POLICY BRIEF

DECLINE IN CORRESPONDENT BANKING RELATIONSHIPS: ECONOMIC AND SOCIAL IMPACT ON THE CARIBBEAN AND POSSIBLE SOLUTIONS

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INTRODUCTION

1.1 Correspondent Banking Relationships (CBRs) exist between banks providing financial services (correspondent banks) and banks receiving those services (respondent banks).

1.2 CBRs are fundamental to the efficient operation and resilience of the global financial system and, by extension, the Caribbean. They facilitate the re-allocation of capital in the global financial ecosystem and cross-border payment systems which are essential for international trade. CBRs also enable financial inclusion by providing access to a wide range of globally networked financial services to governments, corporations and ordinary citizens. In this way, they contribute immensely to the economic, financial and social stability of the Caribbean.

1.3 However, today regional governments, banks and other stakeholders are justifiably concerned by the high incidence of withdrawals of CBRs by some regionally active correspondent banks. This concern, which is also popularly referred to as "de-risking", is receiving urgent national, regional and global attention. The decline in CBRs, if left unchecked, will lead to systemic risks in the regions adversely affected and ultimately impact the stability of the global financial system, global trade and global competition. It can be detrimental to the promotion of financial inclusion and increase use of the unregulated and opaque shadow banking system.

1.4 The most recent regional response to this issue is a call for Caribbean stakeholders to wage a coordinated relentless campaign against what was described as an existential threat and potentially systemic crisis with cataclysmic ramifications to our regional banking sector.[1]

Caribbean Development Bank's role in working to mitigate impacts and reverse the decline of Correspondent Banking Relationships

1.5 The Caribbean Development Bank (CDB) believes that the decline or withdrawal of CBRs from the Region and the potential adverse impacts on the regional financial ecosystem needs to be urgently and comprehensively addressed by all national and regional stakeholders. CDB itself relies on CBRs to deliver development support to our Borrowing Member Countries (BMCs). The decline in/withdrawal of CBRs could also severely impact CDB's mission and reverse economic development gains in our BMCs.

1.6 CDB will continue work to mitigate the impacts of, and to reverse the decline of CBRs. CDB has already engaged with regional stakeholders on this issue primarily to join the advocacy for a swift and sustainable resolution and to voice concerns and share insights with other stakeholders. Most importantly, CDB will offer technical assistance (TA) to fund appropriate proposals and studies focused on finding solutions aimed at reversing the decline in CBRs and mechanisms to mitigate its impact on the Region.[2]

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[1] Caribbean Community's (CARICOM) reporting in 'CARICOM must wage relentless campaign against threat to banking sector' CARICOM Today (February 16, 2016) at http://today.caricom.org/2016/02/16/caricom-must-wage-relentless-campaign-against-threat-to-banking-sector-pm-dean-barrow/

[2] CDB has attended and contributed to sharing ideas at the: (1) Caribbean Financial Action Task Force Plenary meeting in Port of Spain, Trinidad and Tobago on November 25, 2015; (2) Financial Stability Board/World Bank/IMF – regional Consultative Group for the Americas, Roundtable on Correspondent Banking hosted by the Central Bank of Barbados in Bridgetown on December 3, 2015; (3) Caribbean Policy Research Institute Breakfast Meeting and Roundtable Discussion on Correspondent Banking on January 19, 2016 in Kingston Jamaica; and (4) the 27th Inter-sessional meeting of the Conference of Heads of Government of CARICOM, February 16-17, 2016 in Belize; and the Caribbean Association of Bankers held in Miami in April 2016.

1.7 CDB is already engaged with CARCOM and other regional bodies to help define and resolve this crisis through a proactive and coordinated regional response. CDB is willing to mobilise and provide TA to its BMCs, including to develop their institutional capacity for Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT) and financial sanctions compliance. Such support can cover training and other initiatives aimed at enabling BMCs to conduct national risk assessments for AML/CFT compliance and to conduct research on related vulnerabilities and the suite of potential mitigants and the solutions outlined briefly below and discussed in the accompanying paper titled: C*orrespondent Banking Relationships in the Caribbean*, published together with this paper.

1.8 This Policy Brief: (a) outlines broadly and briefly the drivers of the decline of CBRs; (b) examines its current and potential financial, economic and social impact on the Caribbean; and (c) outlines some possible solutions to reverse the decline in CBRs, some steps to mitigate its impact on our BMCs and CDB's role in this regard. It is primarily focused on correspondent banking. It is not intended to be exhaustive nor is it intended to be a substitute for more comprehensive work being undertaken by other regional bodies and groups aimed at compiling information on the broad impact of withdrawals of CBRs on the Caribbean and the development of perspectives and responses.[3]

Drivers of the decline in Correspondent Banking Relationships

1.9 There are many varied and complex drivers of the decline in CBRs which the term "de-risking" is being popularly used to broadly describe. Paramount among these reasons are that: (i) some correspondent banks are finding the business no longer profitable due to high compliance costs, low volume and low returns;[4] and (ii) high risks and substantial penalties imposed by regulatory agencies.

