



THE CORRESPONDENT BANKING PROBLEM

IMPACT OF DE-BANKING PRACTICES
ON CARIBBEAN ECONOMIES

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EXECUTIVE SUMMARY

The Caribbean, more than any other region in the world, now faces a threat that has severe implications for its economic viability. This threat is the termination of Correspondent Banking Relationships (CBRs). Correspondent banking relationships are essential to the global payment system, facilitating cross-border transactions, particularly for international trade, remittances and foreign direct investments (FDI). Outside of setting up branches in foreign countries (which is costly), a domestic (respondent) bank requires a correspondent bank (CB) in that foreign territory to act on its behalf. However, amidst concerns about money laundering and the financing of terrorism (ML/FT), several correspondent banks have been terminating or restricting business relationships with clients or categories of clients to avoid, rather than manage, the inherent risk. This action, referred to as 'de-risking' or 'de-banking', is a challenge that requires urgent and coordinated action from Caribbean economic, regulatory, and political leadership.

WHAT IS DRIVING DE-RISKING PRACTICES?

In general, there are three main reasons for the surge in de-banking practices: (i) a fear of reputational loss, (ii) rising compliance costs and (iii) rising fines and penalties for breaches. Correspondent banks fear the impact on their reputations if they are found to be (or even suspected of being) willingly or unintentionally aiding the financing of criminal organisations. Complying with anti-money laundering and countering financing of terrorism (AML/CFT) regulations is

also increasingly expensive, particularly because laws and standards differ across jurisdictions, creating a regulatory entanglement that is difficult, maybe even impossible as the situation stands, to navigate. In addition, should banks be found in breach of these rules, the penalties are increasingly severe. Altogether, the combination of reputational damage, compliance costs, and breach penalties threaten the profitability of the banks to a degree that does not justify remaining in correspondent relationships and lines of business with low margins.

Underlying all of this is an informational deficiency. There is a general absence of clarity of the standards of customer due diligence necessary as set by the Financial Action Task Force (FATF)¹, particularly exacerbated by differences in rules across jurisdictions. There is also ambiguity surrounding the criteria for de-risking actions and a lack of uniformity in its implementation across institutions. This has contributed to a largely unsubstantiated fear of doing business with banks in the Caribbean, who, despite much progress and their best efforts, still find it difficult to satisfy some correspondent banks. Many Caribbean banks are often unclear about the precise reason their CBRs are being terminated. This inhibits the ability of Caribbean institutions (both the banks themselves and their regulators) to effectively respond to the problem. A general paucity of empirical data further constrains a comprehensive understanding of the problem and how best to address it.

¹ The Financial Action Task Force (FATF) is an inter-governmental body established in 1989 to set standards and promote effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats to the integrity of the international financial system.

WHAT IS THE IMPACT OF DE-RISKING ON THE REGION AND HOW BIG A PROBLEM IS IT?

A dearth of empirical data constrains any attempt at a detailed analysis of the impact of de-risking. Instead, we offer a discussion of the scope and scale of the consequences facing the Caribbean region. First, this is a global problem. CBRs are being terminated across the world, with some CBs exiting over 60 percent of their CBRs. Worryingly, this may actually shift AML/CFT risks to less regulated, less transparent institutions, and may actually, and paradoxically, facilitate laundering of money and financing of terrorism.

De-risking also inhibits trade finance, thereby endangering the imports and exports that are essential to the functioning of an economy in a globalized world. It also poses a danger to the ability of not-for-profit organisations to finance aid support to vulnerable groups around the world. There is therefore a valid humanitarian concern as several poor and vulnerable groups depend on the services of CBRs for survival. De-risking can also limit the flow of foreign direct investment (FDI) to the region. Remittances, which rely on CBRs, represent the most efficient source of social insurance and are a key source of income for the poorest residents in the poorest countries around the world. De-risking may therefore undermine financial inclusion around the world, increase global poverty, and reduce the social insurance of the poor.

The Caribbean region is uniquely susceptible to the effects of de-risking, particularly given its dependence on trade, remittances and foreign direct investment. For example, while trade amounts to one-third of the United States' gross domestic product (GDP), trade is equivalent to almost half the GDP of developing countries of Latin America and the Caribbean (LAC), and almost 100 percent of the GDP in small Caribbean states. De-banking therefore threatens to strangle the supply lines of economic activity with potentially calamitous consequences for economic growth and development in the Caribbean.

SO WHAT CAN BE DONE ABOUT DE-RISKING?

Any plan to manage the problem of financial de-risking must begin with an appreciation of the nature of the problem. The problem has not arisen from a policy decision taken by a particular entity to whom an appeal can be made. Rather, it is an emergent problem. It has emerged from all parties in the global financial industry acting quite rationally in response to changes in the environment in which they operate. Public security authorities are responding to the activities of international criminal organisations; financial regulators separately and independently are responding to the security authorities and the integrity needs of the financial system; large global banks to the regulators and the compulsions of the market; local and regional banks to their correspondent banks and needs of their customers.

What emerges from this network of interests is an opaque, complex, overlapping, and sometimes inconsistent patchwork of regulations and requirements. That stakeholders are acting

sensibly, at least in terms of their own narrow interests, and that so many different actors are imposing independent requirements on the others makes solving the problem uniquely challenging. The easier challenge to address is the informational deficiencies. Addressing the profitability of banks is more difficult. However, solving the informational problem as well as reducing regulatory overlaps and inconsistencies across jurisdictions may help to resolve profitability concerns. Below is a summary of recommendations that represents a starting point towards addressing some of the issues. (See Section 7 for more details.)

1. STREAMLINE REGULATORY FRAMEWORKS AND METHODS FOR DATA COLLECTION AND STORAGE:

Caribbean banks, money services businesses and other relevant, private sector institutions should design a homogenous mechanism, as far as data privacy laws allow, to share data that helps Caribbean institutions "know their customers". All institutions collecting such data must subscribe to benchmark/international standards in banking data security to protect Caribbean citizens.

2. THE USE OF THE LEGAL ENTITY IDENTIFIER (LEI) IN CORRESPONDENT BANKING:

Regulators should combine Bank Identifier Codes (BIC) with LEI mapping capabilities to strengthen AML/CFT frameworks in the Caribbean region. This, requires intensive coordination in the region.

3. RECOMMENDATION ON PAYMENT MESSAGES:

Stakeholders must determine which format of payment messages (e.g. MT 202 or MT 103) is better for them to use.

4. CENTRAL BANK MONITORING:

Central banks across the region should monitor correspondent banking relationships, gathering information on the status of CBRs (i.e. existence of relationships, date and reason for termination, length of time engaged, impact on profits and employment within the firm, etc.). This could help to generate the empirical data needed to inform ameliorative actions.

