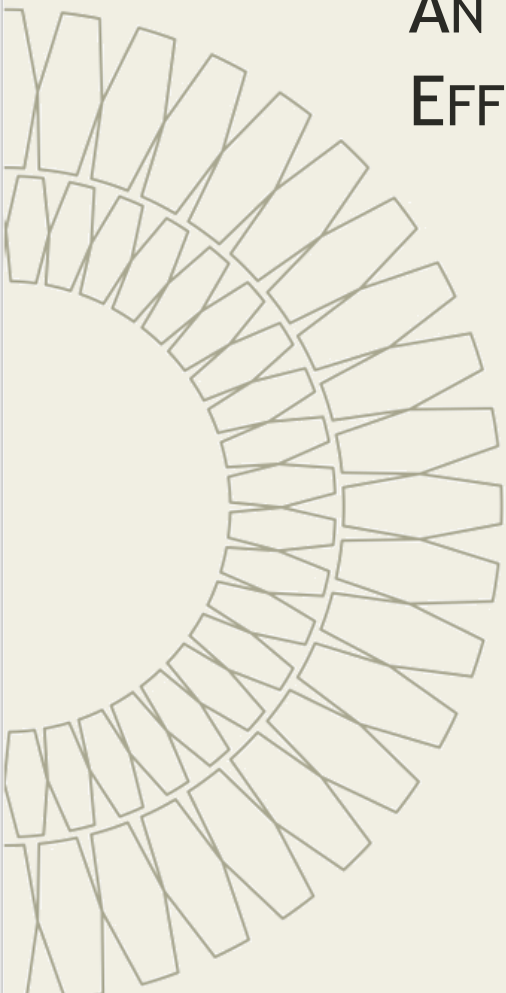




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ASSOCIATION OF SUPERVISORS OF BANKS OF THE AMERICAS

AN OVERVIEW ON DE-RISKING: DRIVERS, EFFECTS AND SOLUTIONS



MEXICO CITY, MEXICO

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AN OVERVIEW ON DE-RISKING:
DRIVERS, EFFECTS AND SOLUTIONS

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I. WHAT IS DE-RISKING?

The regulatory reforms, which have set new international standards, brought about both greater complexity and regulatory requirements to the financial sector and its regulators. These reforms are impacting on the effectiveness and efficiency of both low-income and emerging market jurisdictions.¹ Some of them come from international regulations aimed at protecting the financial sector from criminal use, such as anti-money laundering and countering the financing of terrorism (AML/CFT) requirements. On this matter, the increase of regulatory expectations and the corresponding sanctions have increased Misconduct Bank Costs, which have gone from approximately 10 billion euros in 2009 after the crisis, to 200 billion euros by January 2014 worldwide.² Concomitantly, banks are acting to avoid the risk of non-compliance through reducing potentially high-risk business lines, lower return activities, businesses with increased regulatory requirements, and others that may expose the sector to undue reputational risk.³

The activity mentioned above is better known as derisking, which has significantly affected correspondent banking, which plays an essential role in cross-border transactions; thus, in the global payment system. Through these correspondent banking relationships, respondent banks can provide cross-border payment services in different jurisdictions supporting various economic activities such as international trade and

ASBA's definition of de-risking: ASBA defines de-risking as the process wherein financial institutions leave or significantly reduce certain business lines to avoid compliance and regulatory risks.

Compliance Risk: It is defined as the risk of legal or regulatory sanctions, material financial loss, or loss of reputation a bank may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organization standards, and codes of conduct applicable to its banking activities.

Regulatory Risk: It is the risk that a change in laws and regulations will materially impact a security, business, sector or market. A change in laws or regulations made by the government or a regulatory body can increase the costs of operating a business, reduce the attractiveness of investment and/or change the competitive landscape.

finance, international investment, foreign exchange management, wire transfers, and remittances. Because of de-risking related measures these relationships are being either terminated or limited, directly affecting emerging economies and low-income countries.⁴

¹ Lesetja Kganyago, Governor of the South African Reserve Bank, "Conference on Financial Intermediation in Emerging Markets" (hosted by the University of Cape Town/ Imperial Business School/ Economic Research Southern Africa/ Review of Finance, Cape Town, South Africa, December 7-10, 2016):1.

