

Correspondence closed as banks post changes

Correspondent banking was once the oil that lubricated world trade but it is now drying up rapidly. **Richard Northedge** explains why and looks at whether the activity still has a future

Banks' letterheads used to contain their telegraphic address, a telex number and their correspondent-bank connections. Not now. The contact details have been replaced by email and the list of correspondent banks is shrivelling fast.

A bank developed correspondent relationships with banks abroad so that its customers could deal with account holders in foreign countries where it had no branches. For more than a century, correspondent banking has allowed manufacturers to import materials and to export products; it has permitted people to buy overseas properties and ex-pat workers to remit wages to families. Correspondent banking became a global network of bilateral bank-to-bank relationships that enabled international cheque clearing, wire transfers, trade finance and cash-management – the oil that lubricated world trade.

Now that oil is drying up. Correspondent banks are ending long-standing relationships with respondent banks abroad. Sometimes links to whole nations are being axed, leaving local banks struggling to make cross-border payments. Half of emerging market and developing economies have seen a decline in correspondent-banking services, according to a World Bank survey conducted last year. Eight of the G20 nations have been hit. Of the 20 large global banks surveyed, 15 admitted to a fall in their tally of correspondent banks; even more said they had ended all relationships with some jurisdictions.

The trend is worrying financial regulators. Not only the World Bank, but also the Financial Action Task Force (FATF), the Bank for International Settlements (BIS), the Basel Committee for Banking Supervision, the IMF, the Financial Stability Board (FSB) and a host of regional banking supervisors, regulators and specialist committees are looking into why correspondent banking is shrinking, whether it matters and how it can be revived.

Yet while those financial watchdogs are leading the search for a solution, many people see them as the cause of the problem. The increasingly tough regime that requires banks to spot money laundering, terrorist financing or sanctions breaches – and the increasing fines for breaking the rules – are deterring commercial banks from acting as the conduit for transmitting funds around the world. At the Transaction and Correspondent Banking Conference in London in February, Neil Swift, a partner at solicitors Peters and Peters, argued that “there

A bank must now know its customer and its customer's customer

has been a rebalancing – banks are now taking on more of the role of the state in being gatekeepers against crime”.

Even if the correspondent bank has completed full due diligence on its own account holder and on the respondent partner, it may well know nothing about that partner's client. This fear that the home bank must not only know its customer but also its customer's customer is cited frequently as a reason for ending relationships. For big banks, the fees earned do not cover the reputational risk or the potential financial penalties, never mind the possibility of being barred from operating in major markets such as the US.

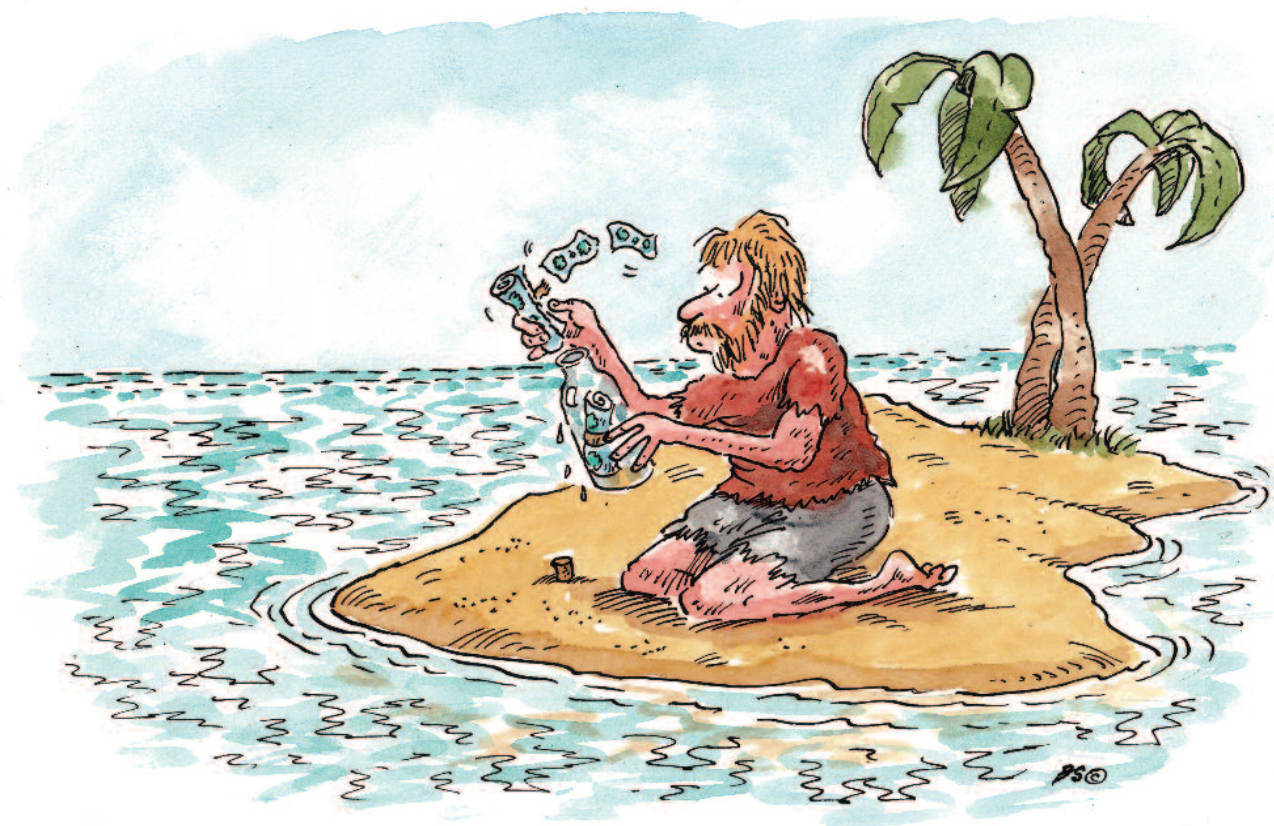
‘There is a fear-based approach instead of a risk-based one’