5. COLLECTIVE LOBBYING AS A REGION:

All stakeholders should combine efforts and lobby for international regulators to clarify ambiguities in regulations governing AML/CFT. Caribbean regulators and authorities across jurisdictions can autonomously develop streamlined definitions, standards, and policies that reduce compliance burdens and improve accountability. These can then be shared with international regulators and the wider international community. Caribbean Heads of Government should also advance these lobbying efforts at the international level as a developmental issue.



INTRODUCTION

The Caribbean, more so than other developing regions, now faces a relatively new threat that has severe implications for the region. This threat is the termination of Correspondent Banking Relationships (CBRs). De-banking (or de-risking) practices pose a direct threat to the developing countries around the world, and to Caribbean countries most significantly.

Correspondent banking relationships (CBRs) are essential to the global payment system for cross-border transactions. The Committee on Payment and Market Infrastructures (CPMI) refers to 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.”² Correspondent banks in foreign territories therefore act on behalf of domestic banks. This is done because the domestic (respondent) bank may have limited access to foreign financial markets, and cannot service its clients abroad without opening a branch in another country. For example, if the Jamaica National Building Society (JNBS) does not, at significant costs, set up its own branches in the United States, the institution must enter into a correspondent banking relationship with a US bank to serve their clients in the US. When financial institutions terminate or restrict business relationships with clients or categories of

these clients to avoid, rather than manage, risk, these financial institutions are said to be “de-risking” or “de-banking”.³

De-risking has become an increasing trend amidst global efforts to reduce incidents of money laundering and the financing of terrorism⁴. International regulators are particularly concerned about banks willingly or inadvertently offering financial services to criminal organisations. Consequently, several banks across the region have had their correspondent banking relationships severed. Given the critical role of trade, foreign investment and remittances to the growth and development of the Caribbean region, and the importance of correspondent banking relationships to these activities, the recent de-risking trends directly threaten every sector in every Caribbean state. This imminent crisis requires urgent and collective attention on the part of policy makers, banks and other stakeholders.

Section 2 explains the causes of de-risking practices around the world. Section 3 aims to explain the scale and scope of the problem. Two case studies are presented in Section 4. Section 5 explores the global implications of de-risking practices while Section 6 describes the impact on the Caribbean region. Conclusions and recommendations are provided in Section 7.

2 World Bank, 2015

3 Financial Action Task Force (FATF), 2014

4 Durner & Shetret, 2015; World Bank, 2015



WHAT IS DRIVING THE PRACTICE OF DE-BANKING?

In general, there are three direct drivers of de-banking practices. These are (i) a fear of reputational loss, (ii) rising compliance costs and (iii) rising fines and penalties. These all directly affect the profitability of banks. However, a less obvious (and likely, underlying) reason for widespread de-banking is inadequate information. These reasons are further elucidated below.

A. DIRECT OR POTENTIAL THREATS TO BANK'S PROFITABILITY REPUTATIONAL LOSS

Concerns that a bank's reputation could be negatively affected may influence a bank's decision to end a particular CBR. For example, in September 2013, a high profile fund manager at the Hongkong and Shanghai Banking Corporation (HSBC), one of the largest financial institutions in the world, announced that

he was selling a multi-billion-dollar holding as a direct result of concern over the impact of future fines.⁵ Another example can be seen with PNB Paribas (another multinational bank) where rumors of imminent anti-money laundering/counter financing of terrorism (AML/CFT) enforcement actions triggered an overall market loss of approximately US\$12.7 billion.⁶ However, it is argued that the long-run implications of reputational damage remain to be seen.⁷

This is because "every 'global systemically important bank,' or bank whose failure may trigger a financial crisis, as identified by the Financial Stability Board, has now been fined, which makes it difficult for investors and stakeholders to avoid engagement with tarnished institutions."⁸ Nevertheless, the fear of reputational loss is sufficient to influence a bank's decision to de-risk.

5 Durner & Shetret, 2015

6 Ibid

7 Ibid

8 Ibid

PROFITABILITY VS. RISING COMPLIANCE COSTS

Cash intensive businesses are often the most severely affected by the termination of CBRs as they are often not sufficiently profitable to justify the significant risks associated with these businesses or the high AML/CFT compliance costs. In 2013 for instance, of its total 414 Money Services Business (MSB) clients, Barclays terminated 258 (62%) of these CBRs, including 146 (88%) of the 165 money remitters.⁹ While MSBs are usually characterized by a loyal and regular client base, the average transaction amount is small, leading to low profit margins, and the high number of transactions increases operational and compliance burdens of correspondent banks.

Central to the discussion too, is the quagmire of complex and overlapping regulations across several jurisdictions that make navigating the correspondent banking regulatory frameworks more difficult and more expensive. There is no single, well-defined, and universally accepted set of standards and regulations that exist across countries. Therefore, when a bank seeks to enter a new jurisdiction, significant effort and financial resources are dedicated to learning the new rules of that jurisdiction and finding some way (sometimes unsuccessfully) to synchronize the current operational procedures and framework of the bank with the framework required in the new jurisdiction.

Satisfying the requirements of multiple complex and overlapping frameworks is not only a source of inefficiency to banks, but also multiplies the compliance costs to these financial institutions. The 2014 KPMG Global Anti-Money Laundering Survey noted that professionals in top global banks recorded increases in their total investment in AML compliance. Twenty-two percent of those respondents indicated an increase of 50 percent during the 3-year period from 2011 to 2014. This was largely due to the difference in regulatory approaches across state, national, and international jurisdictions as differences in national legislations and data privacy combined with the fast pace of regulatory change, made compliance increasingly difficult.¹⁰

An examination of the nominal costs of compliance may further inform why correspondent banks are terminating their relationships with respondent banks. For example, HSBC spent \$800 million on its compliance and risk management programme in 2014, \$200 million more than in 2013.¹¹

Macquarie, an Australian Investment Bank, reported that its direct compliance costs had tripled between 2011 and 2014, to nearly \$250 million.¹² Regulatory costs are adding between 1 percent and 2 percent to Standard Chartered's annual costs, amounting to \$100 - \$200 million annually.¹³ It was also reported that the bank also doubled the number of staff in its financial crime unit and increased legal compliance staff by 30 percent.

Ultimately, rising compliance costs and low profit margins directly threaten the profitability of correspondent banks. The cost of operating across jurisdictions and under multifaceted, overlapping and rapidly changing regulatory frameworks plays a particularly significant role in increasing the cost of sustaining correspondent banking relationships. "Although public image and publicity considerations are an issue for financial institutions, the core decision-making driver [for terminating CBRs] remains straightforward and clear: a cost-profit analysis" (Durner & Shetret, 2015).

RISING FINES/PENALTIES AND SUBSTANTIAL LITIGATION COSTS

According to KPMG, "AML has never been higher on senior management's agenda, with regulatory fines now running into billions of dollars, regulatory action becoming genuinely license threatening, and threats of criminal prosecution against banks and individuals".