1.10 De-risking in this context may be described as the disproportionate withdrawal, often with little or no notice, of CBRs, or the application of restrictions on financial services, undertaken to avoid, rather than to manage risks. Not every withdrawal may be due to de-risking and some United States (US) regulators have pointed this out.[5] Much clarity is still needed on the subject of what constitutes appropriate and inappropriate de-risking.[6]

1.11 The World Bank (WB) Survey of November 2015 is the most prominent study to date, which was undertaken to identify and understand the drivers and causes of the decline in CBRs.

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[3] Note for instance the work by the: Caribbean Central Bank Governors; the Caribbean Project on De-Risking based at the Central Bank of Barbados. The Caribbean Association of Bankers is also engaged.

[4] By all indications, the regulatory regime is about to be even more costly because of the new liquidity requirements of BASEL III which are to be implemented in 2016 and which will impact substantially on correspondent banking operations, thereby inflicting substantially higher operational costs for which correspondent banks have increased fees. According to the Report of the Meeting of Finance Ministers, February 15, 2016, Placencia, Belize, pg. 1, this is one of the main reasons for the significant de-risking occurring currently.

[5] See most recently US Department of the Treasury: Remarks by Acting Under Secretary Adam Szubin at the ABA/ABA Money Laundering Enforcement Conference (November 16, 2015) and also Remarks by Under Secretary Nathan Sheets at the Institute of International Bankers (March 7, 2016).

[6] One view is that "de-risking" as defined above should be distinguished from the term "re-risking" which better describes decisions by correspondent banks to withdraw from on-boarded CBRs which are undertaken after appropriate case-by-case risk assessments and the term "pre-risking" better describes decisions not to enter a certain proposed CBR based on appropriate case-by-case analysis. Each of pre-risking, re-risking and de-risking have significant drawbacks including promoting financial exclusion and driving transactions to the shadow banking sector . See T. Boyce, 'De-Risking, Pre-Risking and Re-Risking of CBRs (forthcoming) (2016) 31 J.I.B.L.R 305 – 310.

The World Bank Survey (2015)[7]

1.12 In its survey of the global decline in CBRs over the period 2012-15, WB found that the Caribbean seemed to be the region most severely affected by the decline in CBRs. The study also noted the US, followed by the United Kingdom (UK) and Canada as the primary jurisdictions for banks withdrawing CBRs and that the currencies most affected were the US dollar, the British Pound, the Euro and the Canadian dollar, currencies in which the majority of the Region's international transactions are conducted.

1.13 WB's Survey among large international banks of the top causes and drivers of the decline in CBRs found that:

(i) 75% of survey respondents blamed it on: (a) the presence of the respondent bank in a jurisdiction that was subject to counter-measures or identified as having strategic AML/CFT deficiencies by the Financial Action Task Force (FATF) or another international institution; and (b) respondent banks having customer base classified as "high risk" for AML/CFT;

(ii) 80% of survey respondents blamed it on: (a) the lack of profitability of certain foreign CBR services and products; and (b) concerns about, or insufficient information on respondent banks' customer due diligence procedures for AML/CFT or sanction purposes;

(iii) 85% of survey respondents blamed it on: (a) changes in the overall risk appetite of the correspondent bank; and (b) lack of compliance with AML/CFT or sanctions regulations;

(iv) 90% of survey respondents blamed it on the imposition of international sanctions on a country or institution; and

(v) 95% of survey respondents blamed it on concerns about increased (and presumably unmanageable) money laundering and terrorist financing risks arising from the CBRs.

1.14 Other causes and drivers covered in the study include: (a) structural changes to the correspondent bank and/or re-organisation of their business portfolio; (b) inability or expense/cost required to undertake customer due diligence on the respondent banks' customers; and (c) changes to the legal, regulatory or supervisory requirement.

The Financial Stability Board's Report (2015)

1.15 In November 2015, the Financial Stability Board (FSB) issued its Report to the G20 on efforts to assess and address the decline of correspondent banking (FSB's Report).[8] The FSB's Report noted that the decline of CBRs in the Caribbean could become a systemic issue for the Region including by driving payment flows underground into the shadow banking sector which could exacerbate the Region's challenges (e.g. with being classified as high risk for financial crime, particularly money laundering and terrorist financing). The risk that the decline in CBRs could drive systemic risks is a major concern because of its potential economic, financial and social impacts.

