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Overview of Correspondent Banking and "De-Risking" Issues

What is Correspondent Banking?

In broad terms, correspondent banking refers to formal agreements or relationships between banks to provide payment services for each other. It is often used to effectuate cross-border payments, and as such, plays an important role in the international financial system. Correspondent banking underpins trade finance, migrant remittances, and humanitarian flows. A typical correspondent banking arrangement is one in which two financial institutions (*respondent banks*) employ a third party, a separate financial institution known as a *correspondent* or *service-providing* bank. The various types of services correspondent banking provides include wire transfers; check clearing and payment; trade finance; cash and treasury management; securities, derivatives, or foreign exchange settlement; and participation in large loans, among other services.

Figure 1 shows the settlement of a payment from Bank A to Bank C via a correspondent Bank (B). Because Banks A and C do not hold accounts with each other, they use a third party, Bank B (the service-providing correspondent bank). Bank B, in this example, holds accounts for both Bank A and Bank C.

The amount of money moved globally through correspondent banking relationships is significant. For perspective, in 2016, the European Central Bank reported roughly $822 billion (€880 billion) worth of daily transactions channeled through correspondent banking arrangements within Eurozone countries alone.

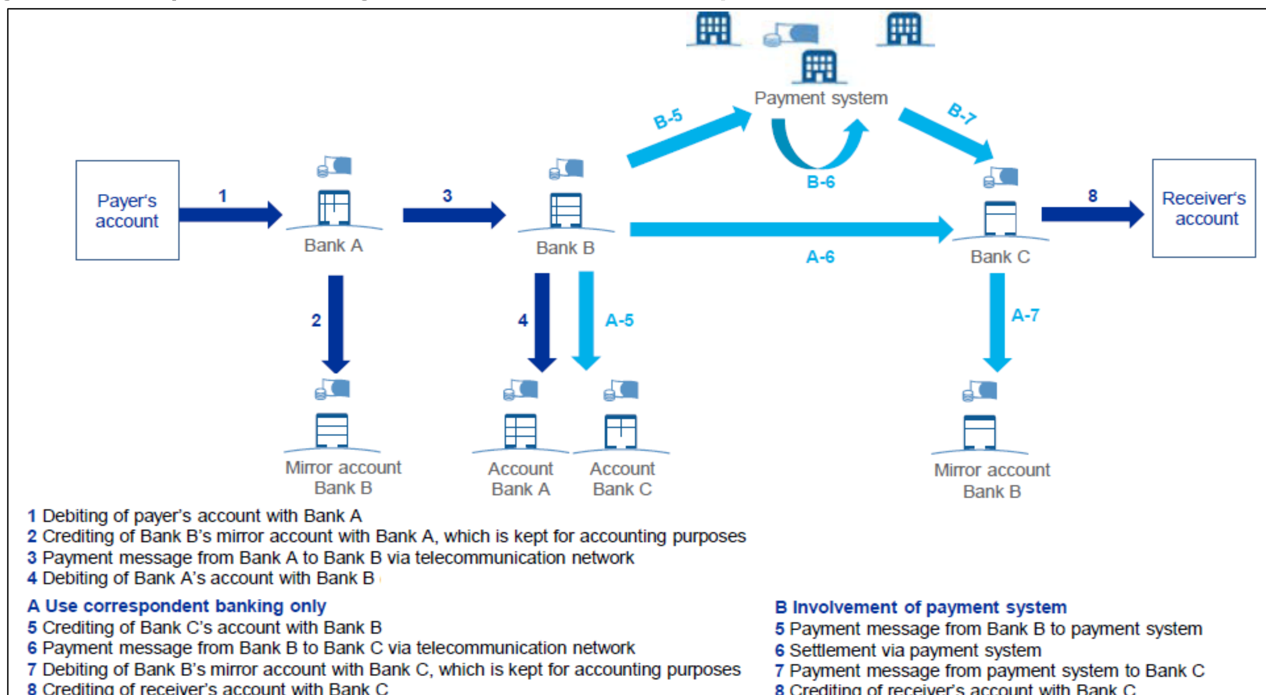
Although these transactions provide significant benefits, they also present several challenges. Two of the primary policy issues involved with correspondent banking are interrelated: (1) what types of anti-money laundering (AML) and countering the financing of terrorism (CFT) controls should be in place to prevent illicit payments? (2) how to prevent excessive industry reaction to such controls, called "de-risking"?

"De-Risking" and Its Implications

International Monetary Fund (IMF) estimates indicate that the global volume of money laundering could amount to as much as 2.7% of the world's gross domestic product, or $1.6 trillion annually. To address these concerns, the United States has a robust AML-CFT framework that also applies to correspondent banks because of these banks' key role in international financial transactions.