The Association of Certified Anti-Money Laundering Specialists (ACAMS) noted in 2012 that while AML/CFT enforcement actions increased slightly from 56 to 59, fines and monetary settlements paid by banks for AML/CFT and sanctions violations increased 131-fold in that same year.¹⁴ Regulatory fines and monetary settlements under deferred prosecution agreements rose from \$26.6 million in 2011 to \$3.5 billion in 2012.¹⁵ This includes a \$1.9 billion settlement paid by HSBC to US and UK regulators for their failure to properly monitor wire transfers that were linked to Mexican drug cartels, and for violation of sanctions through their business with clients in Iran, Libya, Sudan, Myanmar, and Cuba.¹⁶

Fines and penalties are therefore exorbitant costs to banks. It is for this reason that correspondent banks may consider terminating their relationships with respondent banks.

9 Durner & Shetret, 2015

10 Ibid

11 Ibid

12 Ibid

13 Ibid

14 Adams & Monroe, 2013

15 Ibid

16 Durner & Shetret, 2015



B. INADEQUATE INFORMATION

Amidst concerns related to the profitability of the bank, inadequate information is also contributing to wide-spread de-risking activities. Deficiencies in the AML/CFT framework of respondent banks is the most obvious reason to terminate a CBR. However, this perception is attributed to the Caribbean region and prevails despite being unsubstantiated; no Caribbean country is currently being investigated for negligence or regulatory breach by the Financial Action Task Force (FATF) - a leading international regulating agency. Further, as there is no obligation for correspondent banks to give a comprehensive explanation for terminating CBRs, respondent banks like those in the Caribbean, despite their best efforts, may still find it difficult to satisfy all AML/CFT requirements or to satisfy their correspondent banks.¹⁷

There is also a misinterpretation of the FATF standards on correspondent banking and customer due diligence.¹⁸ Particularly, there is uncertainty regarding the extent to which banks must know their customers, and know their customers' customers. This uncertainty may therefore obfuscate regulatory frameworks, making it difficult for domestic banks to satisfy their correspondent banks.

Finally, there is a "domino effect";¹⁹ when banks observe other banks terminating CBRs with a domestic bank, other correspondent banks are likely to follow suit, even without tangible proof of error on the part of the respondent bank.

These informational factors contribute to the perception of many developing countries, particularly in the Caribbean, as high risk. Fearing that it may run afoul of international or regional AML/CFT regulations, amidst such informational uncertainty, a correspondent bank may simply terminate its CBRs.²⁰

Ultimately, de-banking practices are largely influenced by banks' desire to maximize profits. This is particularly within a context of (i) potential reputational loss, (ii) rising compliance costs and (iii) rising fines and penalties. However, these concerns fester, at least in part, due to inadequate or ambiguous information and the regulatory morass of operating across jurisdictions. There is need for greater clarity on the criteria for de-risking actions and the extent to which banks should conduct customer due diligence.

17 Durner & Shetret, 2015

18 Ibid

19 Ibid

20 Ibid



WHAT IS THE SCALE AND SCOPE OF DE-BANKING PRACTICES?

The informational difficulties which help to drive de-banking practices also permeate into an analysis of the scale and scope of de-risking. A lack of empirical data about the extent and nature of the client relationships being exited as well as the decision making process underlying these terminations, hinders an assessment of the scale and scope of the problem. Furthermore, it inhibits the development of effective solutions. The ambiguity surrounding the criteria for de-risking actions and a lack of uniformity in its implementation across institutions contributes significantly to this difficulty.

First, there appears to be no obligation on the part of international banks to provide a comprehensive explanation to regional banks for the withdrawal of their financial services.²¹ This has proven to be a significant obstacle for the Caribbean and other small states to appropriately address the issue as they are often unable to determine the specific causes for the loss of the CBRs or how to directly address the problem, despite considerable efforts on their part. Regional authorities state that when international banks withdraw their services, no explanation is usually given, or in a few instances when a reason was cited, it was as a result of an “operational decision” being made by the international bank.²² Hence, the Caribbean region is seen as high risk despite the fact that Caribbean institutions make themselves compliant with international standards and best practices, including updating their anti-money laundering legislation. Jamaica, for example, is fully compliant with all core and key FATF recommendations.²³ Caribbean states have also signed Foreign Account Tax Compliance Act (FATCA) agreements with the US government.²⁴

The World Bank conducted a survey which provides some information about the scale and scope of de-banking practices. The survey included 110 banking authorities worldwide, 20 large banks and 170 regional banks. It was found that roughly

half the banking authorities, and slightly more local/regional banks were experiencing a decline in correspondent banking relationships. For large international banks, the figures are significantly higher at 75 percent. In total, 89 percent of jurisdictions reported experiencing significant to moderate declines in their foreign CBRs. Of the 19 respondent authorities, 15 reported significant declines and two others noted a trend towards decline or a moderate decline with no significant impact on the banking system overall. In the United Kingdom, a survey by the British Bankers’ Association revealed an average seven-and-a-half percent decline in correspondent banking relationships since 2011, with two banks severing one-fifth of all accounts.²⁵

The World Bank survey also revealed that, in descending order, the United States, the United Kingdom, the European Union and Canada were the jurisdictions most frequently cited as terminating CBRs. The United States, in particular, significantly outpaced the other three. Given that these regions represent the Caribbean’s main trading partners and primary sources of FDI and remittance inflows, it is unsurprising that the World Bank also found that the Caribbean region was the region most significantly affected by the de-banking phenomenon.

In the final analysis, a lack of data makes it difficult to empirically state the precise scope and scale of de-banking practices. The World Bank survey, however, yields useful results. While jurisdictions with small volumes of business transactions such as areas of Europe, Central Asia and Africa are particularly impacted by de-banking practices, the Caribbean is the region most severely impacted by de-risking. Furthermore, the region’s largest trading partners, particularly the United States, are the ones most often terminating CBRs. The de-banking problem is therefore large and widespread, impacting banks even in the developed world.

21 Durner & Shetret, 2015.

22 Ibid

23 International Development Bank, 2015

24 Nicholls, 2015

25 Durner & Shetret, 2015.



CASE STUDIES

Western Union and Jamaica National Money Services are two companies that have had correspondent banking relationships severed recently. The experience of these two companies serves as evidence that de-banking affects the Caribbean and also demonstrates some of the underlying drivers of this de-banking phenomenon.