² Max Alier, 'The Withdrawal of Correspondent Banking Relationships: A Case for Policy Action', IMF, July 8, 2016: 12, accessed February 10, 2017 (www.imf.org/external/pubs/cat/longres.aspx?sk=43680)

³ Finance and Markets Global Practice of the The World Bank Group, 'Withdrawal from Correspondent Banking: Where, Why, and What to Do About it', *The World Bank Group*, (2015): 9

⁴ Bank for International Settlements, "Correspondent Banking", *Committee on Payments and Market Infrastructures, Bank for International Settlements*, July, 2016, accessed February 8 2017, ISBN 978-92-9197-617-1

This document explores the main drivers for de-risking, assesses some of its consequences, and explores a set of possible solutions. The alternatives provided are not mutually exclusive, and the optimal solutions shall stem from an in-depth analysis of the markets being affected, the reasons behind de-risking, the assessment of its impacts, and the identification of solution alternatives. Whatever the solution, its design and implementation would need to be integral, which would require active cooperation between respondent banks, correspondent banks, and the financial sector authorities.

II. DE-RISKING DRIVERS

The de-risking process is driven by a combination of low return business lines for correspondent banking, greater risk management controls, and more stringent and demanding prudential requirements.

Correspondent banking depends on high volume operations to be profitable. Thus, the lower returns environment and the increasing competition of new business models supported by technology are provoking a retrenchment of the financial sector from this type of operations.

Furthermore, the adoption of the Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) standards recommended by the Financial Action Task Force (FATF) and alignment to country specific requirements may be driving up costs and risks of keeping or establishing relationships between correspondent and respondent banks. The uncertainty around AML/CFT sanctions (including acceptable terms of risk appetite) causes concerns about making errors or to inadvertently not comply with certain rules. Indeed, since a considerable share of the total risk is not quantifiable in monetary terms, it is hard to factor risks in the risk-reward ratio assessment, further driving down correspondent bank relationships. Indeed, “given the potential damage to reputation and balance sheet from any enforcement case, firms seek to avoid any counterparties or jurisdictions where there is uncertainty.”⁵

On the other hand, financial institutions are required to practice Customer Due Diligence (CDD) to understand who their customers are and what type of transactions they conduct to be able to prevent illicit activities - such as terrorist financing, money laundering, fraud, and tax evasion - from happening. Key elements of CDD include identifying and verifying the identity of customers and the identity of beneficial owners of legal entity customers (i.e. the natural persons who own or control legal entities); understanding the nature and purpose of customer relationships; and conducting on-going monitoring.⁶

Furthermore, KYC requirements and further due diligence for higher risk clients or countries can become very expensive and time-consuming. Also, different jurisdictions or institutions may have different ways of collecting CDD and KYC information, leading to inconsistent procedures and classification across jurisdictions; which may be magnified by banks avoiding sharing information due to conflicts with Privacy and Data Protection requirements.

In 2015, the World Bank surveyed banking authorities and banks worldwide to examine the extent of withdrawal from correspondent banking, its drivers, and its implications for financial exclusion/inclusion. In total, 110 banking authorities, 20 large banks, and 170 smaller local and regional banks participated in this exercise.

According to the survey results, “Ninety-one percent of banking authorities’ mentioned either lack of profitability of foreign Corresponding Banking Relationships (CBRs) services or structural changes as accounting for the decline in foreign CBRs. Increasing costs of regulatory compliance; notably, the inability

