Global Correspondent Banking: De-Risking and Its Consequences for Global Commerce and the Financial System

A summary report based on discussions on de-risking and money-laundering laws at a Milken Institute roundtable held March 4, 2015 in Washington, D.C.

Overview

The United States has had anti-money laundering laws in place for more than four decades, dating to the Bank Secrecy Act in 1970. However, with the passage of the Patriot Act (2001) and the Intelligence Reform & Terrorism Prevention Act (2004), U.S. agencies wield a number of new legal authorities for dealing with money laundering, sanctions avoidance, terrorist financing, and other financial crimes. And these authorities put global correspondent banks[2] front-and-center in the battle against illicit flows.

In recent years, fines and criminal prosecutions for Anti-Money Laundering/Combating the Finance of Terrorism (AML/CFT) violations also have risen dramatically, prompting banks to reexamine the merits of engaging in correspondent banking and trade finance businesses at all. In a process that has come to be known as “de-risking,” large correspondent banks in the U.S. and elsewhere have begun to sever their correspondent banking relationships with client sectors perceived as high risk or not worth the cost of compliance, such as money-service businesses (MSBs), trade-finance clients, and respondent banks in emerging markets. As a result, these institutions—and their clients—risk loss of financial and banking services, as well as isolation from the global financial system.

On March 4, 2015, the Milken Institute Center for Financial Markets (CFM) hosted a day-long roundtable, *Global Correspondent Banking: "De-Risking" and Its Consequences for Global Commerce and the Financial System,* with AML/CFT policymakers, regulators, financial institutions, affected parties, and experts in order to explore the contours of the issue, to understand the incentive structures of the various parties and to brainstorm possible ways forward. This document summarizes the results of the day’s discussion and participant recommendations and ideas.

The summary is divided into three sections, following the agenda of the day.

I. **The Impact of U.S. AML/CFT Strategy on International Correspondent Banking** – reviews bankers’ and regulators’ perceptions of compliance laws and their enforcement.
II. **The Consequences of De-Risking** – examines the consequences of de-risking on respondent banks, humanitarian agencies, and consumers in high-risk regions.
III. **New Approaches and Possible Solutions** – highlights suggestions for enforcement strategies that reduce the frequency of de-risking and minimize its negative consequences.

[2]A credit institution acting as agent for a bank in a financial center where the latter does not have its own branch. UBS Dictionary of Banking, https://www.ubs.com/global/en/DictionaryOfBanking.html. (Accessed June 9, 2015)

I. The Impact of U.S. AML/CFT Strategy on International Correspondent Banking

The U.S. government's partnership with the banking sector has been critical to its efforts to fight money laundering and the other illicit flows that support illegal activities worldwide. However, for banks, stricter regulations, combined with increased fines, have raised considerably the cost of compliance and the consequences of errors. Roundtable participants flagged several issues of particular importance for banks, including: the disconnect between the goals of policymakers and the execution by enforcement officials; moving regulatory "goal posts"; a lack of policy clarity; and regulatory fragmentation globally. The first session of the roundtable was devoted to an exploration of these issues.

Regulators and banks: A successful partnership

All participants—AML/CFT policymakers, regulators, financial institutions, affected parties, and experts—agreed that cooperation between authorities and financial institutions has been essential to enforcing AML/CFT laws. Because access to the global banking system is critical for bad actors of all types, enforcement efforts globally depend heavily on strong anti-money laundering controls, both at U.S. banks and at their foreign respondents. At the roundtable, a U.S. official was emphatic about "the critical role" that financial institutions play in the effectiveness of the Bank Secrecy Act (BSA), emphasizing that his agency "is keenly aware of the resources and time that go into compliance with BSA reporting requirements, and we are deeply appreciative of it."

For their part, banks acknowledged that the emphasis on combatting financial crime has helped them improve their own compliance processes significantly, as well as motivate them to demand higher standards from the financial institutions with which they do business globally. "There has been a newfound appreciation on the part of banks—driven by U.S. government enforcement actions—of the deficiencies within their own AML/CFT monitoring systems, as well as those of their foreign respondents and the jurisdictions they operate in," observed one participant. Further, as banks step up compliance and strengthen their AML/CFT risk detection systems, "they see more risks than they saw before."

For example, one participant observed, in several countries in the Middle East and North Africa (MENA), local regulators have failed to implement or enforce AML/CFT laws that meet international standards. "If you look at most of the FATF mutual evaluation reports of certainly the Middle East countries, you'll find they're pretty appalling and most of them don't even comply with even half of the 40-plus recommendations. … There is a big problem there." As a result of issues like these, there was general agreement that, as a U.S. official put it, "foreign banks, foreign financial institutions, and foreign jurisdictions need to step up their game if they want to continue maintaining banking relationships in the U.S., given the adverse environment."

And, where financial institutions in foreign jurisdictions have improved their compliance processes, it has often been the threat of losing banking access that has been critical. According to one private-sector participant, the threat of losing a correspondent banking counterparty has "served as a wake-up call" to

foreign banks and their regulators, compelling them to make changes where official efforts were not successful. Likewise, a U.S. official found that "in many cases the banks that have lost their prominent U.S. correspondent have dramatically improved their AML/CFT policies and procedures, and the jurisdictions they were in made great strides as a result." A consultancy participant described how widespread de-risking has led to a "sea change" in the MENA region. "If one or two banks no longer have a dollar clearer, that goes straight to the top of the organization. We are now working with an institution that is spending millions of dollars to upgrade its AML/CFT risk management systems, which was unheard of until recently."

But the compliance bar is high, with severe consequences for falling short

For banks, though, it is not always straightforward to balance what they perceive as a shift from "being a good corporate citizen to acting as an arm of law enforcement." Several participants complained of what they consider "too often a zero tolerance for error" on the part of authorities and bank regulators. As one participant characterized it, "the combination of fines that banks are paying, sanctions that banks are subject to, and the reputational risks that banks have now, getting it wrong is a really big deal. This is why the AML/CFT issue has shot up to the C-level of banking institutions, and at this level banks are very risk averse."