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[7] Withdrawal from Correspondent Banking: Where, Why, and What to do about it (World Bank, November 2015)

[8] FSB to the G20, Report on the Actions Taken to Assess the Decline in Correspondent Banking, November, 2015

ECONOMIC AND SOCIAL IMPACT ON THE CARIBBEAN

2.1 The impact on the Caribbean can be divided into two major, but very related components – economic and social.

(a) Economic Impacts

2.2 Economically, the impact of the continued decline in correspondent banking on the Region has been substantial. Direct financial sector impacts include reduced business by banks and other financial intermediaries [9]. For example, in Barbados, eight financial institutions have had their CBRs severed. Five of seven banks in Belize have had their CBRs terminated. In the Bahamas, two domestic banks and four international banks have also had their relationships brought to an end. In Haiti, all local banks have had their access to correspondent banking either severed or reduced. In the Eastern Caribbean Currency Union (ECCU), local banks that have maintained CBRs now have to pay significantly higher fees. Money Service Businesses (MSBs) such as, cambios in the case of Jamaica[10] and money transfer services (Bahamas, Cayman Islands, Turks and Caicos Islands) have also been significantly impacted. In July 2015, Western Union closed its operations in the Bahamas and Cayman Islands.

2.3 Secondary impacts include reduced access to funding for production, consumption and investment. The Caribbean, which is a very open trading economy, has found its ability to export significantly affected. In Barbados, International Business Companies (IBCs) have had their operations substantially disrupted by new requirements on the part of correspondent banks and longer waiting times for completion of transactions. In the Eastern Caribbean, the operations of IBCs have also been substantially curtailed. In Trinidad and Tobago and in Antigua and Barbuda, the gaming industry has been significantly impacted by reduced access to CBRs.

2.4 Other Caribbean exports (manufacture, /agriculture, tourism etc.) are also substantially dependent on external financial institutions as a conduit for payments of production inputs and revenues from foreign markets. Caribbean exports of goods and services for CDB's BMCs, excluding the Overseas Territories (OTs), averaged 39.5% of Gross Domestic Product (GDP) in 2014.[11] A large portion of economic activity geared towards domestic markets is also very import dependent (wholesale and retail trade, electricity production, transportation, health services etc.). Expenditure on imports of goods and services as a percentage of GDP in the Caribbean is generally very high, averaging 54.6% of GDP in 2014 for CDB's BMCs excluding OTs[12]. A very large percentage of import expenditure payments goes through the international financial system. The very high dependence of Caribbean economies on external trade (estimated at 94.1% of GDP in 2014 for the aforementioned BMCs) likely explains to a large extent why WB's (2015) report found the Caribbean region most severely affected by the correspondent banking crisis.

2.5 While it has not yet been possible to obtain relevant data, the impact on external investment can also be significant, in part because such investment is generally channelled through correspondent banks and also has high import content. Additionally however, external investments are now faced potentially with enhanced risks with respect to repatriation of profits, making the Region less attractive.

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[9] This part of the discussion draws substantially from the report of the Central Bank of Barbados (CBB): *De-risking and its Impacts, February, 2016*.
[10] Jamaican cambios reportedly account for close to 50% of financial intermediation and are estimated to have generated foreign exchange inflows of USD470 million (mn) in 2014. Source: CBB: *De-risking and its impacts, February 2016*, p. 19.
[11] WB: World Development Indicators.
[12] WB: World Development Indicators.

(b) Social Impacts

2.6 As noted above, the Region's MSBs (cambios, money transfer services) have been substantially affected. The industry is a major conduit for remittances on which many of the Region's poor and vulnerable are highly dependent. In light of the foregoing, the social consequences of the crisis can be severe, given the high level of poverty and vulnerability in the Region. This may force increased social spending by governments and widening of already large fiscal deficits. Remittances are also a significant contributor to the Region's balance of payments. A decline in remittances may lead to increased external borrowing and accumulation of external debt.

2.7 The multifaceted and significant impacts of a reduction in access to correspondent banking indicate that it is potentially one of the most severe economic and social risks currently facing the Caribbean. The need for solutions is therefore very urgent. Given the foregoing, the collection of data on CBRs and their impacts is imperative. With significant cooperation of the financial sector, regulatory agencies and international organisations such as the WB, the International Monetary Fund, FATF and others, ongoing monitoring of the regional impacts of the crisis should be a responsibility of CDB.

THE CASE OF BELIZE

The experience of Belize in dealing with the CBR crisis potentially holds some lessons for the rest of the Caribbean. Belize has been highly impacted by the severance of Correspondent Banking Relationships (CBRs) with unjustifiable economic and reputational repercussions. Indications are that those Belize banks that have had their CBRs severed so far have been able to establish alternative arrangements. They have been able to establish CBRs with banks outside of the US (for example, Europe, Asia) or with smaller banks in the US. Notably, it has been the larger banks that have been most aggressive in terminating their CBRs with the Caribbean. Additionally, clients of affected banks have been able to access CBR services through those banks such as Scotia Bank and First Caribbean Bank that have not been affected. Furthermore, the Central Bank of Belize, together with the major credit card companies have put in place new arrangements which have mitigated the impact of the disruption. Also, the Central Bank of Belize has been using its own CBRs to process wire transfers and cash payments.