WESTERN UNION

In July 2015, Fidelity Bank & Trust International, a Caribbean-based financial services company operating in The Bahamas, the Cayman Islands and the Turks and Caicos Islands, ended its near 20-year Western Union²⁶ franchise in Bahamas. Western Union, like all other money transfer businesses, needs a local

bank to carry out transactions. Fidelity played the role of the local bank. But what was the reason for ending this 2-decade old relationship? According to Fidelity's Chairman & CEO, Anwer Sunderji, Fidelity decided to exit the money transmission services market because it was generating too little reward for the risk involved. He noted that money transmission was deemed high risk, and that this risk potentially jeopardised Fidelity's own correspondent relationships with foreign banks. Fidelity Bank, fearing that its operation of the Western Union franchise could possibly result in foreign banks terminating their relationships with it (Fidelity), decided to pre-emptively sever ties with Western Union to create greater assurance of a sustained CBR with foreign banks.

26 Western Union is a money services business which, among other things, facilitates the transfer of remittances across countries.



Another reason for terminating the CBR with Western Union, cited by Sunderij, was the fact that compliance costs were continually increasing for the low margin, high volume business where the regulatory risk simply did not justify the expense. "It's a low margin, high volume business that's expensive to manage. We've gone back to what we know best, and are de-risking our business," noted Suderij to Bahamian newspaper - the Tribune.

Without Fidelity to operate on its behalf, Western Union was forced to close in three countries: the Bahamas, Turks and Caicos Islands and the Cayman Islands. It was not until November 2015 that the Bank of Nova Scotia replaced Fidelity, allowing Western Union to resume operations. Between July and November, then, Western Union lost the revenue it would have garnered from customers had it been in operation.

The case of Western Union therefore corroborates the work of Durner and Shetret (2015) and Adams and Monroe (2013). High compliance costs amidst low profit margins largely influenced the termination of a CBR. Fear of losing other, more profitable CBRs also influenced Fidelity's decision to end its relationship with Western Union. This negatively affected the potential revenue and profit of Western Union.

JAMAICA NATIONAL MONEY SERVICES

Another demonstration of de-banking in the Caribbean can be seen in the experience of Jamaica National Money Services (JNMS).²⁷ In mid-2014, the Cayman National Bank (CNB), which handled payments for JNMS, wrote a letter to Jamaica National (JN), MoneyGram and Fast-Funds (money services businesses), giving them notice to find a new bank. Considering that money transfer companies need a registered local bank to carry out transactions, these institutions risked possibly closing down. The original deadline was the end of July 2015, but was then extended to the end of August the same year.

Wayne Panton, Financial Services Minister for the Cayman Islands, noted that the correspondent bank that took the bulk of cash deposits from Cayman National Bank, said it was no longer going to handle the bulk cash business. According to Leesa Kow, JN Managing Director, higher risks for the cash transfers and increasing costs to comply with international rules were the reasons provided for the termination of the CBR.

To sustain its relationship with CNB, JN offered to pay increased fees if higher AML/CFT compliance costs had influenced Cayman National's the decision to terminate the relationship. The inference here is that higher revenue would justify the risk associated with the business and convince Cayman National, and ultimately Cayman National's correspondent bank, to stay in the bulk cash business. However, Cayman National bank declined this offer.

According to the Cayman Compass newspaper, while Jamaica National Money Service did not close down, it had to limit its services to US dollar transactions. It ultimately took almost 4 months for JNMS (along with other institutions such as MoneyGram and QuickCash) to resume transactions in Cayman Island dollars. The Cayman Compass also reported that, according to Robert Hamaty (a board member of JN Money Transfer and President of Tortuga Rum), the de-banking crisis led to a shortage of US currency in the Cayman Islands as persons were forced to convert local currency to US before sending money to family overseas.

The shortage of US currency was not the only implication of the restriction of JNMS' business operations. More than 8,000 Jamaicans live in the Cayman Islands. According to Cayman officials, this figure represents 40 per cent of the foreign workforce in the country.²⁸ Considering that remittances to Jamaica accounted for 61 percent (or \$110 million) of the almost \$180 million in remittances to various parts of the Caribbean from the Cayman Islands in 2014, one can deduce that several Jamaican families were affected by this de-banking dilemma.

The case of JNMS therefore demonstrates the impact of de-banking practices on a Jamaican business and on Jamaican families who depend on the services of this business. It also demonstrated the added pressure placed on the supply of US currency, required for trading, in the Cayman Islands. The recurring theme of the high risk of money services businesses given their low profit margins and the high compliance costs to satisfy international regulations are once again cited as contributing factors to the de-banking problem. The two cases of Western Union and Jamaica National Money Services ultimately demonstrate how immediate and relevant the de-banking problem is to the Caribbean region.

27 JNMS is a Jamaican-based money services business which operates in several territories in the Caribbean.

28 Cayman Compass, 2015



CONSEQUENCES OF DE-BANKING

While correspondent banks aim to comply with AML/CFT requirements and shield themselves from undue risks and threats to their profitability, de-banking can have negative, and unintended consequences. This section therefore discusses some of the global consequences of de-banking.

De-banking practices may result in shifting AML/CFT risks to less secure areas and may in fact be counter-intuitive to AML/CFT efforts. According to James Richards, a top AML official at Wells Fargo, “The ironic result of de-risking is re-risking... you are sending them [institutions whose CBRs have been terminated] to banks that probably can’t handle it.”²⁹ De-banking may therefore encourage entities to move into less regulated (or even illegal) channels, thus reducing transparency and limiting monitoring capacities.

De-banking may also negatively affect international trade and finance, particularly for developing countries. The US dollar is used for 45 percent of all world payments, followed by the euro at 28 percent and the British pound at nearly eight percent.³⁰ Without CBRs, legal access to these currencies for international trade and finance becomes impossible. Furthermore, with the

majority of CBRs being held by fewer and fewer banks, a default of one of these interconnected banks could lead to closures of customer banks, as well as significantly reduced access to the global financial system for developing economies.³¹

There are also humanitarian concerns. Termination of CBRs can negatively impact the ability of human rights and not-for-profit groups to get financial assistance to vulnerable populations who need it. De-banking threatens livelihoods of people, most often in the developing world, with limited access to financial institutions. The case of Somalia is the most widely cited example. The May 2013 decision by Barclay (a British multinational bank) to close money transmitter accounts in Somalia not only threatened money services businesses, but also threatened the livelihood of Somalia citizens as more than 40 percent of the population relies on remittance inflows as a key source of income. These remittances account for between 25 percent and 45 percent of the country’s total GDP.³² With the poorest people in the poorest countries losing access to remittances (which form a huge part of their income), de-banking has the potential to escalate to a humanitarian crisis if left unaddressed.

29 Durner & Shetret, 2015.

30 Ibid.

31 Ibid.

32 Ibid.



IMPACT OF DE-BANKING PRACTICES ON LATIN AMERICA AND THE CARIBBEAN

The World Bank, through its survey of authorities and international and regional institutions, has noted that Latin America and the Caribbean (LAC) appears to be the region most significantly affected by de-banking practices. However, given the paucity of data, information regarding the actual and potential impact of de-banking practices on economies in the Americas remains largely anecdotal and based on inference. The approach taken below therefore seeks to highlight key features of the economies in the Americas that make them uniquely vulnerable to the impacts of de-banking practices. Such an approach will examine trade, remittance and investment flows.