U.S. officials repeatedly sought to correct the impression that they are taking a zero-tolerance approach. A U.S. official emphasized that his agency is "committed to investigating and prosecuting cases involving entities and individuals who *willfully* violate the Bank Secrecy Act, but does not seek to discourage financial institutions from serving lawful industries or businesses that may be considered high risk." He went on to explain that "all of us here today share the goal of ensuring a financial system free from illicit proceeds and criminal abuse, but the department recognizes the pursuit of that goal does not require perfection." Another acknowledged that, "As a practical matter, it is not possible for a bank to detect and report all potentially illicit transactions that flow through its institution."

Official-sector participants in the room argued further that banks are reading too much into the large fines imposed recently. "You can look at some of these big bank cases that we've brought in one of two ways. You can say 'these banks just got clobbered; they've been forced to pay billions of dollars in fines, and one of these days somebody's going to jail.' Conversely, though, you can say that their conduct was egregious and the result of intentional, willful conduct. This means you're not going to trigger a violation simply by doing business with an entity or a country that may be considered high risk. It's what you do about that in light of that risk." From the point of view of a lot of banks, however, the government position that banks should not avoid risk, just manage it on an individualized basis "is akin to saying 'We dismiss your de-risking concerns—just get it right.'"

Moreover, as one participant emphasized, "industry perception is that regulators' expectations are constantly changing," and the very effort towards compliance reinforces a constantly rising bar. "If enough banks seek to implement controls that are more risk-averse than the industry standard, the industry standard itself becomes more conservative and risk-averse, and a positive feedback loop ensues." As another participant noted, "banks look at what are the best practices across the industry,

add a buffer to that, and that has become for them what they hope is good enough. And in some cases this has led to a bit of an arms race."

Official-sector participants in the room acknowledged the issue for banks. As one U.S. official put it "yes, it appears that the way the industry seems to hear it is `Goldilocks, don't do too little, don't do too much—do just right.' We can't tell you what 'just right' looks like exactly, and we may come after you with individual or institutional criminal or civil penalties, but please do a really good job." However, the bottom line for this participant was that "We believe it is possible for financial institutions to balance their BSA obligations without engaging in wholesale de-risking of otherwise legal entities."

Bankers' conundrum: Managing "real risk" and "compliance risk"

As one participant argued, "there is a very big difference between what we might call regulatory enforcement risk or exposure to enforcement by regulators or prosecutors, and the real risk that money laundering or terrorist financing is occurring in a particular market at a particular time." Banks must manage both kinds of risk, but several participants in the room argued that compliance risk is fundamentally what is driving de-risking. The reason, one participant argued, is that "what banking institutions are being assessed on is a demonstration of rigorous due diligence, and if we fall short in this area, our entire risk-management culture may be called into question."

The risk for banks, therefore, is not so much that money laundering or sanctions violations will occur without the bank noticing; rather, the risk is that "we might not be able to answer all of the questions a regulator might have about a particular client relationship." This inflates due diligence costs because banks feel unable to use their own discretion to determine which relationships merit greater scrutiny and which relationships merit less and to apportion their resources accordingly.

As one private-sector participant put it "the risk is more that when the examiners come and start looking at our files and asking us tough questions—which is what they're supposed to do—the risk is that we don't have a good answer. That's more what's driving the de-risking in many cases, more than the inherent riskiness of the client." And a rigorous due diligence process is costly, in particular if it includes flying a team out to meet with a foreign respondent bank's representatives and regulators, and to directly examine its AML/CFT controls. "This inflates our due diligence costs and renders more of our correspondent banking relationships unprofitable." Another added, "it's just better for us just to cut the account than to be second-guessed by a regulator." "The risk-based approach clearly applies to financial institutions," concluded another participant, "but it should also apply to regulators."

Lack of clarity about compliance expectations

A private-sector participant emphasized the difficulties that banks face in determining what constitutes 'bad behavior' and the enforcement actions that such behavior will bring. "There has long been an understanding, at least among U.S. banks," he said, "regarding the need to have a risk-based approach and what that means in terms of having policy procedures, and certain trigger points that lead to escalation. Lately, what that entails has become less clear. And when banks are unable to determine

what best practices are, they may throw up their hands and say, 'I don't think I can get it right, so I'm not going to risk trying and failing.'"

A fragmented regulatory environment and conflicting regulations from country to country have added to the lack of clarity. Participants noted that most regulatory decisions are taken without a coordinated approach, and further, that regulations are not consistent across jurisdictions, which is a problem in particular for global financial institutions. As an extreme example, privacy laws can impede information-sharing across jurisdictions, even within the same institution. This siloing of information can make it difficult for banks to get a clear, comprehensive view of the transactions they are being asked to facilitate. This inevitably adds to their overall risk aversion.

In particular, several participants noted that a major problem is the lack of clarity surrounding what, precisely, constitutes an adequate AML/CFT risk management system in the eyes of regulators. "Good practice," it was argued, is open to interpretation and banks are not given explicit guidance. Beyond OFAC country and designated-persons lists, U.S. law enforcement officials do not give banks detailed guidance as to who they should and should not do business with, leaving it to banks to make their own determinations. In response, a U.S official argued that "success looks like what you *don't see* in an enforcement action. An enforcement action tells you all the things to stay away from and it tells you what you need to do. So I think we have clear standards using that as a communications tool." Further, this participant argued, "it is also important for regulators to understand that banks' businesses and clients are different and therefore require flexibility in approach."