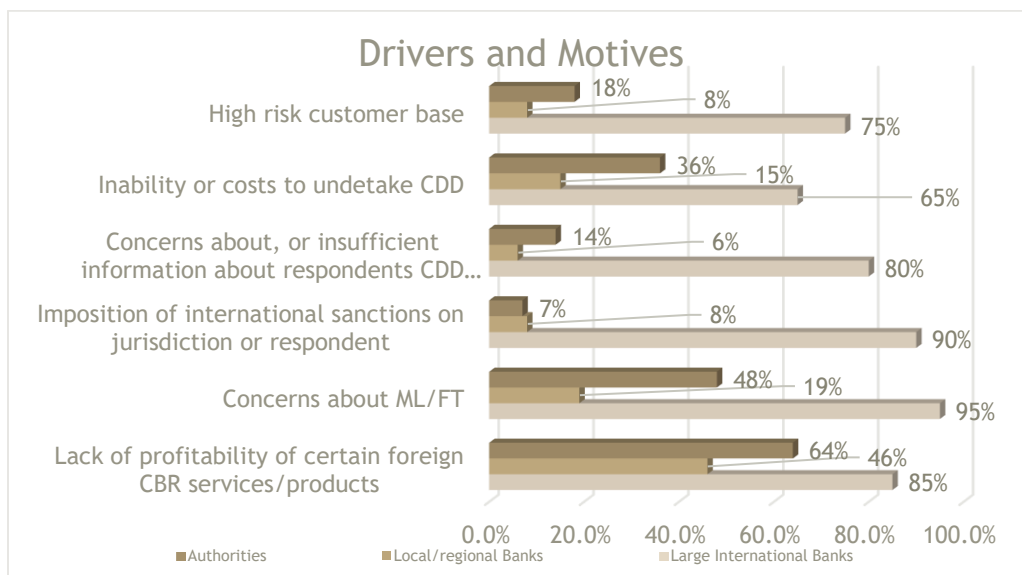
⁵ Finance and Markets Global Practice of the World Bank Group, ‘Withdraw from correspondent banking: where, why, and what to do about it’, *The World Bank Group (2015)*: 29-29, accessed February 9, 2017. (<http://documents.worldbank.org/curated/en/113021467990964789/Withdraw-from-correspondent-banking-where-why-and-what-to-do-about-it>).

⁶ Financial Crimes Enforcement Network, Department of the Treasury, ‘Customer Due Diligence Requirements for Financial Institutions’ (May 11, 2016):8, accessed February 8 2017; RIN 1506-AB25 ,(<https://s3.amazonaws.com/public-inspection.federalregister.gov/2016-10567.pdf>)

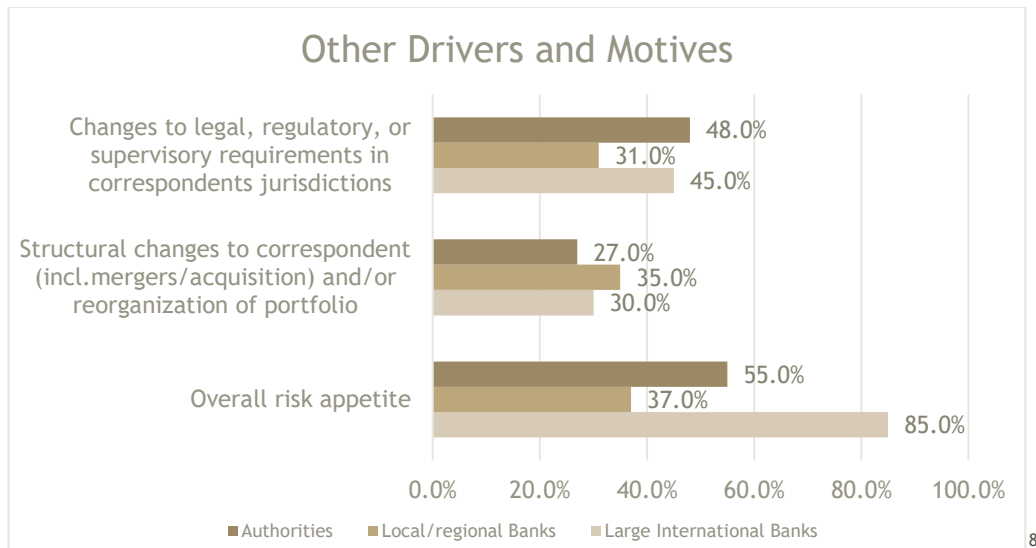
and cost to undertake CDD and insufficient information about respondent’s CDD procedures, have been cited by half of the respondent authorities. Also, almost half of the respondents mentioned overall risk, concerns about AML/CFT risks, and changes to legal or regulatory requirements in foreign jurisdictions, as causes of decline. Together, seventy-three percent of respondent banking authorities mentioned AML/CFT concerns as one of the drivers for restriction or termination”.⁷

However, a more accurate approach suggests that there are some contrasts between the parties in the survey. The entities more worried about de-risking were large international banks. Specifically, the AML/CFT sanctions imposed, risk appetite, lack of profitability, and concerns about sufficient information regarding respondents CDD procedures were of concern for at least 80% of the major international banks’ respondents.

In contrast, local or regional banks and authorities do not consider insufficient information about CDD procedures an important driver for de-risking. The same holds true for the high-risk customer base. This contrast suggests that there might some incentives incompatibilities when dealing with de-risking since different parties deem some factors relevant while others do not.