A. TRADE

Correspondent banking is the asphalt on which global trade is driven, facilitating cross-border payment services, without which, international trade is nearly impossible. Particularly in Latin-America and the Caribbean (LAC), trade is intricately tied to economic growth and development. One way of measuring the importance of trade to a country/region is to account for trade as a percentage of gross domestic product (GDP). For example, in 2013, while trade corresponded with about one-third of GDP in North America as a region and the United States (USA) as a country, trade accounted for almost half the GDP for developing countries of LAC over the same period. For Caribbean small states, trade is equivalent to almost 100 percent of GDP. This demonstrates the disproportionate vulnerability of the Caribbean to de-banking practices.

B. REMITTANCES

Remittances are particularly important to developing countries. According to the World Bank Migration and Remittances Brief (2015), remittances are a key source of funding for developing countries globally, far exceeding official development assistance (ODA) and even foreign direct investment (FDI).³³ Remittances also have the advantage of being less volatile than official aid flows and are also at least as much as foreign exchange reserves in many small countries. The importance of remittances can be observed at the level of households or at the level of the entire economy.

Remittances are largely personal transactions from migrants to their friends and families. The United Nations Development Programme notes that remittances tend to be well targeted to the needs of the recipients. When families receive money from relatives abroad, they tend to invest in education and healthcare, more so than non-recipient households. Remittances have also been found to contribute to higher school attendance and educational achievement. Such remittances also act as social insurance, helping to reduce the severity of poverty.³⁴ A review of 71 developing countries found that a ten percent increase in international remittances from each remitter lead to a decrease of 3.5 percent in the share of people under poverty.³⁵ Remittances also form a part of the risk-spreading strategies of households, reinforcing the household's ability to cope with unforeseen circumstances and emergencies.³⁶

33 This conclusion excludes China.

34 Kamuleta, 2014.

35 Kamuleta, 2014 citing Adams and Page, (2005).

36 Kamuleta, 2014.

TRADE AS A PERCENTAGE OF GDP

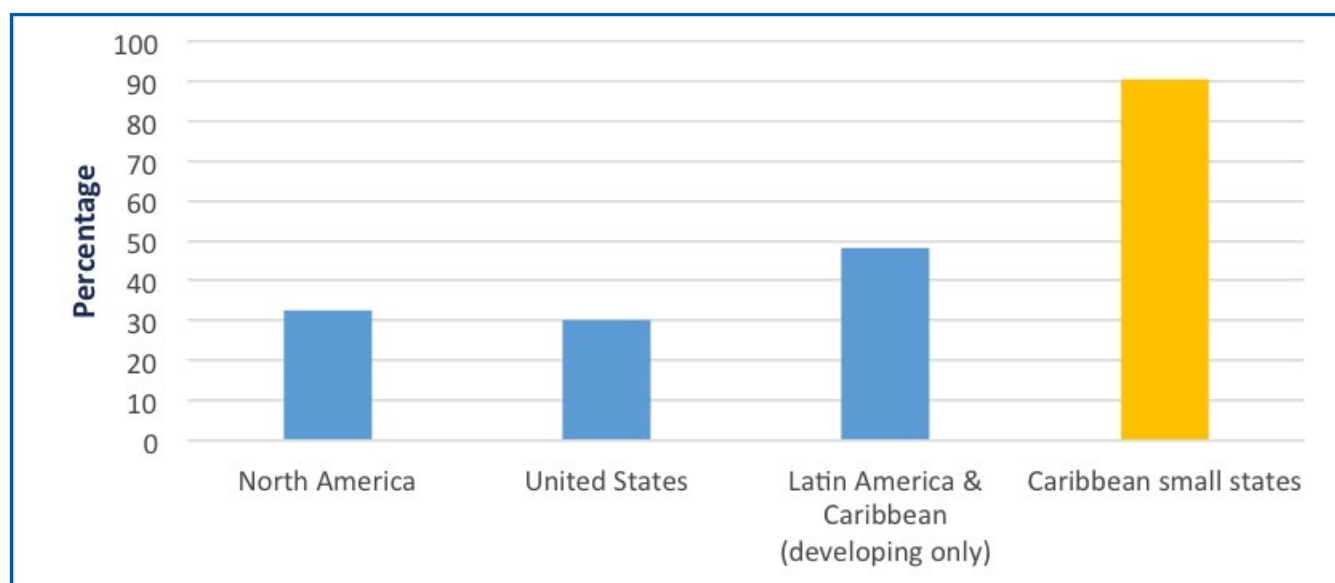


Figure 1: Trade as a percentage of GDP.

Source: World Bank, 2013.

From a broader perspective, remittances can potentially contribute to economic growth through increased consumption and investment.³⁷ The International Monetary Fund (IMF) and World Bank (WB) recognize the benefits of remittances as a stable and countercyclical source of external financing when assessing how much debt low income countries could safely handle. The IMF-WB Debt Sustainability Framework launched in 2009 allows recipient countries to carry higher levels of debt when the ratio of remittances is higher than 10 percent of GDP and 20 percent of exported goods and services. Higher levels of remittance inflows therefore allows countries to borrow more, and this extra borrowing power could be used to finance investments which may promote national economic growth.

This “counter-cyclical” of remittances means that remittances tend to increase when the economy worsens. This is another advantage of this commodity. When economies contract, the poorest citizens are often the most severely affected. This unique characteristic of remittances, given how well focused and targeted they are to the recipients’ needs, makes remittances one of the best forms of insurance for poor people.

It is therefore no surprise that poorer countries receive the majority of the world’s remittances, and the poorest persons in the poorest countries benefit the most from remittance inflows.

Remittances are therefore crucial to developing countries. They benefit primarily the poorest persons in the poorest countries, and represent the most efficient form of social insurance in an economy. However, compliance with AML/CFT requirements appears to have increased the overall cost of remittances.³⁸ Latin American and Caribbean countries are ultimately peculiarly vulnerable to the impact of de-banking practices.

VULNERABILITIES OF LATIN AMERICA & THE CARIBBEAN

The vulnerabilities of Latin America and the Caribbean to de-risking practices are again emphasized when one examines the region’s dependence on this inflow of cash, as opposed to countries like the United States of America.

For the period 2000-2013, in terms of average remittances received as a percentage of GDP, among the most vulnerable countries are Haiti (21%), El Salvador (16%), Honduras (15%), Jamaica (15%) and Guyana (14%)³⁹. Trinidad and Tobago (0.6%) is the least vulnerable among English speaking Caribbean countries while Venezuela (0.07%) is the least vulnerable Latin American country to the effects of de-risking, as far as dependence on remittances is concerned. The reliance of LAC on remittances therefore makes the region exceptionally vulnerable to the impacts of de-risking.