A U.S. official described their approach: "We do use a risk-based approach, although it might not feel that way at times, and we don't see every firm the same way. When we decide whether or not to place a bank under action we're really looking at the systemic issues. We're not in a "gotcha" mentality and it's not a light decision to place a bank under action. We work with the firms to really try to understand management's commitment. You can't touch it, you can't feel it, but you can get a sense of how serious they are based on their action plans—are they hiring the right people? Is there momentum? And are they able to sustain improvement over time?"

The disconnect between policy making and enforcement

Participants noted that there is sometimes a significant disconnect between the intentions of policymakers and the requirements of individual bank examiners. As one participant argued, "I think from the regulators' perspective, we've certainly seen—and this roundtable is a further demonstration of it—that at the policy-setting level, the issues are getting understood, and there's a desire to help. Where we see the disconnect is between what happens at the policy level and what happens at the examination level. And for us, the pointy end of the spear is the examination level."

For example, in the case of Know Your Customer (KYC) requirements, the spirit of the law may be far more onerous than the letter. There is no legal requirement, for example, for banks to know their customer's customer (KYCC,) a point that some U.S. officials emphasized at the roundtable. However, as another U.S. official acknowledged, banks are required to know "enough about their direct and indirect

customers to be able to determine and report on suspicious activity." And while the process has always contained an element of subjectivity and has thus always been vulnerable to second-guessing by regulators, stepped-up enforcement and stricter penalties have greatly increased the consequences of banks getting it wrong.

In a related complaint, participants noted that sometimes there is "a significant disconnect between what law enforcement sees as the real threats and the real risks, and what institutions are being assessed on." As one participant argued, AML/CFT risks, as perceived by regulators, are not always aligned with real risks. "For example, trade-based money laundering is often cited as a high-risk business, because money can potentially be laundered by over- and under-invoicing or by recording fraudulent shipments. However, we've only seen two trade-finance transactions involved in money laundering in the last twelve years."

For banks, the cost-benefit calculus of correspondent banking does not always work

According to one participant, the onboarding cost of a new company may be anywhere from $50,000 to $75,000. "So if you add that to your ongoing run cost, including the fact that these customers are in a high-risk jurisdiction or a high-risk business, it is easy for your costs to exceed the revenue you expect from the client." Another participant added: "These are just the costs of assessing risk. There are certainly costs associated with banking high-risk customers, but even understanding those customers can be quite costly."

Because AML/CFT enforcement has significantly raised the fixed costs of onboarding in terms of the due diligence spend required, "it is inevitable that there will be clients that pose absolutely no compliance risk, but for economic reasons, no longer make sense for us to continue doing business with" argued one private-sector participant. In a low margin, high-volume business, only large client volume can absorb the additional costs. As a shareholder of International Bank (Liberia) Limited (IBL) noted, "our governance standards are far superior to the Nigerian banks, but they have the advantage of scale. Global correspondent banks are not going to cut a relationship with a Nigerian bank because, quite frankly, the volumes are worth the risk."

Therefore, even when a given bank or country poses little AML/CFT risk, the cost of performing rigorous due diligence may render the relationship uneconomical. "We all need to recognize that there are costs associated with assessing risk," another participant elaborated, "and it can be a perfectly rational business decision to just say, 'I'm not going to make individualized decisions when I don't understand this business, and it's complex to understand.'" This is especially true for banks with regard to client relationships in non-presence countries. As a result, banks are, in effect, asking themselves, "what is our core business and what are our core markets?" "In the end," another argued, "it comes down to this: if the banks feel they can make sufficient profits given the risk, they'll stay in the business. If they don't, they're going to exit the business."

II. The Consequences of De-Risking

De-risking can take several forms. It can include banks limiting the types of services they offer to certain high-risk customer sectors, countries, or regions. It can also include banks reducing or completely eliminating their exposure to high-risk areas, regardless of whether a potential client has adequate controls. As one participant described it, “de-risking is taking place when the discussion as to the quality and sufficiency of the AML/CFT controls of an institution is secondary to the threshold question, when banks are denied access independent of whether they have excellent controls.” The sectors most vulnerable to de-risking include foreign respondent banks, money-service providers, and humanitarian charities (among others). Representatives of each of these sectors participated in the roundtable to share their experiences and observations.

The impact of de-risking on affected parties

De-risked parties find their payment and financing options constrained, or they lose them altogether. Furthermore, the inability of banks in small countries to enter into correspondent relationships with U.S. banks can have a deleterious impact on trade, on remittances, and on economic activity in general. Since the end of 2012, a public-sector participant estimated, approximately 200,000 trade-finance lines to Africa have been cut. “The implications have in certain cases been immense because when a country is unable to maintain foreign correspondent banking relationships there will be no international trade into that country. Nobody set out to have that impact, but regulators need to appreciate that the consequences these regulations have had, not just for fragile countries, but for developing economies around the world, is quite serious.” Likewise, money service providers have been affected and therefore so have remittance flows. “The whole system has been threatened today,” warned a Middle Eastern money-service provider, “because access to U.S. dollars is not available, this means cutting off, not one or two persons, but millions of people and their ability to send money home through the official channels.”

Humanitarian aid has also been impeded by the constriction in correspondent banking, which has exacerbated disasters such as the recent Ebola crisis, when funds for humanitarian aid were held up in the correspondent banking system. “There are times in these fragile economies when they're going to need some additional support,” one participant noted, “and not having access to the global financial system could be the difference between life and death for many people.” In the extreme, an entire country can lose access. “The unintended consequences of U.S. AML/CFT regulations are not only onto the individual banks in these countries, but the risk is that entire countries are going to become unbanked.” Mauritania, a participant recounted, nearly had a critical fuel auction fall apart when Western banks pulled out due to the unrest in neighboring Mali. “Suddenly,” she said, “Mauritania realized it was not going to be able to import any energy at all.” (The auction proceeded though IFC’s intervention.)