⁷ Finance and Markets Global Practice of the World Bank Group, “Withdrawal from correspondent banking: where, why, and what to do about it,” ‘ibid’, 31
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III. EFFECTS OF DE-RISKING

A. SOCIO-ECONOMIC IMPACT

The withdrawal of correspondent banking has a direct effect on MTO's (Money Transfer Operators) and other remittance institutions. The latter facilitates the international transfer of money to smaller economies, of which the population greatly depends on; consequently, slowing down development and growth in such countries. Also, entrepreneurial activities, are decreasing due to less access to funds.

The lower access to foreign currencies also plays a role in the tourism industry. For example, the Caribbean where the tourism sector is one of the largest contributors to the GDP. If access to foreign exchange services or wire transfers diminishes then tourism flows and investments in this areas and other related activities also diminishes.

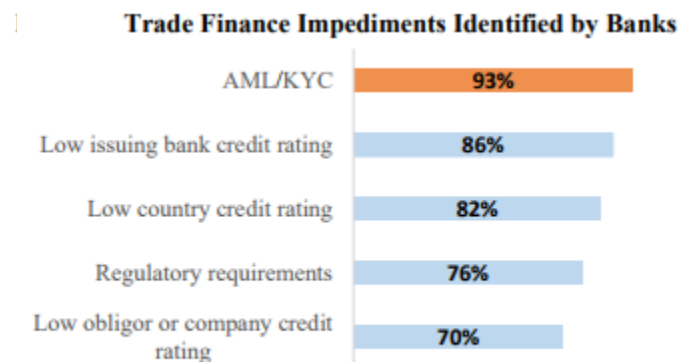
B. TRADE FINANCE

Finance services from correspondent banks play a major role in cross-border trade. Banks provide trade finance services such as:

- Export/import letters of credit
- Standby & back-to-back letters of credit
- Discounting
- Contract guarantees

⁸ Finance and Markets Global Practice of the World Bank Group, "Withdrawal from correspondent banking: where, why, and what to do about it," 'ibid', 33(<http://documents.worldbank.org/curated/en/113021467990964789/Withdraw-from-correspondent-banking-where-why-and-what-to-do-about-it>). The following graphs were made with information taken from the World Bank document. They reflect approximate results.

Without these services, small to medium exporters are less able to participate in trade. This affects many countries' Balance of Payments. Also, small exporters will potentially move to already saturated working markets or partake in criminal activities.⁹



Source: ICC Global Survey on Trade Finance, 2016.

C. DECREASE IN FINANCIAL INCLUSION AND PRESSURE ON SMALL BANKS TO TAKE ON HIGH-RISK CUSTOMERS

The retraction of correspondent activities affects financial inclusion directly. On the one hand, the withdrawal of CBRs implies that fewer services are being provided in the region, translating into less access to banking services. Moreover, as a measure to avoid risks, correspondent banks may treat a larger proportion of consumers as high-risk customers. As such, de-risking provides incentives for banks to group customers inefficiently to prevent potential sanctions.

Thus, when CBRs are terminated, the high-risk and poor populations need to find substitutes to get financial services. An alternative for excluded consumers is to search for smaller banks willing to provide CB services, leading to smaller, less prepared banks to serve these customers. This implies that the efforts to mitigate risk paradoxically result in higher risk exposures.

D. RECREATING RISK: PROMOTING USE OF NON -REGULATED FINANCE, FINTECH AND SHADOW BANKING

Another alternative that consumers have for accessing CB services that are no longer provided by correspondent banks is to acquire financial services in less regulated, riskier, and unknown environments such as Fintech and shadow banking. These alternatives are attractive for the population due to lower costs, ease of access, and sometimes are the only services available. Fintech is a growing area in finance that has enabled many opportunities to provide financial services more efficiently. However, even though Fintechs are developing rapidly, their regulation is still at an early stage.

The above creates a regulatory paradox. The higher compliance and regulation requirements aimed at reducing and preventing money laundering and terrorism financing activities are provoking derisking, which, in turn, pushes operations to less regulated and monitored markets.