37 Kamuleta, 2014.

38 World Bank, 2015.

39 Author’s calculations based on World Bank, 2015 data.

C. FOREIGN DIRECT INVESTMENTS

Foreign direct investment (FDI) refers to cross-border acquisitions of productivity assets. In other words, FDI represents investment (usually in the establishment of operations or the acquisition of tangible assets) made by a company or entity based in one country in a company or entity based in another country.

Foreign direct investments can help countries in several ways. FDI has the unique feature of inserting local businesses into the global supply chain. FDI allows the transfer of technology—particularly in the form of new varieties of capital inputs—that cannot be achieved through financial investments or trade in goods and services. FDI can also promote competition in the domestic input market, reducing the input costs of businesses.⁴⁰ Additionally, FDI results in employee training in the course of operating the new business, and this contributes to human capital development. Profits generated by FDI can also contribute to corporate tax revenues in the host country.⁴¹ However, this is only when countries do not forego this revenue by cutting corporate tax rates, which is a typical practice in an effort to attract FDI from other locations.

Like remittances, FDI has a positive impact on economic growth in developing countries.⁴² Latin America and the Caribbean's dependence on FDI and other inflows make this region highly susceptible to the effects of de-banking.

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Without CBRs, the flow of FDI is significantly inhibited. The reliance of Latin America and the Caribbean on foreign direct investment therefore makes the region vulnerable to de-banking practices. Figure 3 below illustrates the average value of net FDI inflows to the region for the period 2000-2013. The data demonstrates that Caribbean small states have more to lose if FDI inflows are impeded by de-banking practices. For example, net FDI inflows correspond to 17 percent of GDP in St. Kitts & Nevis, 14 percent in St. Vincent & the Grenadines and Antigua and Barbuda, and 11 percent in St. Lucia and Grenada. Among Latin American countries, Panama (8%) and Chile (7%) are the most vulnerable.

AVERAGE REMITTANCES RECEIVED (% OF GDP) 2000-2013

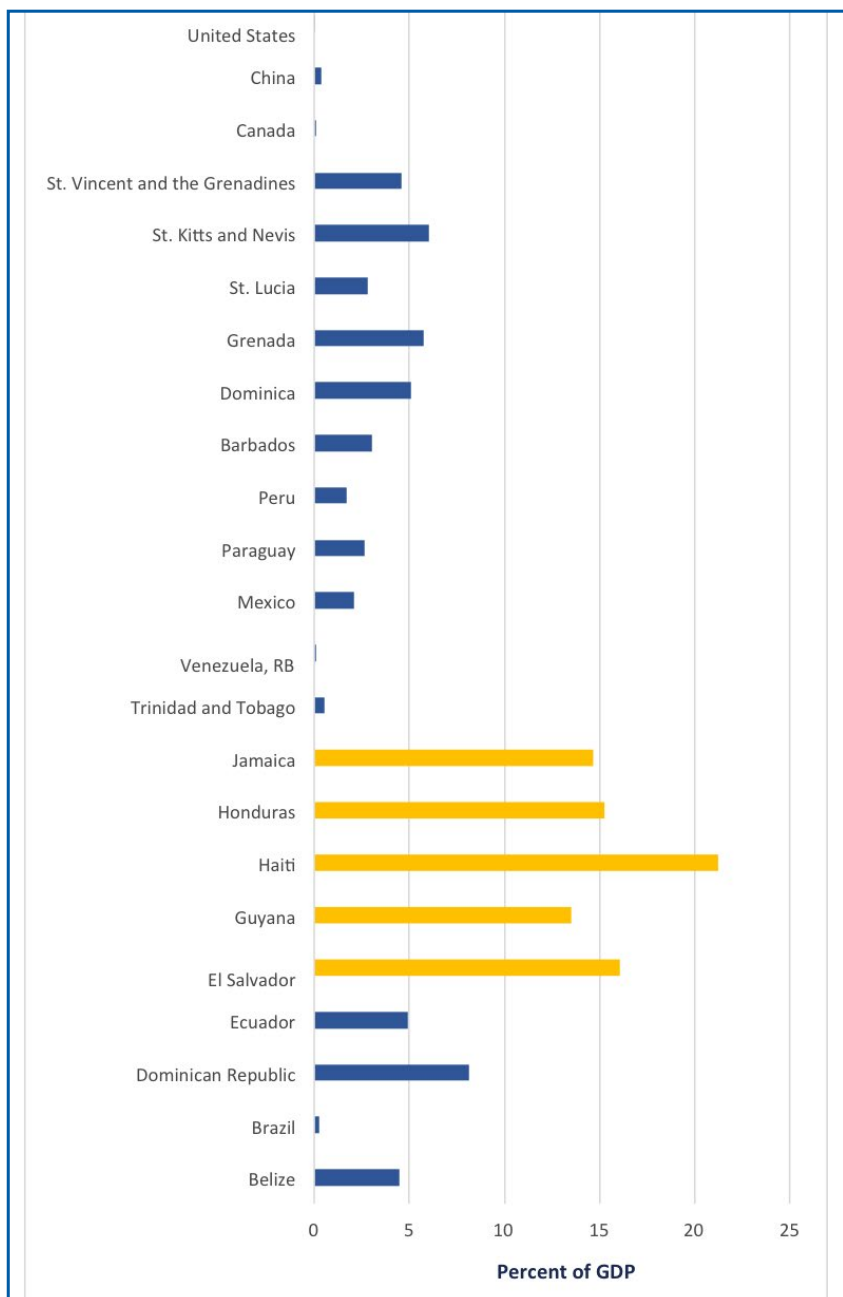


Figure 2: Jamaica Trade Statistics

Source: Author's calculations based on World Bank data
 *Trinidad & Tobago calculated from 2000-2011; Venezuela calculated 2000-2012; Canada from 2005-2014

