a low interest rate environment, correspondent banking is a lower margin business. Given these factors, some banks may see the current climate as an "opportunity to get out of a loss leader", one expert noted.

At the same time, the panel said that banks are facing a considerably higher regulatory burden than in the past, with tax issues, AML requirements and international sanctions all contributing to the challenging regulatory environment.

Recent compliance fines may also have prompted some banks to ask why they are continuing to operate in certain markets.

As a result of these factors, the panellists said that many financial institutions are re-evaluating their business models in the current market – and that some are deciding to scale back their cross-border business.

"I think we have to apply common standards to [the relevant] countries and recognise that the gap that they have between the standard and reality is quite large. But that should not cause us automatically to press the 'goodbye' button – we have to work with them to close that gap."

John Cusack, Global Head, Financial Crime Compliance, Standard Chartered

Country Risk

The panel also talked about the nature of country risk and how it is measured. One of the panellists said that the standards set for anti-money laundering by the Financial Action Task Force (FATF) have recently been revised. The rules call upon countries, financial institutions and others to identify the risks, understand the risks and find a way to mitigate them.

The experts noted that country risk used to be the single most important factor when gauging the risk associated with specific banks. This is less the case now: many other factors are also taken into account including the types of business that a customer is doing, the behaviour and the business volumes. As a result, a strong bank in a high-risk jurisdiction and a less strong bank in a low-risk jurisdiction may have significantly different risk profiles.

"Are we seeing a macroeconomic impact? No, we are not seeing it at this point in time. But we are certainly concerned about the effects on some individual members."

Richard A. Lalonde, Senior Financial Sector Expert, International Monetary Fund

Impact of de-risking

The discussion highlighted some of the consequences of de-risking for affected banks, customers and countries around the world – particularly the risk that some countries will be "cut off from the global financial system".

One of the experts noted that the area of remittances has been heavily affected by this trend – and that making it difficult to get money into a particular country through legitimate channels means that money flows have to go through alternative channels. This outcome is arguably at odds with the industry's goals of increasing transparency and making it easier to track funds.

The consequences for individuals can be considerable. As one panellist pointed out, it is common in some markets for people to earn most of their income from tips from tourists. With access to foreign exchange restricted, it may be difficult for them to exchange this money back. In other markets, de-risking has resulted in higher costs for importers and exporters which are trickling down to the general population.

The pace of de-risking may now be slowing down. Nevertheless, challenges remain and the way in which de-risking is taking place is continuing to change. According to one of the panellists, some institutions are moving away from exiting specific markets and are now applying restrictions to particular products or to the correspondent's clients – for example, by stipulating that they will accept commercial business but not payments associated with money service bureaus (MSBs). The expert described this as 'hidden de-risking', noting that while it may be less visible, the implications will still be felt.

Overcoming the issues

The experts discussed some of the potential solutions to these issues, including using KYC utilities such as The KYC Registry, and ensuring that banks affected by de-risking are fully compliant with the relevant international standards.

"There are countries around the world that do not implement international standards in a correct manner, or that fall short. Although this is not a short-term solution, countries that are affected by this particular issue should be looking at their own systems in a clear and frank way."

Richard A. Lalonde

Another expert argued that exiting markets is a legitimate business decision for banks – the difficulty arises when there isn't enough capacity in those markets for other banks to step in and provide the relevant services.

The panellist added that while banks are entitled to choose where they do business, it is also important to address the consequences for individuals.

Among the possible solutions to these issues, the panellists said that collaboration is needed between the industry and the relevant regulators. They noted that there are indications that this is beginning to happen, with more discussions taking place about the nature of the risks and the possible consequences.

One panellist said that a proactive approach has been taken in Mexico in order to solve these issues. This approach involved engaging in a dialogue with the regulator in the US to identify and resolve privacy laws which prevented banks from providing certain information to US banks.

> **"If we keep the anti-money laundering rules and the CFT rules as they are, blockchain will not make a difference. In order for blockchain to make a difference, we will need to think of new rules, or new application of those rules."**
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> **Jochen Metzger,** Director General of Payments and Settlement Systems, Deutsche Bundesbank

Also discussed was blockchain and whether this technology can play a role in addressing the challenges facing correspondent banking. The panel noted that a utility based on a distributed ledger model could be interesting – but that regulatory approval would be needed to facilitate this.

Time to re-risk?

The discussion concluded with the panellists considering how low-risk clients can be banked in high-risk jurisdictions, and whether it is time for banks to 're-risk'.

Possible solutions set forth by the panellists included working with regulators to set achievable and realistic standards, as well as working with high-risk jurisdictions to help them avoid remaining high-risk. The experts also noted that a dialogue should be taking place between correspondents and their respondents which may be at risk.

Finally, one of the experts pointed out that it is indeed possible to bank good customers in high-risk jurisdictions: "You can do this with an extra dose of due diligence – a strong dose," the panellist commented. "I know it is difficult, but yes, you can."

Conclusion

As the panel discussion illustrated, de-risking presents considerable challenges both for financial institutions and for end customers.

Banks are entitled to choose where they operate – but there is a risk that some countries and customers will be cut off from certain financial services as a result of de-risking. While discussions are already taking place, it is clear that further engagement is needed between banks and regulators to find solutions to these issues.


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