⁹ Tracey Durner and Liat Shetret, 'Understanding Bank De-risking and its Effects on Financial Inclusion', *Global Center on Cooperative Security, Oxfam*, (November 2015): 19-20, <http://www.globalcenter.org/wp-content/uploads/2015/11/rr-bank-de-risking-181115-en.pdf>

IV. SEARCH FOR SOLUTIONS

A. INCREASED USE AND ENHANCEMENT OF LEI (LEGAL ENTITY IDENTIFIERS)

A Legal Entity Identifier (LEI) is a unique 20-character, alphanumeric code that can be used to identify distinct legal entities that engage in financial transactions so that each firm can be traced and information made widely available. It is a tool to effectively assist with identification and measuring of risk by increasing immediate access to credible knowledge of transactional counterparties.

Each LEI is assigned to a unique legal entity and each legal entity. The LEI code is associated with reference data, currently including basic identification information, such as the official name of the legal entity and the address of its headquarters. The expectation is that the standard will be enhanced in the future so that the reference data will also include the direct and ultimate parent(s) of legal entities and information on relationships (including ownership). It is important to highlight that the LEI is envisaged for the unambiguous identification of legal entities (and trusts), but is not applicable to natural persons. The LEI is not intended to be a source of AML information, nor is it used as a routing code for cross-border payments (instead, the Business Identifier Code (BIC) is widely used for this purpose). LEIs are issued in various jurisdictions through Local Operating Units (LOUs) for a fee, which validate the reference data upon issuance, and periodically go through certifications. LOUs make the LEIs and the associated reference data publicly available free of charge.

Properly implemented LEIs allow banks to compare across different legal entities to detect their relationships and ownerships structures, allowing for a more efficient consolidated risk assessment, enabling banks to make better decisions and reducing uncertainty regarding interlinkages in the system.

However, LEIs today are limited in their scope since they do not apply to natural persons and do not give information about owners of legal entities—an important AML/CFT requirement—which currently limits the current applicability of LEIs for due diligence processes.

Potential benefits on LEIs: If LEIs—or a new indicator— evolves in such a way that it allows moral and natural persons' comparison, then banks would get more insight on all the transactions of any entity. If the development of this indicator allows tracing the final owner of legal entities, then LEIs would become a valuable tool for matching customers across distinct databases, improving the quality of risk assessment.

Pros

- Easily adaptable; LEI can complement the standardization of KYC utilities through the identification of the parties in a transaction; through the true ownership structure and headquarters.
- Financial institutions will be able to identify specific entities when screening sanctioned entities.
- Identify transactions of common entity reported by different financial institutions more easily.
- Can integrate originator and beneficiary information in wire transfer payments for FATF compliance.

Cons

- LEI do not apply to natural persons.
- LEI provides information on ownership and relationships between legal entities. However, it does not cover identification of natural persons as beneficial owners of legal entities. This is one of the aims of AML/CFT requirements.
- LEI is not designed to perform CDD on behalf of third parties.
- Currently banks use the BICs as they are the basis for all message routing, which already include corporate bodies and natural persons.
- Does not substitute AML/CFT due diligence.

B. KYC UTILITIES - STANDARDIZATION

KYC Utilities are electronic repositories where respondent banks store and update their customer information. This allows clients to reduce their administrative costs when opening different accounts in several banks. Also, these would allow correspondent banks to access such repositories for conducting their due diligence.

Responsible use of KYC utilities would imply that respondent banks control access making their information available only to designated correspondent banks. KYC Utilities can significantly reduce time, cost, duplication of effort and complexity for both parties, making it an attractive solution to reduce compliance burdens.

However, if different KYC utilities contain different information requirements, the efficiency gains from these tools can be diminished. For instance, if correspondent Bank B requires a specific set of criteria for conducting its due diligence, but respondent Bank A uses a repository that contains different information then the purpose of the utility is not achieved. Thus, it is important to standardize the minimum requirements that KYC utilities must have to be properly used. Doing so would provide certainty to correspondent banks that their due diligence process will be considerably smoother and faster.

Potential benefits of the use of KYC utilities: The use of KYC utilities in general - given that they store at least a minimum set of up-to-date and accurate information - can be supported as an effective means to reduce the burden of compliance with some KYC procedures for banks active in the correspondent banking business. Relevant stakeholders may 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 must be ready to provide to others which require information.

Pros

- Independence and control: Respondent banks are in charge to provide information and maintain full control of data and to determine which banks have access to it.
- Number of times respondent bank would need to send information would be reduced.
- Accuracy and consistency of information increased, due to one set of updated information.
- Reduced costs.
- Speed and ease of access for financial institutions.