40 Loungani & Razin, 2001.

41 Ibid

42 Driffield & Jones, 2013.

AVERAGE FDI NET INFLOWS (% OF GDP) 2000-2013

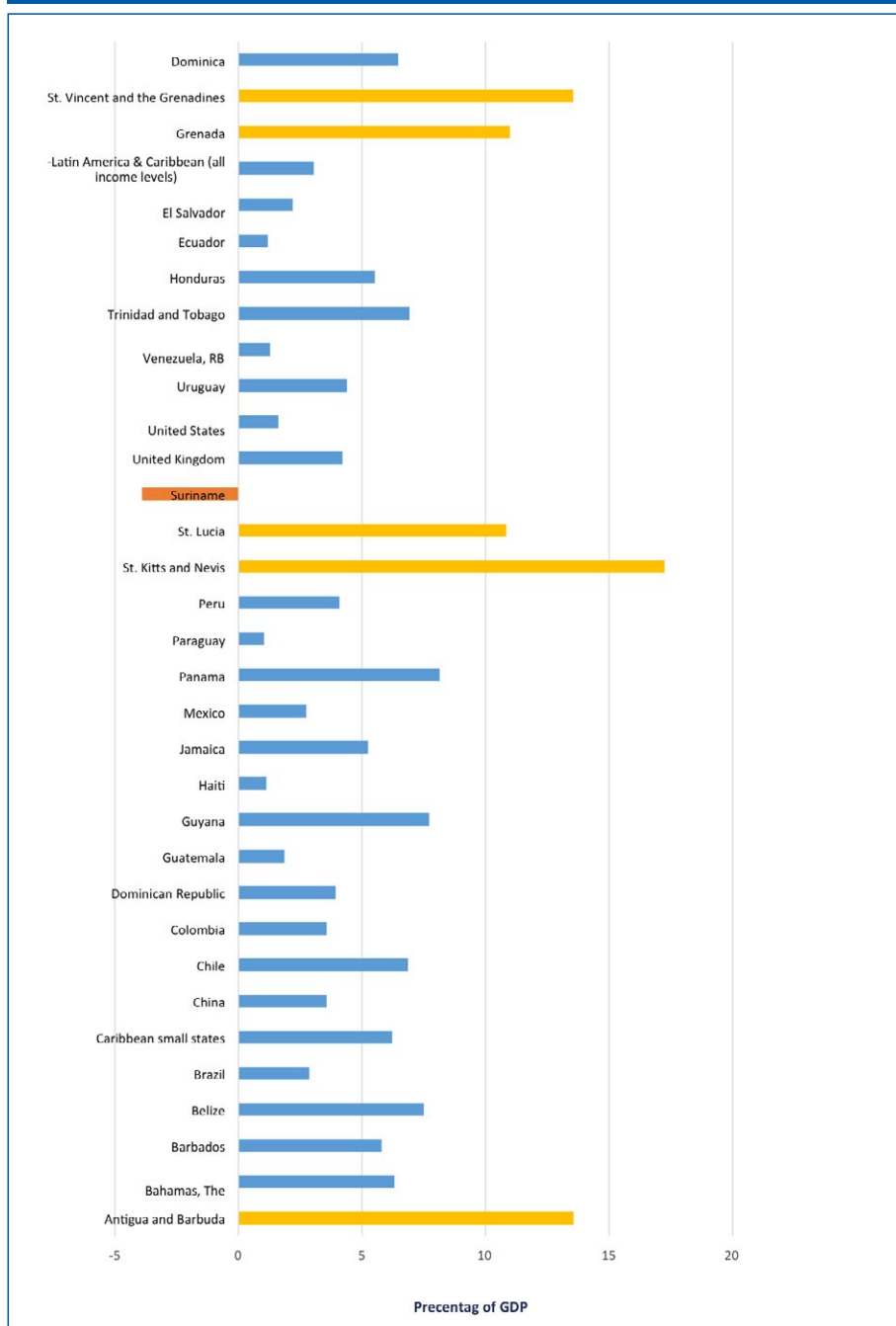
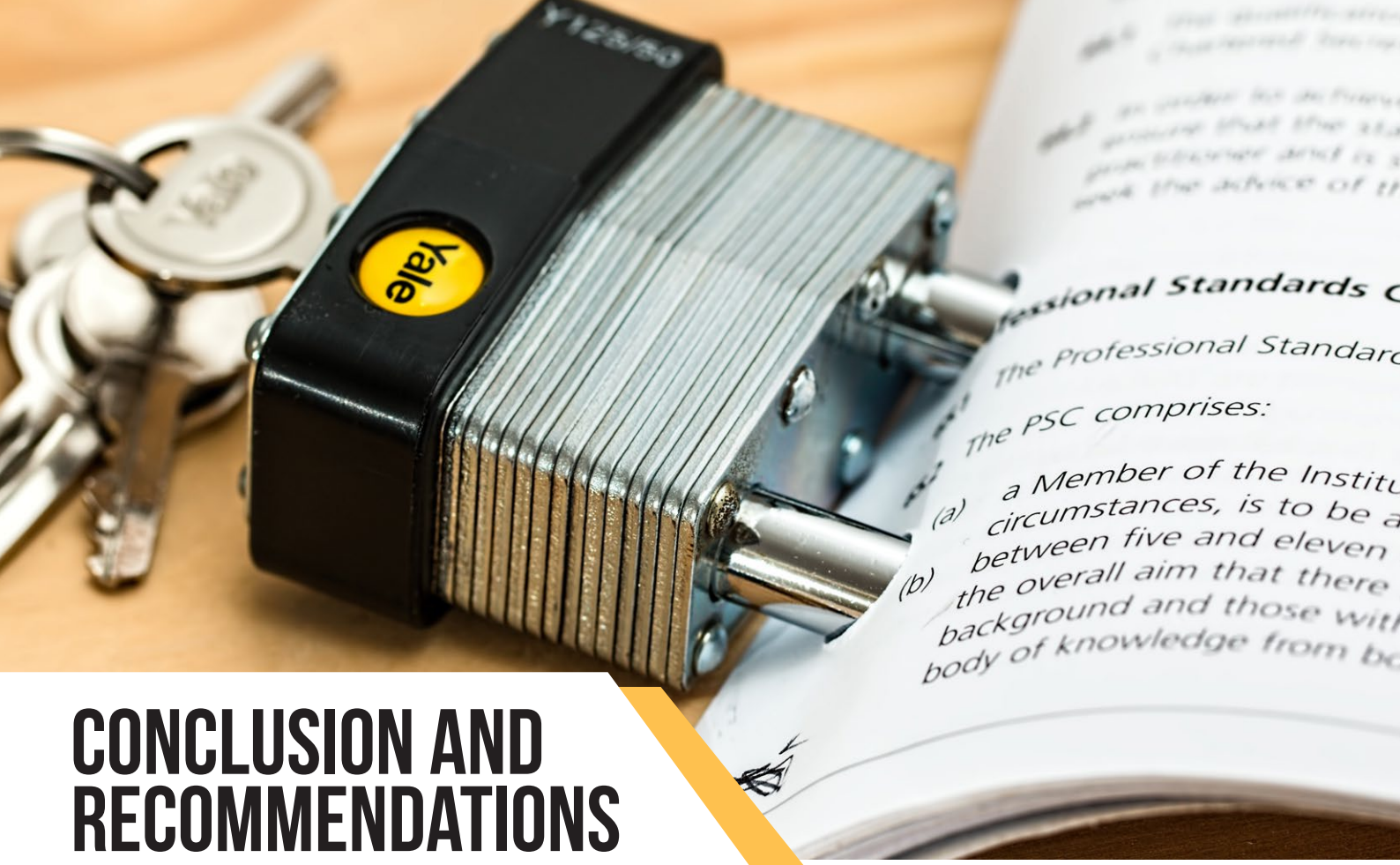


Figure 3: FDI inflows (% of GDP) for selected LAC countries. Source: World Bank (*Venezuela calculated using data from 2000-2012)

In conclusion, correspondent banking relationships play a critical role in facilitating the flow of cash across national borders. This means that international trade, the flow of remittances and foreign direct investment all rely on CBRs. Because Latin American and Caribbean countries rely heavily on trade, remittances and foreign

direct investment, de-banking practices, which result in the restriction or termination of correspondent banking relationships, directly threaten the economies of Latin America and the Caribbean. De-banking can therefore lead to economic contraction, increased levels of poverty and increased unemployment.



