No end in sight for the decline in correspondent banking relationships

De-risking has become one of the hottest issues in international banking. Big international banks are cutting back on the services that they offer to smaller banks overseas, and in emerging markets those smaller banks are complaining that reduced access to international finance is compromising economic growth and pushing some of their customers to use informal and unregulated financial services.

International bodies such as the World Bank and the Financial Stability Board have recognised that there is a problem and have responded by publishing reports and statistics. Standard setters and regulators have issued guidance that they hope will slow the decline in cross-border banking activity.

Arab Banker's Editor, Andrew Cunningham, considers what 'de-risking' means in practice, and asks what emerging market banks can do to maintain access to international financial services.

In 2015, the World Bank asked big international banks, emerging market banks and bank regulators to describe the changes they were seeing in the correspondent banking market. Their responses confirmed what emerging market banks had been saying, and large international banks shyly admitting, for some time: there had been a huge decline in the availability of international correspondent banking relationships (CBRs) during the previous three years.

Sixty per cent of the 170 local or regional banks that responded to the World Bank's questionnaire said that they had witnessed a decline in CBRs. Seventy-five per cent of large international banks that responded said that they had reduced the number of correspondents to whom they offered banking services.

The World Bank also surveyed banking authorities. One hundred and ten responded, and half of these confirmed that they were seeing a decline in CBRs in their jurisdictions.

The World Bank report identifies international wire transfers as the service most significantly affected as large banks reduce their CBRs. Wire transfers denominated in US dollars are particularly heavily affected. Next in line were clearing and settlement services and cheque clearing services, followed by trade finance and cash management.

US banks were most frequently cited as those that are reducing CBRs, followed by British banks.

The dangers presented by this trend go beyond the inability of some regional banks to fulfil the needs of their clients. As the World Bank points out, as international banks end their relationships with higher risk customers (or those perceived to be higher risk) the system as a whole pushes that risk into less transparent channels with the result that risk within the system actually increases.

This is particularly true in the field of remittances. As regional and local banks lose access to international financial networks, their customers may start to rely on informal payment channels. Having worked hard to bring money exchange firms, including the 'hawala' networks in the Middle East, into the formal, regulated banking system, international standard setters may find that they are unwittingly incentivising millions of expatriate workers to find remittance arrangements outside the regulatory framework.

When challenged on their reasons for reducing CBRs, the large international banks generally cite supervisors' heightened expectations for due diligence and compliance, and in particular the large fines handed out by supervisors for failure to comply with sanctions and anti-money laundering regulations.

The large enforcement actions are well known, such as the $8.9bn fine levied on BNP Paribas by the US authorities in 2014 in respect of violations of economic sanctions, and the $1.9bn payment levied from HSBC in 2012 as part of a settlement related to alleged money laundering through the bank's branches in Mexico.

But enforcement actions have not been confined to large western banks. In 2015, the British regulator fined the Indonesian company Bumi for weak internal controls, and it fined Bank of Beirut for failures in its compliance and internal audit functions. Also in 2015, the US authorities took action against China Construction Banking Corporation for deficiencies in its anti-money laundering programme.

It is important to recognise that the decline in correspondent banking is rooted in a wide variety of factors that extend beyond rules on money laundering and the financing of terrorism (ML/FT) and it precedes the current era of large regulatory fines.

In 2014, the *Economist* reported that the number of CBRs in the eurozone had fallen by nearly 30% between 2003 and 2010 and that the principal driver of this trend was consolidation in the banking industry.

But the decline in CBRs accelerated rapidly after 2010, falling by about another 20% in the next two years, the *Economist* said.

This accelerated decline has been driven by two factors. The first is indeed the fear of regulatory sanctions, but the second relates to broader economic and financial factors that include bank consolidation, but also arise from new regulations on bank capital and liquidity.

The Basel III capital standards, first announced in 2010 and still in the process of implementation, require banks to hold more capital than in the past, particularly against riskier assets. These higher capital requirements are squeezing risk-adjusted profitability, forcing banks to think more carefully about the value of the services that they provide.

In the case of the Middle East, there is an additional factor. The fall in oil prices since 2014 has reduced liquidity in the Gulf States and in other oil exporting countries. Banks in these countries were often happy to pay a small fee to international banks to keep correspondent banking lines open, even if they never expected to use them. But as liquidity contracted, some of these banks began to draw on their lines, forcing international banks to consider the importance of their relationships with smaller banks in smaller economies and the value of the fees that they had been receiving.