STORIES FROM THE TRENCHES

The CEO of a money exchange and remittance service provider in the MENA region explained the dynamic behind losing U.S. correspondent banking relationships, explaining that “today, most of the domestic correspondent banks are no longer willing to open accounts for exchange houses like ours, because the U.S. correspondent banks have asked them to stop dealing with us. The U.S. banks give banks in the UAE two options: ‘You are either with us or against us. If you want to continue with your relationship with us and New York, you need to cut with your exchange houses.’ And we don’t have real clarity on the reason. We send funds directly to the nostro accounts[3] available in different countries, so it’s very traceable. But the impact is significant. If I send a million dollars to India, behind it there are thousands of individuals, thousands of families. The whole system has been threatened.”

International Bank (Liberia) Limited could take no proactive measures to preserve those relationships. A participant from IBL described the bank’s efforts to raise its AML/CFT control standards and to provide additional assurances to its U.S. correspondent banks. “We knew we had to be better than the local laws,” he said. “We also knew that the key for our bank to continue to be successful was to have strong links to the international financial community.” When it first noticed the de-risking trend in 2012, it tried to take a number of preventative actions. First, it offered to only allow pre-approved clients, mainly Western corporations, to clear through their bank. It also implemented SWIFT[4] sanctions screening protocols into its SWIFT communications, as well as offered to hire a third-party AML/CFT monitor. “The irony is that all of these ideas were well received by our correspondent banks, but in all cases we were eventually told that it wouldn’t make a difference.”

The CEO of IBL went further to explain that “We had relationships that actually worked very well. They understood our business, and they understood all the mechanisms we put in place against money-laundering, but because of regulations coming out of the U.S., they cannot continue to operate in developing countries like Liberia.” GN Bank in Ghana recounted a similar story. When it obtained its universal banking license and attempted to enter into direct correspondent relationships with U.S. banks, it found no interest. “As a relatively new entrant,” the Vice President and General Counsel recounted, “it feels as though the ladder has been kicked in terms of access and participation in the global banking system.”

The impact of de-risking on the global banking system

As de-risked parties find their traditional payment and financing options foreclosed, they have turned to other routes that are often less efficient and less transparent. As Tier I U.S. banks pull out of correspondent banking, business is pushed down to Tier II U.S. banks and/or pushed through a series of nested correspondent banking relationships. As a participant from IBL remarked, “Currently, Liberian banks are batch-clearing through Nigeria, which is a much bigger market, but one with weaker AML/CFT controls. “If the goal here is to make our system more transparent and more accountable, I think there is a perverse action here where people are moving into less regulated jurisdictions that have the advantage of being larger, and that’s what’s really hurting smaller, standalone banks like ours that are working very hard to be compliant with global regulations.”

Likewise, Middle East and Central Asian countries are doing much more dollar clearing through nested relationships. One participant recounted that “clients in Afghanistan might access dollar clearing and trade finance through Turkish banks, who then clear through financial institutions in New York.” He added, “This is pushing everything into a less transparent quadrant, which goes against everything that the folks around this table have tried to work for over the last 10 to 20 years, which is to bring more

[3] An account maintained by a domestic bank with a foreign bank in foreign currency. UBS Dictionary of Banking. https://www.ubs.com/global/en/DictionaryOfBanking.html. (Accessed June 9, 2015)
[4]Abbreviation for Society for Worldwide Interbank Financial Telecommunication. Domiciled in Brussels, the company operates a computer-guided communications system to rationalize international payment transfers. UBS Dictionary of Banking. https://www.ubs.com/global/en/DictionaryOfBanking.html. (Accessed July 13, 2015)

transparency to the system." And a participant from the Middle East remarked that Middle Eastern countries are increasingly eschewing the formal financial system altogether. "Migrants in the gulf, finding themselves cut off from Western financial institutions, are returning to the Hawala system,[5]" he said. "We've spent more than two decades encouraging people to use the official system. Now we are seeing all these people going back to square zero. Something you have built up over 20 years can disappear in no time."

One participant noted that as more and more foreign individuals and businesses avoid or are forced out of the U.S. financial system, there has been a marked decline in SWIFT traffic, and that to some extent financial flows are shifting away from U.S. dollar-clearing, to the benefit of the Euro and the Renminbi (now the third-highest currency in terms of payments volume). In addition, digital currencies such as Bitcoin have seen an uptick in flows. "Bitcoin's network has now passed the Discover Network in terms of payment volume," said one participant. "It's not just a consumer going to an internet store and making a payment using a virtual currency. There is real commercial traffic that's actually now starting to manifest itself through some of these unregulated systems."

The impact of de-risking on U.S. AML/CFT and development efforts

Participants also discussed the extent to which regulation increases risk when regulators can no longer see a clear, comprehensive picture of global financial flows. As one AML consultant noted, this loss of financial transparency has had important effects on U.S. law enforcement and intelligence gathering, which now risks losing a critical source of information. He noted that while serving as the U.S. Treasury Deputy Assistant Secretary for Intelligence and Analysis, the information he received from banks was often as good as, if not better, than anything he received from the intelligence community. "If we keep going where we're going," he warned, "that's not going to exist." Another participant added that "the categorical de-risking of entire industries can have adverse effects for law enforcement. The BSA reporting that financial institutions provide is often the only window that law enforcement has into these industries. When they are excluded from the formal financial system, law enforcement is denied a critical source of information."

Some participants argued that the real challenge is to bring high-risk countries into the financial system, not to cut them off from it. "Money follows a path of least resistance where it will not be subject to the same level of scrutiny or accountability," argued one participant. "There is a lack of visibility in countries like Kenya, Ethiopia, Djibouti and the UAE because of the de-risking phenomenon. The challenge is to incorporate them back into the network so that these countries are not left out of the grid and, therefore, not subject to regulatory oversight. This is the long-term solution."