Cons

- Responsibility still lays on correspondent banks to practice due diligence.
- KYC templates might differ between utilities.
- KYC utilities need to set adequate parameters regarding which events will trigger the necessity to update information.
- Privacy laws of some jurisdictions may prohibit sharing, storing or mining of basic information in KYC utilities.
- Due to different requirements in information from correspondent banks deriving from the non-standardized risk- based approach, bilateral relations will still have to be used to obtain further information.
- Risk-based approach required by AML/CFT makes it unfeasible to standardize information. Utilities would only provide minimum information for correspondent banks to practice due diligence.

C. CENTRALIZED REGIONAL/NATIONAL DATABASES

Even if data sets and repositories for KYC are standardized, there is still another important element that needs addressing. If a single customer has a relationship with several banks, each bank would have a specific profile for this client. Such profiles might and probably have duplicate information, which is inefficient.

Thus, the development of centralized databases for AML/CFT purposes, in which banks would provide information on the identities, business, and transactions of their customers active in cross-border payment services. These databases could help reduce duplicate reporting, as respondent banks would then send such information only to the database, where it could be accessed by all correspondent banks and authorities with a legitimate interest.

Another advantage of centralized databases is the access to updated and better information by correspondent banks. A database of this nature aggregates a client's transactions creating more comprehensive customer business' profiles. The main advantage of this approach is the additional data that could be used by every bank when performing due diligence.

Furthermore, the management of highly confidential information stored in such a database might require the support of a public authority to ensure its integrity, which could also increase the confidence of correspondent banks and their authorities in the reliability of the information. Also, the centralization of data requires proper cyber-security measures, because a security breach would affect the whole dataset.

Potential benefits of centralized databases: The creation of an information-sharing mechanism for centralizing and sharing due diligence information might be an adequate solution for jurisdictions where banks are facing difficulties in opening or maintaining correspondent banking services with other jurisdictions. This would reduce duplication of efforts, reduce costs, and improve risk analysis.

Pros

- Reduce duplicate reporting and efficient process line.
- Access from all authorized correspondent banks and authorities when needed.
- Better and up to date information, as the transactions of a single customer from different correspondent banks could be aggregated into a customer's profile.
- The sharing and storage of this sensitive information in a single database may need the intervention of a regional public authority, further promoting the legitimacy and reliability of the information, encouraging its use by correspondent banks.
- Segmentation of transactions by product, sector, and others.

Cons

- Privacy laws: In certain jurisdictions, specific customer information may be protected by privacy laws and impede the sharing of specific information with other banks. This situation of non-sharing may lead correspondent banks to classify these customers' transactions as suspicious and risky, leading to their rejection and blockage. As a snowball effect this can push for the termination of correspondent banking relationships.
- This information sharing has the purpose for banks to differentiate between customers to benefit those of less or negligible risk. Nevertheless, due to the mass scale of information sharing, identical names may repeat themselves, leading to erroneous service denials.
- The concentration of sensitive information in a single database may lead to threats of hacking and other cybersecurity issues, leading to reputational and legal risks.
- Set up and maintenance costs of database.
- Decision process to select a public authority to manage may be time-consuming.
- Impact on competitiveness of regional banks.

D. CONSOLIDATION OF CBRs THROUGH MAJOR CORRESPONDENT BANKS AND NESTING

Another issue that needs to be considered in dealing with de-risking is the CBRs' need of high volumes of traffic to be profitable. An option to deal with this problem is concentrating national transactions' traffic, where banks could rely on using one or just a few correspondent banks. This would, in turn, increase the volume absorbed by these correspondent banks and reduce costs, further improving the problem of lack of profitability through insufficient volume.

Consolidation of transactions could take place at the national level or the regional level through Centralized Transactions Hubs. At the national level is a short to medium term solution, while a consolidation at a regional scale, even though it could be cumbersome, would be desirable in the long run. Either way, this approach would increase the business volume for correspondent banks since the reduced costs due to larger scales could be shared among them.

Another way to help aggregate volume for CBRs is nesting. Nesting involves correspondent banks themselves providing correspondent bank services to other banks in the same nation or region to facilitate international banking services on behalf of clients of the downstream correspondent bank. The primary correspondent bank must conduct due diligence on the respondent bank, and the nesting correspondent bank and its downstream services to comply to AML/CFT. Same stringent KYC standards must be met in detailed CDD.