CONCLUSION AND RECOMMENDATIONS

Having described the nature of the de-risking crisis and the impact it is having (and can have) on the economies of the region, it remains to explore initiatives that can be taken in the Caribbean that can help to resolve the issue. Unsurprisingly, there are no easy answers. Fundamentally however, recommendations must address two sets of problems. The first, and perhaps the easier problem to address, is the informational opacity plaguing the international financial system. The second and more difficult issue, concerns the profit-loss considerations of banks. With regard to the second issue, all invested stakeholders (banks, regulators, and clients) seem to be acting rationally and in their own best interest. It is precisely this factor that makes resolving the issue uniquely challenging. The unintended consequences may therefore represent a market failure.

To this end, recommendations of the CPMI (though limited to technical issues), combined with targeted approaches to address the driving forces behind de-risking discussed in previous sections of this paper, may prove instructive in identifying the ameliorative actions for Caribbean stakeholders.

1. STREAMLINE REGULATORY FRAMEWORKS AND METHODS FOR DATA COLLECTION AND STORAGE:

Caribbean banks, money services businesses and other relevant, private sector institutions should design a homogenous mechanism, as far as data privacy laws allow, to share data that helps Caribbean institutions “know-their customers”. To this end, all banks in the Caribbean could agree to collect and store the same type of data in the same format to make information sharing more efficient. (This does not necessarily mean that all institutions need to use the same software or use a single

online platform as this may pose a potential security risk. If just one institution is hacked, then the entire Caribbean may become vulnerable.)

This recommendation corresponds with the CPMI’s recommendation on the use of Know-Your-Customer utilities. Know your customer (KYC) utilities include methods for collecting information about users of banking services. This would include specific data series such as name, address, occupation etc. The CPMI recommends that stakeholders review the templates and procedures used by the different utilities and identify the most appropriate data fields to compile a data set that all utilities should collect as best practice and that all banks have to be ready to provide to banks which require the information. This could possibly help to reduce compliance costs.

International AML/CFT regulators can be consulted on what specific data on customers are needed. The public/customers should be made immediately aware of what data is collected on them, who has access to their information, the specific criteria for sharing specific data with other institutions and what, specifically, the information will be used for. The protection of consumer privacy and customer security should remain central to any discussion on information sharing, to prevent customers from being held hostage by the collective effort of Caribbean financial institutions, whose services are critical to customers’ wellbeing, and whose collective powers may supersede the average individual’s. All institutions collecting such data must therefore subscribe to the benchmark/international standards in banking data security.

2. RECOMMENDATION ON THE USE OF THE LEGAL ENTITY IDENTIFIER (LEI) IN CORRESPONDENT BANKING:

Legal Entity Identifier (LEI) is a 20 character, alpha numeric code, used to uniquely identify legally distinct entities that engage in financial transactions. The use of the LEI for all banks involved in correspondent banking as a means of identification should therefore be provided in Know-your-customer (KYC) utilities and information-sharing arrangements. Using existing LEI mapping capabilities, Bank Identifier Codes (BIC) and financial transactions could be tied to LEIs to more accurately determine the source and route of funds. This would potentially strengthen AML/CFT frameworks in the Caribbean region, giving correspondent banks more confidence in the Caribbean. This however, requires intensive coordination.

3. RECOMMENDATION ON PAYMENT MESSAGES:

MT 202 is a specific format of communication between banks when making cover payments. Cover payments are used in correspondent banking, usually to facilitate international transactions. They are payments made through a chain of correspondent banks to settle ("cover") a credit transfer message that travels a more direct route to the ultimate beneficiary's bank. The MT 202, which is sent to intermediary banks, does not require the inclusion of originator and beneficiary information that is contained in the underlying MT 103 (which is sent to the beneficiary's bank, but not to the intermediary banks when the cover payment is used). The CPMI recommends that stakeholders determine which format is better for them to use.

4. CENTRAL BANK MONITORING:

Central banks across the region should monitor correspondent banking relationships, gathering information on the status of CBRs (i.e. existence of relationships, date and reason for termination, length of time engaged, impact on profits and employment within the firm, etc.). This could help to generate the empirical data needed to inform ameliorative actions.

5. COLLECTIVE LOBBYING AS A REGION:

Banks, Money Services Businesses and other relevant, private sector institutions should combine efforts and lobby for

international regulators (the Financial Action Task Force and the Basel Committee on Banking Supervision AML/CFT Expert Group (AMLEG)) to clarify ambiguities in regulations governing AML/CFT; articulate clear, specific guidelines governing how far customer due diligence should go in order to ensure regulatory compliance (i.e. to what extent do banks need to know their customers' customers?).

Additionally, Caribbean regulators and authorities across jurisdictions can autonomously develop streamlined definitions, standards, and policies that reduce compliance burdens and improve accountability. Since there is ambiguity on the part of the International regulators (e.g. FATF), the Caribbean can approach these regulators with their own proposed standards and policies. Feedback from FATF and others may lead to greater clarity. This can then be advanced at the international level, having other regions around the world subscribe to these definitions, standards and policies. This would also require that Caribbean banks, regulators and Heads of Governments engage in discussions with their counterparts in foreign countries in order to share ideas on how to solve the de-risking problem, gain consensus on ameliorative actions and form strategic alliances to advance their concerns and recommendations at international level as a developmental issue. However, any collective effort (technically or at the policy level) as a region requires leadership dedicated specifically to this task and the concomitant financial resources to do so.

Ultimately, the recommendations outlined may help to address the underlying problem of inadequate information. A direct solution to the profitability concerns of banks may be difficult to identify. However, addressing the informational concerns, as well as some of the technical issues related to correspondent banking, may reduce compliance costs, reduce the fear of reputational loss and ultimately, reduce the likelihood of CBRs negatively affecting banks' profits. What is clear, is that further discussions at the regional level are required. The Caribbean region needs to identify a leader to drive coordinated efforts to address this crisis, supported by adequate financial, human and technical resources.

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The Caribbean Policy Research Institute (CaPRI) is a not-for-profit, public policy think tank based at the University of the West Indies, dedicated to the provision of impartial, evidence-based knowledge to inform economic and social policy decision-making in Jamaica and the wider Caribbean.

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