Finally, participants noted that de-risking is hampering the international private aid, peacekeeping and charity efforts that make up an important part of the foundation of overall U.S. development policy towards poor countries. More fundamentally, global market access has always been an important

[5] An alternative or parallel remittance system that operates outside of traditional banking or financial channels. U.S. Treasury, "The Hawala Alternative Remittance System and its Role in Money Laundering." http://www.treasury.gov/resource-center/terrorist-illicit-finance/Documents/FinCEN-Hawala-rpt.pdf. (Accessed June 9, 2015)

component of U.S. foreign policy, and when developing countries lack access to the global financial system, it can work against this broader policy objective.

SOMALIA: AN EXTREME CASE

Many of these issues have come together in a kind of financial tsunami for Somalia. Somalia is one of the most remittance-dependent countries in the world. Globally, the Somali diaspora remits approximately US$1.3 billion to Somalia every year, mainly via the Somali money transfer operators (MTOs). This amount is estimated to represent 25-45 percent of Somali GDP, and is greater than all the income it receives from aid, foreign direct investment, and exports combined.[6] But at the same time, Somalia is on the U.S. OFAC list, amid heightened concerns about al-Shabab, a militant Islamic group.

As a result, Somali MTOs have found it increasingly difficult to access correspondent banking services in the U.S. This has made it difficult for Somali-Americans to remit money to their families back home through transparent and legal channels. The Somali diaspora is facing similar difficulties elsewhere, including in the United Kingdom, Australia, and Kenya. Because Somalia is emerging from a twenty-year civil war and is just now beginning to rebuild its government institutions and its formal financial sector, its ability to enforce international AML/CFT standards is still low.

The dramatic reduction in remittance flows is occurring at a time of otherwise cautious optimism about Somalia. The U.S. is in the process of re-engaging with Somalia diplomatically and economically. But while aid and technical assistance will certainly help Somalia over the medium to long term, the country's continuing dependence on remittances in the near term means that the de-risking of Somali MTOs poses additional challenges to the broader development goal of putting the country on more stable footing.

Difficulties assessing the scope of the problem

The lack of data on de-risking and the attendant reliance on anecdotal evidence means that there is still a high degree of uncertainty about the scope of the problem. Some government officials expressed skepticism. "We've taken part in a lot of dialogues like this over the last year and a half," said a U.S. official, "and we hear a lot of negative stories and the potential for bad ramifications, but when we ask for hard data—about systemic implications on dollar clearing, on trade finance, on remittance costs, on remittance volumes—showing any negative trend lines, we haven't seen it. In fact, we continue to see sort of explosive growth or very positive trend lines across the board and in almost any cross-border corridor I can think of."

Part of the problem is that some banks may not be truthful about why they are dropping clients. Instead, they may blame regulators for forcing their hand, or say nothing, rather than voice their concerns about their clients' AML/CFT controls. Clients (and the media) may also misinterpret banks' actions or the explanations banks give them. Both can give the impression that de-risking is more common than it actually is. And data collection is challenging, because banks guard their clients' information closely. From the client point of view, there is reticence as well. De-risked clients are usually loathe to talk about their situation openly: "The downside of disclosing that you've been exited from your correspondent is that you will not be picked up by others." This behavior perpetuates the lack of systemic data about the de-risking phenomenon.

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[6] Adeso, Global Center on Cooperative Security, and Oxfam, "Hanging by a Thread: The Ongoing Threat to Somalia's Remittance Lifeline," 2015, p. 1.

III. New Approaches and Possible Solutions

The challenge for both policy makers and participants in the financial system is how to enable a more discriminatory risk-management approach, without the wholesale risk avoidance of entire sectors or regions. The discussion during this session focused on possible ways forward, including ideas for better regulatory standardization and clarity, tools to better identify risky parties and transactions, self- and third-party monitoring ideas, options for changing the incentive structures for banks, and new payments technologies.

The importance of risk-based sensibility in regulation

While acknowledging that de-risking by banks put risk avoidance ahead of a more sophisticated risk-management approach, participants also challenged regulators to take a more thoughtful, risk-based approach to regulation. For example, in deciding where to focus attention and resources, regulators could do a better job of distinguishing between likelihood and impact. Some risks, such as consumer fraud, have a high probability of occurring, but do not threaten widespread harm; other risks, like terrorism financing, are just the opposite. As one U.S. official noted, “One of our highest likelihood events is that a grandmother in Washington, D.C. will be a victim of fraud, so we spend a lot of energy protecting people from themselves. But while the high likelihood events may be in dense markets in rich countries, high impact events can be in a village in Somalia.”

A more nuanced approach means that regulators would also recognize the different risk typologies from different kinds of financial transactions and businesses. As one participant noted, currently these differences are not adequately reflected in the way that regulators conduct their examinations. “In the remittance industry, it’s a very different profile than the banking industry. Yes, we see desperate people moving across borders, sending money to pay for people who helped them get across the border, and yes, we see some organized crime. But we do not see looting of state treasuries. We do not see shell companies hiding huge fraud proceeds.” Again, regulators might do well to more explicitly consider impact both in policing activities and in their overall resource allocation to AML/CFT monitoring.

In light of these ideas, a number of participants suggested that there might be a minimum dollar limit under which enforcement officials would be less concerned about whether or not flows were illicit and violated AML/CFT guidelines. Such a threshold would help protect the remittance industry in particular. To the argument that many small-sized flows can add up to large, important flows, participants suggested that this would be easy to monitor through aggregation technologies.

Moving towards standardization of regulations globally

Some participants argued for the importance of global regulatory standards. There should be “a level playing ground and comparable level of scrutiny, otherwise transactions will be forced to take the path outside of the banking system,” argued one participant. There ought to be “comparable accountability standards in other jurisdictions otherwise there will be fewer USD transactions and the system will become opaque.”