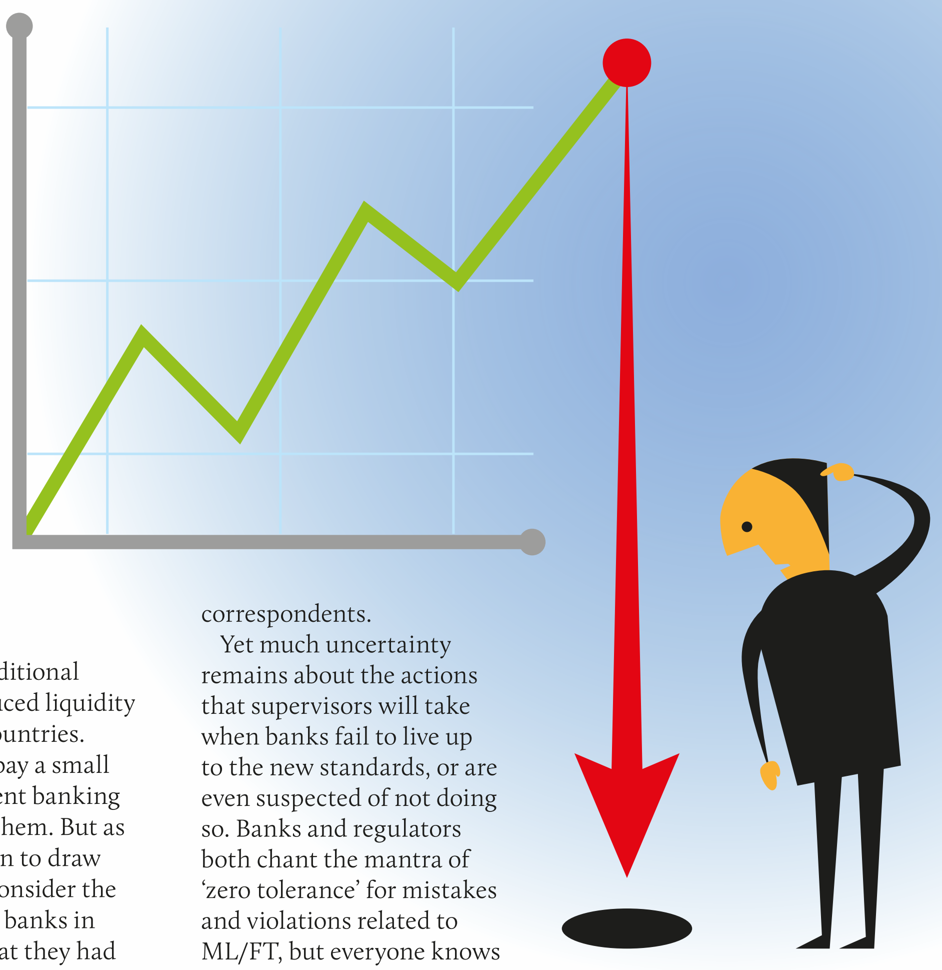
If current regulatory expectations on due diligence lead to the bank having to send staff half-way round the world, on business class flights, to conduct annual reviews of correspondent banks, profits on CBRs can disappear very quickly.

This problem is compounded by the introduction of the Net Stable Funding Ratio, the new Basel liquidity standard that limits banks' ability to fund long-term assets with short-term liabilities, and also takes account of foreign currency mismatches within the asset/liability structure. In simple terms, if a eurozone bank is going to extend lines in dollars (for example to a bank in the GCC), then there is greater pressure than before to fund that line with dollars rather than with euros.

Nonetheless, discussions about CBRs and de-risking inevitably return to issues of compliance and to fears that banks may unwittingly offer services to others who engage in criminal activity, or whose customers engage in criminal activity.

New standards on capital and liquidity may be pressurising banks' profits, but the challenge is not new and, more importantly, capital and liquidity ratios can be controlled and managed by the banks themselves. In contrast, compliance risk has been transformed in recent years as a result of new standards and huge changes in regulators' expectations.

There is no shortage of guidance for banks on how to manage CBRs and specific risks related to ML/FT. For example, guidelines published by the Basel Committee on Banking Supervision in February 2016 include specific recommendations related to account opening and the information that should be gathered by a bank on its correspondents.



Yet much uncertainty remains about the actions that supervisors will take when banks fail to live up to the new standards, or are even suspected of not doing so. Banks and regulators both chant the mantra of 'zero tolerance' for mistakes and violations related to ML/FT, but everyone knows that you cannot run a commercial business if every possibility of making a mistake has to be excluded.

Until the supervisory responses to mistakes and violations become more predictable, we are unlikely to see a revival of international correspondent banking. ■

Key documents on de-risking and the decline in correspondent banking*

Withdrawal from Correspondent Banking: Where, Why and What to Do About it. World Bank, November 2015.

Report to the G20 on Actions Taken to Assess and Address the Decline in Correspondent Banking. Financial Stability Board, November 2015.

Effective Supervision and Enforcement by AML/CFT Supervisors of the Financial Sector and Law Enforcement. Financial Action Task Force (FATF), October 2015.

Sound Management of Risks Related to Money Laundering and Financing of Terrorism. Basel Committee on Banking Supervision, February 2016.

Consultative Paper on Correspondent Banking. Committee on Payments and Market Infrastructures, October 2015.

* These documents contain references to numerous other recent reports and studies relevant to correspondent banking, AML/CFT and, more broadly, compliance and internal controls in banks.