POSSIBLE MITIGANTS AND SOLUTIONS

3.1 There are many possible approaches, solutions and mitigants that may be engaged to slow or arrest the decline in CBRs. These solutions and their pros and cons are further explained in our solutions-oriented paper: "*Strategic Solutions to De-Risking and the Decline of Correspondent Banking Relationships"* which articulates an approach that could help all regional, national and institutional stakeholders to identify, assess and implement preferred solutions.

3.2 This list is not exhaustive and the solutions are not listed in any order of priority. The solutions and mitigants most relevant and likely applicable to the Region are each profiled briefly below.

Regional High-level Political Diplomacy

3.3 The decline in CBRs has already been met with an appropriate high-level politically driven response by Caribbean political leaders. A formal diplomacy-driven coordinated regional high-level political solution commenced at the 27th Inter-Sessional meeting of the Conference of the Heads of Government of CARICOM in Placencia, Belize on February, 16-17, 2016 at which a high-level ministerial advocacy group was appointed to create greater international awareness and represent the interest of the

Caribbean on this issue, including at the United Nations, World Trade Organisation, and United States Congress.[13]

Regional and National Centralised Information Repository/Database and Sharing Hub

3.4 At the **regional** level, this solution requires the creation of single centralised information repository, reference hub or database on regional respondent banks. It can be used to hold and share information with correspondent banks conducting due diligence, particularly on respondents' business and customers. This solution responds directly to the scope and quality of information relied on by correspondent banks to make decisions to maintain, restrict or sever CBRs based on risk assessments consistent with their own stringent statutory and regulatory know-your-customer (KYC) requirements to conduct detailed due diligence. Another option is for this centralised repository to be done at the **national** level in each Caribbean jurisdiction as was reportedly done in Mexico.[14]

Centralised Regional Transactions Hub – Consolidation of Regional Transactions

3.5 The costs of CBRs is so high that one option is to pool regional transactions through a single mechanism. This option may involve the creation of a new regional financial institution or use of an existing one to function as a hub or conduit for 'cleared' correspondent banking transactions traffic to the foreign correspondent banks. The costs of establishing and operating the regional transactions hub could be shared by the banks that use the facility and/or fully or partially underwritten (subsidised) by a regional financing arrangement or regional fund.

Financial Action Task Force and Basel Anti-Money Laundering Experts Group (AMLEG) Guidance

3.6 The guidance of international standard setters like the Basel Committee on Banking Supervision and FATF is proving to be of great utility in the global response to de-risking, particularly the search for solutions. The extent to which such guidance is delivered, respected and adhered to could prove to be an important solution or serve as a spine or platform for multiple solutions.

3.7 Over the last two years FATF has had to address the issue of "de-risking" particularly because the view that the mis-application of the FATF Recommendations (2012) with respect to the Anti-Money Laundering and Countering Financing of Terrorism (AML/CFT) call for application of a risk-based approach (discussed below), is heavily blamed as being a driver of de-risking.

3.8 FATF's then President Roger Wilkins has pointed out since October 2014 that "nothing in these standards require a rigid, blanket application of that requirement" and that what is most likely required is the "communication of more flexible regulatory practice and standards, and more refined and intelligent assessment of risk".[15]

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[13] Communique issued at the conclusion of 27th CARICOM Intersessional Meeting, (February 19, 2016). Available at http://today.caricom.org/2016/02/19/communique-issued-at-conclusion-of-27th-caricom-intersessional-meeting/. This may also include lobbying the Organisation of American States (OAS).

[14] Committee on Payments and Market Infrastructures Consultative Report on Correspondent Banking (October 2015) p.21

[15] FATF President Roger Wilkins, 'The danger of driving both illicit markets and financial exclusion', Remarks at the 6th Annual International Conference on Financial Crime and Terrorism Financing, (Kuala Lumpur, October 8, 2014).

3.9 FATF also promised to provide more helpful guidance to banks and other financial institutions and it has done so in October 2014[16], June 2015[17] and October 2015.[18]

3.10 FATF acts in the Caribbean through its regional style body the Caribbean Financial Action Task Force (CFATF) which was established in 2009. CFATF is an organisation of states and territories which have agreed to implement common counter measures against money laundering. FATF delivers valuable assistance and monitors compliance for all of the regional states and territories. It is well positioned to lead on this solution. However, it is under-resourced and will need the assistance of all regional stakeholders.

3.11 The Basel Committee on Banking Supervision (BCBS's) Anti-Money Laundering Experts Group (AMLEG) is also capable of providing very helpful guidance to banks on these issues.[19]

3.12 BCBS's CPMI in its Consultative Report on Correspondent Banking of October 2015 recommended that both FATF and AMLEG can be invited to provide guidance on:

(i) additional clarity on due diligence recommendations for upstream banks, particularly with respect to the extent to which banks need to know their customers' customers ("KYCC");

(ii) further clarify data privacy concerns in the area of correspondent banking; and

(iii) detail, to the extent possible, the type of data that information-sharing mechanisms could store and distribute in order to be a useful source of information.