Under the current regulatory approach, correspondent banks may bear liability, regulatory and reputational risk for AML-CTF violations by the respondent banks. As a result, in recent years, concerns on the part of large international banks about regulatory compliance with AML and customer due diligence (CDD) requirements have led some large banks to shed their correspondent banking relationships with some smaller

Figure 1. Correspondent Banking: Illustrative Settlement of Payments



Source: European Central Bank, *Tenth Survey On Correspondent Banking In Euro 2016*, February 2017, at https://www.ecb.europa.eu/pub/pdf/other/surveycorrespondentbankingineuro201702.en.pdf?651487aa2ace9afbac36d8d7e7784203.

banks, often in emerging markets viewed as "high-risk" for AML. This phenomenon is known as "de-risking." Rising costs and uncertainty about how far CDD should go to avoid regulatory sanction are cited by banks as among the main reasons for cutting back their correspondent relationships, according to the Bank for International Settlements (BIS). Other factors in the decision to curtail correspondent banking relationships include profitability considerations and concerns over potential liability and reputational damage. Also, the need to safeguard against cyber risks has led to the development of new standards that have increased the cost of correspondent banking relationships, further reducing their appeal.

A March 2018 Financial Stability Board (FSB) study on correspondent banking found a marked reduction in the number of correspondent banking relationships between 2011-2017 in all regions of the world, although the reductions varied across regions. At the same time, the total volume of payment messaging has not fallen, indicating that banks in smaller countries might be seeking out intermediary banks to conduct correspondent banking for them, in what is known as *lengthening the payment chain*. Moreover, the correspondent banking market continues to be a concentrated market, with a few key players accounting for the majority of transaction volumes serviced. A 2016 paper by IMF researchers cautioned that de-risking could potentially disrupt financial services and cross-border flows, such as trade finance and remittances, which could undermine growth in certain emerging markets. Nationwide impacts thus far have been mitigated by affected banks' ability to find other correspondent banks or to use alternative means to transfer funds, the IMF paper concluded.

The Role of Wire Transfers and SWIFT

As discussed, correspondent banking relationships are fundamentally about moving money and effectuating payments as opposed to other banking activities, such as deposit-taking or issuing commercial loans. Many such payments involve wire transfers. Facilitating nearly 30 million transactions daily, the Society for Interbank Financial Telecommunication (SWIFT) is one of the most commonly used means of sending cross-border transactions, so issues affecting SWIFT can impact correspondent banking.

SWIFT is neither a bank nor a clearing and settlement institution, and it does not manage accounts or hold funds. It is organized as a cooperative under Belgian law and is owned and controlled by its shareholders. It provides the standards enabling member banks to exchange financial information needed to make payments. As of 2017, it served over 200 countries and over 11,000 financial and corporate entities. SWIFT's regulatory challenges include complying with a large number of AML/CFT regimes while maintaining neutrality on sensitive policy issues, such as sanctions.

Regulatory Requirements

For the United States, a central U.S. requirement for wire transfers and SWIFT payments from the AML/CFT perspective is the so-called travel rule issued by the Financial Crimes Enforcement Network (FinCEN) in 1996. The travel rule requires financial institutions to pass on certain information along with a wire transfer. The rule was designed to help law enforcement agencies detect, investigate and prosecute money laundering and other financial crimes by preserving an information trail about persons sending and receiving funds through funds transfer systems.

Banks are also required to conduct due diligence on customers opening accounts, with special attention to foreign correspondent banking account relationships. Special record-keeping and certification requirements apply to foreign correspondent banking accounts. A bank that maintains a correspondent account in the United States for a foreign bank also must maintain records identifying the individual owners of each foreign bank, and must ensure it is not a "shell bank" without bona fide banking activities. Some banks have complained these requirements make it costly to open and maintain correspondent accounts, particularly for banks in countries with high civil unrest, strife, or criminality—and that that has led to de-risking. Others argue that foreign correspondent accounts have been used at times to circumvent U.S. sanctions and in illicit payments, and deserve special scrutiny to safeguard the financial system.

The U.S. sanctions regime can also affect correspondent banking. Title III of the 2001 USA PATRIOT Act (P.L. 107-56) to a degree extends the obligation to comply with sanctions lists of the Office of Foreign Assets Control to some foreign banks, particularly through correspondent banking relationships with U.S. banks, thereby increasing the reach of U.S. regulation. Under Section 311 of the USA PATRIOT Act, FinCEN is authorized to impose "special measures" on U.S. financial institutions to mitigate money laundering threats associated with foreign jurisdictions or institutions found to be "of primary money laundering concern." These measures range from additional recordkeeping, reporting, and information collection requirements to prohibiting the opening or maintaining of correspondent accounts. According to a 2015 study by the nonprofit Center for Global Development, based on their analysis of AML, CFT, and sanctions-related fines, 25% of the 40 largest non-U.S. banks by asset size were fined by U.S. regulators between 2010-2015, underscoring the impact of U.S. sanctions on foreign banks and correspondent banks.

In an attempt to address problems stemming from de-risking, the Office of the Comptroller of the Currency (OCC) issued guidance in 2016 to banks regarding the withdrawal of correspondent banking relationships. It advises banks to conduct periodic risk reevaluations of foreign correspondent accounts and to consider any information provided by foreign financial institutions that might mitigate risk, and provide institutions with "sufficient time to establish alternative banking relationships before terminating accounts, unless doing so would be contrary to law, or pose an additional risk to the bank or national security, or reveal law enforcement activity." The guidance, however, does not otherwise relieve banks of their AML requirements. It notes that the OCC does not encourage banks to terminate entire categories of customer accounts "without considering the risks presented by an individual customer or the bank's ability to manage the risk." It is unclear, however, what impact, if any, the OCC's guidance has had on banks' practices.

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