Both approaches make use of the same principle to help Correspondent Bank's profitability. If services provided by banks have a low market profitability, then aggregating volume implies that economies of scale may be achieved, reducing overall costs. In turn, small banks would have lower cost burdens by working together with larger banks with better capacity to deal with higher costs.

Nonetheless, concentrating transactions in a few banks, either by consolidating traffic or by nesting activities, implies concentrating risk, making it necessary to come up with proper, efficient regulation and monitoring. This is relevant since all transactions would be clustered, poor risk management from the larger banks could affect the whole stream of operations.

Potential benefits of aggregating traffic: Aggregating traffic might help deter de-risking by improving the profit of CB services. Two options to do so are presented in this document. Authorities and stakeholders need to analyze and determine which is most adequate. This aggregation needs to be supported with proper monitoring and risk management.

Pros

- Reduce CBR costs burden on small banks.
- Could potentially produce sufficient volume and profitable traffic.
- Can be done short to medium term.
- Assist in volume of traffic and profitability.

Cons

- Traffic may still be classified as high risk by foreign correspondent banks due to aggregation.
- High-risk actions from a single bank could taint the whole stream of traffic.
- Considered high concentration risk.
- Requires enhanced due diligence.
- Concentrates target area for regulators on primary bank.

E. REGULATED ADOPTION OF FINTECH

The above solutions focus on the traditional banking system. However, recently a new wave of financial services provided through the use of technology has started and continued to grow. These services are known as Fintech and they can be a complement to CB services if handled in a responsible, regulated way.

Fintech has many potential benefits for the financial sector. Fintech helps to cut costs and improve efficiency reflected in lower prices. Another advantage of Fintech is the use of data. Employing data analysis tools allow banks to have greater insight into the risk of customers, which in turn helps to differentiate high-risk poor customers from ML/FT high-risk ones, increasing KYC and due diligence processes. Finally, Fintech services allow customers to overcome geographical restrictions, deepening financial inclusion.

However, Fintechs have negative aspects as well. For example, Fintech use of large amounts of sensitive third party data leads to data privacy concerns. A lack of regulation brings concerns about consumer protection as well. In consequence,

Potential benefits on Fintech: Fintech is a growing sector that focuses on technology to provide financial services or supportive services for the financial sector. Technology can improve efficiency and deepen financial inclusion, but it can also increase risks and disrupt the financial ecosystem. Proper monitoring and regulation are necessary to secure the responsible adoption of these services.

Pros

- Lower costs and improved efficiency in the finance industry that can be reflected to the customer with lower interest rates than conventional banks.
- Use of alternative data. New ways of assessing risks through algorithms that do not base themselves just on single credit scores, such as digitally collected data, including e-commerce and mobile transaction histories, social media, can complement or substitute traditional methods of client identification and credit risk assessment.
- Creation of less-concentrated customer bases by industry and geography.
- Financial Inclusion outreach and accessibility to financial services.
- Personalized services.

Cons

- Data privacy and consumer protection.
- Digital data is used to fund or pay for criminal activities.
- Investors may not be fully aware of the risks.
- The growing gap between regulation and growth in technologies limit the supervisory capacity to understand and monitor new technologies/applications.
- Increased cybersecurity risks for customers.

V. CONCLUSIONS

De-risking is a consequence of increased regulatory and compliance costs aimed towards reducing ML/FT problems. De-risking is driven by a combination of low-return business lines for correspondent banking, greater risk management costs and more stringent and demanding prudential requirements.

In this document, we comment a set of probable solutions, such as centralized databases; developing properly established LEIs; low volume Correspondent Banking; Regulation of Fintech might as well help to mitigate the effects of de-risking, reducing costs and deepening financial inclusion.

In any way, the solution for de-risking needs a coordinated effort among respondent banks, correspondent banks, regulators and stakeholders and a deep analysis regarding the benefits and drawbacks of each alternative in each jurisdiction or region. De-risking is in ASBA's agenda as an important topic, and thus the Association is carrying out internal discussions on the matter. Also, ASBA is participating in a project on the Caribbean to come up with more insight on what are the best solutions for de-risking in the region. This document is a first effort to provide a set of alternatives to deal with de-risking and its consequences.

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