A Risk-Based Approach: the search for common ground and FATF Guidance

3.13 FATF recommends that countries should identify, assess and understand their money laundering and terrorist financing risks and allocate resources aimed at ensuring that the risks are mitigated effectively. It expressly recommends that, based on the assessment, countries should apply a risk-based approach (RBA) to ensure that measures to prevent or mitigate money laundering and terrorist financing are commensurate with the risks identified.[20]

3.14 There is some degree of divergence among national regulators and financial institutions on the issue of how RBA should be interpreted and applied. The inconsistent application of this recommendation appears to have become the most prominent driver of the decline in CBRs and, more specifically, the inappropriate "de-risking" of CBRs. The WB Survey reports that 95% of respondents (the highest percentage for any response) indicated that concerns about money laundering and terrorist financing risks were a top cause or driver for CBR withdrawals by large international banks.

3.15 In responding to this issue, FATF has already provided clarification of RBA and even more clarification is expected before the end of 2016 as FATF continues to review and update its RBA guidance.[21]

[16] FATF clarifies RBA: case-by-case, not wholesale de-risking, (Paris, 23 October 2014).
[17] Drivers for "de-risking" go beyond anti-money laundering/terrorist financing (Brisbane, 26 June 2015)
[18] FATF takes action to tackle de-risking (Paris, 23 October 2015).
[19] Also known as the 'BCBS AML/CFT Expert Group'.
[20] Recommendation 1 of the FATF Recommendations (February 2012)
[21] Since 2013 the FATF has issued: (1) Guidance for a Risk-based Approach to Prepaid Card, Mobile Payments and Internet-based Payment Services (26 June 2013); (2) Guidance for a Risk-Based Approach to Virtual Currencies (26 June 2015); (3) Guidance for a risk-based approach: effective supervision and enforcement by AML/CFT supervisors of the financial sector and law enforcement (23 October 2015) and most recently (4) Guidance fro a Risk-Based Approach for Money or Value Transfer Services (23 February 2016).

3.16 The captioned policy suggestion is very important and one defined by FATF for the adoption of national financial system regulators.[22] In principle, it implies that the wholescale categorisation of entities in a sector such as money transfer services, foreign embassies or non-governmental organisations as high risk is unacceptable. Rather, the risk posed by individual entities within these broad categories should be assessed in accordance with RBA. In principle, application of RBA should lead to significant reduction in unnecessary de-risking and in massive collateral damage to institutions and persons not guilty of criminal offence.

3.17 WB (2015) recommended that national regulators "should set out the tenets for a reasonable risk assessment for establishing correspondent banking relationships. This also implies that financial system regulators and the national AML/CFT policymakers clarify the acceptable level of risk tolerance." The appropriate risk assessment procedures consistent with the targeted level of risk within individual jurisdictions, sectors and the various categories of customers would have to be determined. Clearly, this new approach by national financial systems requires regulatory clarity, substantial analysis, training and other institutional strengthening. It is an area in which those institutions with the required technical capability such as FATF and FSB should have the responsibility of enhancing the required skills of regional institutions.

National Risk Assessments

3.18 CDB can provide funding for TA focused on strengthening the AML/CFT compliance framework in its BMCs at the national and institutional levels.

3.19 At the regional level CDB is also able to support the work of CFATF. With FATF fourth round of national risk assessments underway under the supervision and coordination of CFATF, CDB's interventions can greatly enhance the Region's ability to identify, manage and mitigate money laundering/financing of terrorism (ML/FT) risks to remain compliant and increase attractiveness to and reduce compliance costs for correspondent banks. At the institutional level there is a need for strengthening in niche areas such as the computerisation of compliance activities in financial institutions. CDB directly, and in partnership with other donors can help to meet this need. Such donor partnerships can enable the Region's financial sector to enhance current capabilities for identifying, evaluating and managing the risks that it currently faces.

3.20 To assist a correspondent bank in understanding country risk context, it was recommended that countries publish their national risk assessment in order to demonstrate their commitment to AML/CFT and to inform outsiders of the risks they face and how they intend to address them.[23] The US has published their 2015 national risk assessments.[24]

Consultancies on Operational and Technical profile and shortcomings

3.21 This is likely to be a very helpful way to have an insight into what is driving the withdrawals of CBRs and also respond in a manner that takes account of the peculiar requirements of e.g. US correspondent banks and their examiners.