Several participants pushed back on the feasibility and even desirability of global standards, however. As one participant argued, "regulators should describe what they want to see in terms of compliance, regime, and information that we can capture and document, but enforce it in a way that also recognizes that not everywhere in the world is going to be up to the standard that's required at the moment." And, one participant reminded the group "we mustn't forget that a good chunk of the global population is un-banked and they're never going to be a part of the banking system. They don't even have identification documentation. All they have, in many cases, are the MSBs or the Hawalas. And all of this talk about bank standards is never going to address the grandmother in rural Chad whose grandson is trying to send her son $50."

In any event, there was agreement that it would be useful even to have a better understanding of the KYC requirements of different countries. "An official report of the KYC requirements globally should be commissioned somehow," suggested one participant. Another argued that, "I think there needs to be far more explicit acknowledgement, particularly at the regulatory level and the examiner level, that there is a tiered KYC system." More specifically, participants also argued that work needs to be done to bring about a common understanding of important terms, such as "politically exposed persons." Some argued that clarity around these terms at the FATF level will be extremely helpful, but acknowledged that they are "really difficult to flesh out when it comes to a lot of the more high-risk jurisdictions." As one participant explained, "for example, a politically exposed person, is that a clan member, or is that just your wife and your daughter?"

In general, participants stressed the need for an open dialogue between the U.S. regulators and emerging-market regulators in terms of the "wish list of compliance priorities and information requirements." Several participants suggested that federal regulators in the U.S. should travel abroad more often and have regular discussions with the affected markets regarding their expectations. As one participant observed, "the banks in these affected markets have as much or more to lose than U.S. financial institutions that get hit with a supervisory action. So it's almost incumbent upon OFAC as well as the Fed and the OCC to be out on the road on a regular basis talking about what the expectations are." To this point, a U.S. official informed the group that they are building engagement with the Gulf countries and that they are now reaching out to the regulators in emerging markets, on both a bilateral and multilateral basis.

Enhancing regulatory guidance

A private-sector participant argued that "keeping communication channels open between the various regulatory bodies is a prerequisite for demonstrating that there is a desire to help the correspondent banking industry at the policy level." More specifically, several participants noted the need for regulators to share information with industry, and in particular to give more clarity around what they perceive as risky (and bad) behavior. Here, a participant cited the Australian financial intelligence unit (AUSTRAC), as a potential example for U.S. authorities. AUSTRAC released a document that clearly identifies areas of risk for the banking sector, including an identification of specific money services businesses that should be avoided. In addition, it has declassified a range of materials and made them

available to banks' financial intelligence units. According to this participant, this is seen by the banking sector in Australia as a very helpful guidance tool.

Several participants noted that the AUSTRAC idea of providing a list of black-listed entities is not going to work in the U.S. As one U.S. official reminded the group, "We don't tell banks who to bank and we're not legally permitted to do so." However, more communications about the thought processes of the regulators in terms of different risks was seen to be helpful. As one participant observed, "I know that this concept of white listing and black listing has been talked about and we understand that that is not going to happen, but I think to the extent that there can be more communication about what regulators think of the different risks that are presented and how banks can use that information in a more realistic way would be helpful."

Similarly, a request that came up repeatedly was to have greater clarity about "what does good look like" in terms of a bank's compliance programs. As one participant noted, "we understand why the examiners in the agencies in different jurisdictions can't come out and say, 'do it like they do it.' But nonetheless it is very important for the industry to be able to understand what `good' looks like." Another suggested, "Can we codify best practices and share that information publicly? If it's not competitive or proprietary information, let's make it publicly available." More specifically, one participant suggested that FATF expand its public "name and shame" list of International Co-operation Review Group (ICRG) jurisdictions. This list identifies high-risk and non-cooperative ICRG jurisdictions, their specific deficiencies, and their action plans for addressing these shortcomings. She suggested that it could be beneficial to also highlight jurisdictions that are doing a good job.

However, there are limitations to sharing client practices, including the fact that regulators cannot disclose the results of bank examinations. A private-sector participant suggested that industry bodies could serve as a conduit to channel information back to the banking industry. "BAFT, the Clearing House, the Institute for International Finance (IIF) and similar bodies are good agencies for the public sector to use to demonstrate to the industry what "good" looks like. Regulators could inform those bodies, who could then make that information available to their members in a less-than-fully-explicit way. This way, we can all see that there are banks that are managing risk well because they have certain systems, they have certain practices."

In response, a U.S. official noted that the U.S. government is working to improve communication through law enforcement engagement with banks, as well as through FinCEN advisories and a new bank examination manual. The banks at the roundtable acknowledged that there has been some demonstration from the regulatory side that the issues for banks are understood by regulators. In June 2015, the U.S. Treasury released new versions of the *National Money Laundering Risk Assessment* and the *National Terrorist Financing Risk Assessment*. The assessments are the products of an inter-agency consultation that included the U.S. Department of Justice, the U.S. Department of Homeland Security, and others. By publicizing what it knows about the illicit finance landscape, the U.S. government hopes that financial institutions will be able to further refine their AML/CFT controls.

Reducing blanket de-risking with better, more surgical information

The issue of de-risking in banking is an example of a problem that economists know well. If a consumer cannot easily distinguish between honest and dishonest sellers, he/she is less likely to buy the product at all. Similarly, if it is difficult and costly for banks to distinguish between good and bad actors, then they are less likely to engage in correspondent banking. If banks can have, then, at reasonable cost, a better, more nuanced understanding of the "good" vs "bad" flows, the owners behind those flows, and the chain of relationships among those entities—and if they can have greater confidence that none of the end users has ties to forbidden parties—then they will be able to differentiate and continue banking good parties, even if they are small. In this way, as one participant termed it, "a more surgical approach to dealing with (or not dealing with) certain entities becomes possible."

An approach that enables drilling down to the level of independent relationships with each financial institution makes the process of understanding risk more dynamic. Again, the idea is that with greater accuracy, greater discrimination is possible. "Better information leads to better decision-making and confidence in terms of these relationships and to more specific or targeted decision-making in terms of what accounts to take on or to cut off."

EXPLOITING PUBLIC INFORMATION

The CEO of Sayari Analytics described its approach of using public data to exploit multilingual cross-border public records to map out networks of beneficial owners and related entities, looking for red flags in cross-border transactions in the financial sector. In this way, they map explicit sanctions, designations, and black lists that represent a real risk to the network of the banks, companies, correspondent, and respondent banks. The key to their approach is the use of public data, and the standardization and traceability that is inherent in it. "When you're working with publicly-available data, you have traceability and you have auditable records and standards. You're never going to have the complete picture, but the goal is to more specifically and accurately quantify the risk of that missing data and enable somebody like a chief compliance officer to have the confidence to be able to sign off on a system because they can see the auditable trail, rather than having to rely on negative media with unverified sources that's currently being used in an open source kind of capacity right now."

The potential for third-party monitoring

Several roundtable participants suggested that AML/CFT monitoring could be outsourced to third parties, and that such outsourcing would be cost-effective for a given financial institution as compared to having personnel on the ground in every region in which it operates. Ideally, third parties would document specific risks and controls and then determine if the transactions are being monitored to a satisfactory degree. As one participant explained, third-party monitoring can also create a profile of the account holder and monitor their transactions on a regular basis to check whether the transaction being undertaken by a particular account is consistent with its historical transactions pattern. This process is also known as "transactional monitoring" and is a complement to the "relationship monitoring" that the client bank undertakes. It further involves re-verifying the facts and the accounts for the account holder on a regular basis.

Participants agreed that third-party monitoring could have merit, but raised some concerns. First, there is a risk with engaging a third-party to monitor the transactions, as not all third-party monitoring organizations have the same systems or level of knowledge about specific issues and risks. Second, third

parties are incented to over-deliver information in the form of news and other analysis that banks then have to "sift through." Third, there was concern that banks might get "dinged" for relying too heavily on a third party. A private-sector participant reminded the group that "banks cannot simply outsource their due diligence process to third-party auditors, as the banks should have the ability to satisfy themselves that the background of the client is going to be acceptable to the regulators." Third parties can help do investigative work, but the responsibility will remain with the banks.

Bank self-reporting to a third party

Participants also thought there was merit in exploring further the idea of an enhanced self-reporting system. Here, banks would self-report to a third party that established rigorous standards for compliance-systems and other requirements. Potentially for some, presumably smaller, parties, the effort of going through the enhanced due diligence might be worth it to preserve their correspondent relationships. As one participant suggested, the conversation might run as follows: "Currently, if we go through the traditional channels, it may take you nine days to get your cash. But if you pay and you're willing to subject yourself to this enhanced due diligence through a third party that would verify that your information is correct, your transfers could be virtually as close to real time as possible." He continued: "For a lot of users of the international kind of architecture, it's worth it. And for some, it's not."

The benefits to the idea are twofold: First, while it would not substitute for a correspondent bank's own due diligence, it would give that bank additional comfort that a reputable third party had also monitored and validated the systems of the client bank in question. Second, it might improve efficiency. For the client bank, instead of providing documentation to every correspondent bank with whom it sought to have a relationship, it could provide that information to a third-party registry that correspondent banks could access. Participants noted that these are two distinct "services." First, the third party institution could serve as a registry for information, and second, but distinctly, it could provide validation services.

Most participants felt that to be effective, this entity would need to be either run by or at least blessed by regulators. As a banking participant suggested, "a strong challenge for us as banks is how do we go about assessing the adequacy and reasonableness of the foreign correspondent bank customer that is in, say, Liberia or Vietnam? How do we assess whether their AML and sanction compliance program is adequate and reasonable? Could that be something that could be contracted out to a third party? So rather than Citibank going around assessing everybody and JPMorgan and BOA and Deutsche Bank doing the same thing, could a utility that was blessed by various regulatory bodies do that?" He elaborated further that "a respondent bank in, say, Liberia, could say 'I want to be a good user of correspondent services. I'm going to go meet with this entity, tell them about my program. They can assess its reasonableness and give me the stamp of approval which then is accepted by those who regulate us.' That kind of a system would take a lot of the guesswork out of the equation for the global banks."

However, public-sector participants in the room unanimously agreed that this kind of public official endorsement would be impossible. Banks could capture some of the efficiency benefits at least, by

joining together to form such an entity. But, likewise, participants felt that there were both legal and competition factors that would inhibit this arrangement. As one participant noted "I would have a hard time seeing it as a banking owned organization where the banks share because there are going to be legal issues with sharing. There may be accusations of collusion and other things."

There seemed to be general agreement that the establishment of a non-profit entity was the most practical, politically feasible idea. Such an entity would vet and certify on a regular basis those companies that offered to contribute their information into the pool. The information would then be shared among institutions which in turn would pay for the use of that information, and perhaps certification, in their risk-profiling exercises. One participant noted, though, that "the success of such a utility depends largely on its reputation, not just from a local standpoint but globally, and I don't know who would meet that type of standard." But participants agreed in general that, "there must be a way to pool resources in some way and make it available to the money center banks so that we can improve the efficiency of the global process." And that "if there was an opportunity there that could at least reduce some of the cost and some of the burden, then this would have merit because it would potentially allow more time for focused decision making and perhaps more tolerance of risk."

Correspondent banking fast track: Self-reporting by beneficial owners

As one participant noted, "the biggest piece of the puzzle is identity—being able to identify with whom you're doing the trading. The sender and receiver, not just the institutions." As such, several participants suggested a system for self-reporting by end users, or beneficial owners. This idea is akin to the U.S.'s *Global Entry* program, which puts the reporting and examination onus on the traveler as opposed to the airline or the border patrol agency. As one participant suggested, "this would make it possible for some people to be transparent up front and then be exempted from the heavy scrutiny just as, if you sign up for *Global Entry*, you don't have to go through this search every single time you go through the airport."