3.22 These kinds of consultancies can be undertaken by respected retired bank examiners and other financial regulators who "know their own banking and regulatory system inside out". These consultancies can focus on gaps and shortcomings in the operational and technical profiles of regional respondent banks

[22] FSB, November, 2015, p.6.
[23] WB (2015), p.7.
[24] https://www.treasury.gov/press-center/press-releases/Pages/jl0072.aspx

in the form of a diagnostic assessment but also assist their planning going forward on what it would take to retain current CBRs or recover lost CBRs. Many US-based, particularly Washington DC-based consultancy firms and top tier law firms offer these kinds of services.

Know-Your-Customer Utilities

3.23 KYC Utilities are facilities which are electronic repositories for respondent banks to store and update their customer information which correspondent banks can then access to conduct their due diligence. Respondent banks control access and thus can make their information available only to designated correspondent banks with whom they already have (as part of ongoing due diligence) or hope to have CBRs. KYC Utilities can significantly reduce time, cost, duplication of effort and complexity for both parties. [25]

Legal Entity Identifiers

3.24 Legal Entity Identifiers (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 effectively a tool to assist with identification and mitigation of financial risk by increasing immediate access to credible knowledge of transactional counterparties. LEIs can be embedded in the knowledge data banks available through KYC Utilities. Consideration can be given to imposing mandatory use of LEIs.

Insurance

3.25 Insurance, as a tool, can be used to transfer and mitigate some key risks related to this issue, particularly, the risk of enforcement actions leading to, or accelerating the decline in CBRs. Fines related to AML/CFT levied against banks spiked in 2014 to $11.9 billion dollars. Hence the use of insurance requires careful thinking and planning to ensure that it is workable and practical. Appropriate pricing and financial assistance with premiums will be needed. Stakeholders will need to ensure that the correct insurable events are identified (e.g. enforcement related events like fines and other sanctions and that they identify the appropriate insurer (whether each regional bank individually, as a pool of regional banks or a single regional bank acting as a hub or agent of other banks) and provider. Pooling may reduce policy costs.

3.26 The scope of such insurance policies would primarily cover insurable events based on determinations made by consulting with financial regulators or other enforcement bodies (for example the Department of Justice in the US) and include: AML/CFT compliance enforcement sanctions including monetary penalties and fines; adverse regulatory directives; regulatory investigations; and settlements whether negotiated before or after any final judicial or administrative determinations. Institutional legal defence costs can also be covered by these policies in the same way that modern directors' and officers' insurance policies provide coverage for defence costs associated with regulatory investigations and sanctions.

Block Chain and Digital Currencies

3.27 Bitcoin is a digital currency that exists on a public network and can be used as an alternative payment method to traditional wire transfers. Each bitcoin user owns his/her bitcoin and a wallet that is

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[25] See the CPMI Report on correspondent banking 2015 p.12 which lists some KYC Utilities including: Thomson Reuters Accelus; SWIFT KYC Registry; Bankers Almanac; depository Trust Clearing Cooperation (DTCC) – Clarient Entity Hub; and Markit/Genpact KYC Service.

used to make and receive payments. Blockchain is a public log (ledger) of all bitcoin transactions between various bitcoin wallets. Transactions in the blockchain are irrevocable. Hence the blockchain stores all of the background supporting data awaiting approval that can be used to verify the transaction also known as the 'proof of work'. With each approval and validation of the data, a new block is created and added to the blockchain. Each block carries data that establishes a sequential link with the previous block. Blockchain can be used for other forms of property other than bitcoin.

Lobbying for an amendment to the Liquidity Coverage Ratio

3.28 The 'lack of profitability' driver is exacerbated by the impact of the Basel III Liquidity Coverage Ratio (LCR). LCR is a standard that was designed to increase banks' liquidity buffers in direct response to the role liquidity played in causing or exacerbating the 2007-09 global financial crisis. LCR will require banks to hold a buffer of high quality liquid assets (HQLA) sufficient to withstand a 30-days stressed funding scenario which national regulators may vary. Banks will be required to hold 25% of HQLA for deposits held as necessary for operational transactional purposes and classified as 'operational deposits' and 40% of HQLA for other non-financial unsecured wholesale corporate deposits classified as 'non-operational' deposits. Each type of deposit is assigned an expected outflow factor.[26]

3.29 A key concern is that LCR is expected to be fully implemented by 2019. However, the federal financial regulators in the US have implemented a 'modified LCR' which requires implementation by January 1, 2017. In effect LCR appears to increase the cost of holding CBR deposits and may eliminate any incentive for a correspondent bank to undertake a CBR.[27]

3.30 US-based correspondent banks have already begun to pass on the cost by increasing significantly, the pricing to keep out certain types of short-term (e.g. overnight) deposits and to offset the cost of carrying such deposits that attract a 100% outflow rate factor. Regional Central Banks and other national financial regulators are well positioned to lead a coordinated effort to lobby BCBS and relevant national regulators, particularly in the US, to address this issue in a manner that balances the need for adequate liquidity coverage and support the creation of sound CBRs.[28]

US-based presence through a Caribbean-owned bank, clearing institution or agency

3.31 Another possible solution is the establishment in the US of a Caribbean-based presence through a Caribbean-owned bank, clearing institution, agency or representative office as an entity with or through which regional institutions can have CBRs.[29]

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[26] Bank for International Systems (BIS), Basel Committee on Banking Supervision, Basel III: The Liquidity Coverage Ratio and liquidity monitoring tools, (January 2013) para 106.

[27] In the US for instance, operational deposits must meet eight qualifying criteria from which some correspondent banking deposits (though not all correspondent banking arrangements) are excluded from qualification. The wholesale unsecured deposits typically made pursuant to correspondent banking activities (i.e. arrangements whereby correspondent banks holding deposits owned by respondent banks and provide, overnight deposit accounts for excess funds, payment and other services in order to settle foreign currency transactions) are not treated as operational and will receive a 100% outflow treatment except to the extent that operational services are utilised by respondent banks, in which case associated deposits may be included as operational deposits. US federal regulators have noted in their Final Rule that the relative instability of correspondent bank deposits including excess funds placed in an overnight deposit, which do not warrant their classification as non-operational deposits a lower outflow rate. The liquidity risk profile of financial sector entities are significantly different from those of traditional corporate entities. They also noted that during the 2007-09 financial crisis, funding from wholesale counterparties including financial sector entities like respondent banks were generally more sophisticated than funding from retail counterparties and thus presents far greater liquidity risks to correspondent banks during a stress period when they tend to withdraw large amounts of funds to meet their obligations.

[28] One way to achieve this would be to adopt an activity-based approach to the classification of correspondent bank deposits.

[29] There does not appear to be any similar suggestion being made for the establishment of an equivalent presence in other countries like the UK and Canada.

3.32 The operational burden to establish such an institution, particularly given the high barrier to entry to conduct business in highly regulated financial markets like New York, would require careful planning and investigation. Among other things, the registration and licensing costs, time and operational risks associated with establishing such an institution could prove to be prohibitive. A strong sustainable pipeline of correspondent banking traffic is likely to prove attractive to such an institution, but its success will always be subject to the variety and costs of the risks involved. Such an institution may be created or acquired but will not be immune from the same compliance and regulatory enforcement risks currently faced by US-based correspondent banks.

Road shows and meetings to lobby US, Canadian and UK regulators

3.33 Targeted roadshows by Caribbean stakeholders, including direct engagements by national stakeholders (e.g. governments) or regional stakeholders (e.g. CARICOM) with the US federal regulators have already commenced. These opportunities must be continued proactively because they can work well to reduce information asymmetries, increase visibility and top-down engagement.

Information sharing contract clause

3.34 This solution promotes the broader use of specific contractual provisions intended to facilitate easier and faster information sharing between respondent and correspondent banks. Such contractual provisions would enable customers to authorise their banks to release promptly relevant information related to AML/CFT due diligence and for compliance purposes, to the correspondent banks and other information databases/hubs and sharing mechanism, as discussed above.

Correspondent Banking Relationships at parent level

3.35 CBRs can be effected at the parent level to increase volume and also to reduce the number of risk-related barriers that may arise if the CBR is effected at the subsidiary level.

Correspondent Banking Relationships with second and third-tier foreign correspondent banks

3.36 Access to the US financial system through second and third tier foreign banks, including banks outside of the US, is another solution to be considered.

Nested Correspondent Banking Relationships

3.37 Nesting of CBRs occurs in the context of "downstream' CBRs when a respondent bank itself provides correspondent banking services to other banks domiciled inside or outside of their home country to facilitate international financial services on behalf of the clients of the downstream correspondent bank. In these circumstances, the primary or "upstream" correspondent bank must conduct due diligence on its respondent bank, the nesting correspondent bank and its downstream services including its AML/CFT risk profile and its AML/CFT controls. The same stringent KYC standards will have to be met with detailed customer due diligence (CDD) being conducted on each nested respondent bank. Nesting typically requires enhanced due diligence and high levels of internal approvals of the CBR by the management of the upstream or primary correspondent bank.

Guidance on Payment messages

3.38 This solution refers to guidance on how payment messages exchanged via SWIFT among correspondent and respondent banks can be enhanced to ensure that all key information requisite for

AML/CFT compliance is supplied in payment messages. BIS' CPMI relatively recently issued a Consultative Report on Correspondent Banking in October 2015 (CPMI Report).[30] The CPMI Report helpfully reviews the advantages and disadvantages of certain technical measures related to payment systems. These measures are: (a) KYC Utilities; (b) LEIs; (c) information-sharing mechanisms; and (d) improvements in payment messages.

Consolidation of national transactional traffic through few major Correspondent Banks

3.39 Consolidation of transactional traffic could take place at the national level or at the regional level through the Centralised Transactions Hub solution option (above). Consolidation of transactional traffic at the national level is a short to medium-term solution. This envisages that all or most of the banks in a particular country could use one or only a few correspondent banks. This will increase the volume for that correspondent bank(s) and the reduced costs (of providing the service to many banks instead of one bank) could be shared among those banks.