In the same way, clients "could report in to regulators, declare who they are, provide their biometric information, their account information, and so on and so forth. They give that information to the regulators directly, so the onus is not on the bank to be questioning continually every business relationship." This, several participants argued, would fundamentally change the dynamic of the correspondent banking relationship with clients. "A bank would be able to just say something like 'if you want to do correspondent banking, submit your information, your biometrics, your relationships, and your beneficial owner information to this third party.'"

Taking the idea further, participants discussed whether there could be some kind of universal system or standard for identifying beneficial owners. The system might be akin to that of a *Legal Entity Identifier* (LEI), an idea that the UK's Financial Services Board (FSB) is implementing with large financial institutions in the United Kingdom. Here, beneficial owners would be designated, "which would take a lot of the guesswork out of the equation for banks." For the most part, though, participants felt that there were significant challenges to getting regulators to coordinate with each other around this idea, and that "even if G20 and the FSB made it a priority, it would take a very long time to implement."

As an alternative to a universal standard, participants discussed the idea of an Open Standard system, similar to the *OpenID Connect* function used by PayPal. In this scheme, a variety of standards could be met at the same time. The function would hold personal details of the client, and third parties would have the ability to attest to those details, where third parties would vary by country according to the domestic regulatory environment. The underlying idea, argued one participant "just from a pragmatic standpoint, is to focus on getting attestations of individuals as automated as possible. This is a really important thing for us all to be thinking about, and open standards are a really good way to do that."

Participants cautioned that the idea of a utility that verifies customers is fundamentally a dynamic environment, however. "You couldn't just do it once—there would have to be some kind of ongoing monitoring." Furthermore, as discussed, the correspondent bank would have to retain the compliance risk. Fundamentally, as one participant noted, "banks risk-score clients according to internal criteria for the simple reason that they have different risk tolerances, different appetites for taking certain kinds of clients, and different focuses of their businesses." Given this, a universal standard becomes problematic. An open standard approach, it was generally agreed, is better as it would enable individual firms to overlay their own ideas of risk scoring and dynamic monitoring.

With end user identifiers, ideally "governments could take over some of these functions from industry. And as technology moves forward and there's much more data available and it's available publicly and cheaply, governments won't need to be as reliant on institutions for information all the time." And, as another participant explained, "there are a number of technological advances that are being made now with reputation monitoring and others, sort of beyond biometrics. So the solution may be out there."

NEW PAYMENTS TECHNOLOGIES: RIPPLE LABS

The Ripple protocol enables banks using the protocol to settle funds from any country and in any currency directly to one another immediately, bypassing the correspondent banking system. In short, the protocol enables direct settlement, thereby completely bypassing the series of "hops" that comes with a nested correspondent banking system. It also enables the immediate identification of sender and receiver information, as well as the global traceability of funds.

In the current correspondent banking process, as described by the participant from Ripple, "the sending bank doesn't know at the outset what the path will be—through what banks it will go before it arrives at the receiving bank. And it's a manual process; it's a sequential process. And it has been subject to manipulation very dramatically." Ripple Labs attempts to solve this problem by enabling banks using the Ripple protocol to settle with each other directly. "They're settling with each other instantaneously, so there's no sequential process. And the information about the sender and receiver is immediately visible to both sides." This leads, by extension, to the global traceability of funds. You can build technology on top of the ledger that lets you see relationships between accounts, and then trace flow of funds through accounts.

While new technologies will never replace the traditional banking system, one interesting use case for this technology might be for banks to use it for less profitable clients and payments corridors. "Because the protocol does allow banks to settle with each other directly, those less profitable payments corridors that are just not interesting to the larger banks could be very interesting to smaller banks. And it could be worth it to them to put in the time and effort to have the controls in place to be able to make payments in these smaller corridors, whereas it's just so complicated to do that when you're talking about layers and layers and layers of banking relationships."

Improving the benefit-risk calculus for banks

Participants discussed the feasibility of putting in place legislation along the lines of the Community Reinvestment Act to give banks CRA-type credits for banking the deserved yet unprofitable. The CRA itself, participants noted, is not the right vehicle, as it is exclusively targeted towards banks that make investments in local communities in the U.S., but both officials and other participants in the room felt that this idea was worth further exploration.

Establishing the rights of affected parties

Much discussion focused on the fact that there is no appeals process for affected parties with banks, nor for banks with their regulators. As one participant termed it, "What recourse do MSBs or banks or anyone else have when they get de-risked? Likewise, what is the appeals process for banks with their regulators? Where do they go when they think they've been unfairly dropped?" Participants asked if there could feasibly be a formal appeals process and who would manage that process. Could or should it be enforced, and by whom? As several participants noted, there is not "right to a bank account" in the U.S., as there is in other countries, but perhaps there could be some kind of mechanism for affected parties to be heard.

And, as one participant noted, this lack of an appeals process also contributes to the overall lack of information on the size of the de-risking problem: "This perpetuates the lack of hard data with what is really going on out there because those that are de-risked who feel that they have no recourse are loath to scream about it too loudly for fear of risking any other chance they have with another bank."

The importance of dialogue

Finally, participants noted that it is important to "leverage public-private sector dialogues like this one to engage in solutions, because we really do believe that this is not a case where the public sector has the solution or where the private sector solution has the solution. It needs to be an integrated solution. We are hopeful we can get there."

About the Author

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Global Correspondent Banking: De-Risking and Its Consequences for Global Commerce and the Financial System

A working roundtable hosted by the Milken Institute Center for Financial Markets

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Twelve participants, from both the public and private sector, chose to participate anonymously, so their names have been removed from this list.