Consolidation in the regional banking industry

3.40 Consolidation of banks in the regional banking industry is a medium to long-term solution likely to be driven by both market and non-market considerations including the traditional drivers like profitability, footprint, synergies, size, scale, as well as AML/CFT and other compliance-related complexity and costs.

Uniform exit guidance and notification to respondent banks

3.41 This is more of a mitigant than a solution. A key part of the problem is that information asymmetries have led to respondent banks being blindsided; CBRs are being closed without any notice or reasons provided to the respondent bank. Yet, among the many policies, procedures and processes that the US correspondent banks are required to have in place is "*established criteria for closing the foreign correspondent financial institution account"*.[31] In the circumstances, it is relatively easy to establish notification periods and uniform guidance and a template for closing CBRs which both the correspondent and respondent can reliably use. According to the World Bank (2015):

(a) large banks should consider placing limits or trial periods instead of terminating relationships, or give a longer notice period;

(b) correspondent banks should consider placing appropriate credit and other limits/conditions on their client banks, rather than terminating the relationships;

(c) correspondent banks may also consider trial periods, and are encouraged to extend their notice period for termination to at least three months;

(d) correspondent banks should be transparent with respect to their reason(s) for terminating a relationship. This would enable particularly small banks to address possible concerns about AML/CFT issues if that was among the bases for terminating the relationship.[32]

3.42 The foregoing proposals regarding protocols for termination of CBRs are very worthy of consideration and should be part of the discussion and negotiation by the regional and international

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[30] http://www.bis.org/cpmi/publ/d136.htm.
[31] Federal Financial Institutions Examination Council Bank Secrecy Act/AML Examination Manual p.179
[32] WB (2015), p.8.

community. Implementation of the foregoing proposals would reduce the current uncertainties and collateral damage that accompanies sudden disruptions of correspondent banking relationships. The provision of reasons for breaking the relationships would also move the global community towards a much better understanding and resolution of the underlying causes.

Strengthening implementation of international AML/CFT standards

3.43 The fact that the Caribbean has been identified as the most affected region impacted by the decline in CBRs suggests strongly that there is much more work to be done with respect to key drivers of CBR withdrawals, particularly the AML/CFT framework and support for regional institutions like CFATF.

3.44 Foreign correspondent banks will pay attention to what is often described as poor regional harmonisation of AML/CFT legislation and to failure to enact legislation in some cases (for example, Foreign Account Tax Compliance Act). These are critical regional issues that generate uncertainty and need to be addressed.[33] The Region is vulnerable as a transit route for trade in illegal narcotics. Hence the deep concern about money laundering activity and the need for very robust systems. While the Caribbean is not regarded as a major source of terrorists and terrorist financing, a weak regional AML/CFT framework can lead to the Region being a conduit for financing of terrorism, a concern about which has intensified in recent years with the rise of the Islamic State of Iraq (ISIS) and increasing terrorist attacks in the US, Europe, Africa and elsewhere. As terrorists are being increasingly confronted and beaten back they will continue looking for new and weaker AML/CFT frameworks to exploit. The very clear recommendation emerging from the foregoing is that the Caribbean needs to strengthen substantially its regional AML/CFT framework to avoid becoming an easy target for dirty money and terrorist financing.

3.45 According to the WB (2015) study, "concerns about the effective implementation of AML/CFT obligations by countries and jurisdictions featured prominently among the reasons large banks are withdrawing from correspondent banking relationships - despite significant ongoing work by many countries to improve their AML/CFT regimes. All jurisdictions must therefore ensure that the legal and regulatory AML/CFT framework is in place and that their financial institutions are being effectively supervised for risk-based compliance with those obligations."[34]

3.46 However, indications are that there is need also for significant institutional strengthening within and beyond the financial sector to deliver the required results. Given the size of the challenge posed by the institutional deficiencies noted above, a well-coordinated, simultaneous and substantial involvement by CDB and the wider donor community in the Caribbean will likely be necessary to address the issue with the desired level of urgency and effectiveness. The regional scope of the challenge suggests that substantial efficiencies may be gained by embarking, where possible, on regional approaches complemented by other national solutions like the sharing of information and best practices.

CONCLUSION

4.1 For the Caribbean and other severely affected jurisdictions, very much is at stake in the resolution of the current CBR crisis. The likely severity of the economic and social impact and difficultly in quickly implementing sustainable solutions clearly require the meaningful involvement of several stakeholders at the regional, national and institutional levels to contribute with their specific expertise to resolution of the crisis. CDB will continue to do its part in supporting the resolution to this issue.

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[33] Report of the Meeting of the Committee of Ministers of Finance on Correspondent Banking, Placencia, Belize, February 15, 2016, p.3

[34] WB, 2015, p. 7.

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