As the World Bank admits: “Uncertainty regarding regulatory obligations or expectations leads bank to err on the side of caution.” Or, in the words of one bank: “We're supposed to have a risk-based approach but what we have is a fear-based approach.”

There are also other reasons, not least that banks no longer measure success by the length of their correspondent lists. Nor do margins now allow cross-border transfer systems to be run as loss-leaders for fee-earning activities. Not only do mergers mean there are fewer banks, financial pressures are forcing those players to withdraw from certain sectors and territories. The creation of the euro means fewer currency transactions too, with even non-eurozone correspondents now needing only one bank in the zone.

That partly explains why the latest European Central Bank (ECB) analysis shows the number of correspondent banks in the eurozone maintaining correspondent accounts for other banks falling from more than 26,000 in 2002 to just 12,207 in 2014. (The ECB only included those banks with an average daily turnover on so-called “loro accounts” – that is accounts for other banks, usually those based in another country, of at least €1bn.) The total daily turnover of euro transactions settled via correspondent banking in 2014 was, on average, around €1tn. Of this, around 12 per cent of the total value was settled through correspondent banking alone, without using payments systems.

Those figures confirm international statistics that show the decline long preceded the global financial crisis. Yet the crisis spawned the raft of extra regulation, with its expensive due diligence and the tighter capital and liquidity requirements that are squeezing margins. It also reduced banks' appetite for risk. Some also think the world is now a more dangerous place – hence



the temptation to “de-risk” by ending relationships with whole nations rather than individual banks. The surveys show the Middle East hit especially hard – and when a link is cut in one direction, the local bank may well end the reciprocal relationship.

The World Bank likes to divide the causes for the decline into commercial or regulatory reasons, but it has to admit that the two explanations are related. Compliance hits profits. Correspondent banking has fixed costs and it benefits from economies of scale: once volumes fall, banks need to raise fees, but that can force users to seek alternatives.

It is that search for other ways to transfer money that worries regulators. Mark Carney, the Bank of England (BoE) governor who chairs the FSB, quotes anecdotal evidence of charities feeling the pinch and fears for financial inclusion if whole nations are abandoned, but his real concern is where the money goes if it is not transmitted by a closely regulated bank.

When a top-tier bank cuts the correspondent link, it is now the case that another rarely replaces it. But if the local partner has to turn to second- or third-tier banks – or worse, when a prime relationship is ended – using such alternatives not only raises users’ costs, but increases overall risk, not least of money-laundering and terrorist financing. Gloria Grandolini, a senior director at the World Bank, says: “There is a real risk that turning away customers could actually reduce transparency in the system by forcing transactions through unregulated channels.” Or, as the FSB warns: “De-risking can introduce risk.”

Fewer banks in the network mean less competition, which could itself push up prices. The ECB uses three measures of concentration but admits: “All three ratios point to the same conclusion – that of a highly concentrated correspondent-banking market, typical of an oligopoly.” The World Bank warns of

smaller banks “being at the mercy” of only one correspondent bank; when the final relationship is terminated, those banks could go out of business.

If the global regulators’ concern is for the stability of the financial system, some governments worry about the risk of their banks being cut off from international finance, while millions of people working overseas face difficulties in transmitting money. The money remitted by migrants to families back home is a large component of certain economies, such as that of the Philippines.

Money-transfer operators, such as MoneyGram and Western Union, and remittance providers, together with small and medium-sized exporters, are the customers hardest hit by the shrinkage of correspondent banking. The product showing the greatest decline is wire transfers, especially in dollars, sterling or euros – the currencies of the banks ending the relationships. So fearful are non-US banks of US regulators that, according to the BIS, correspondent banking in dollars is increasingly being left to US banks as other banks withdraw

The regions most affected are the Caribbean, eastern Europe, and the central and east Asia-Pacific region. Smaller countries are hit hardest, especially those deemed to be high-risk financially and with significant offshore banking activity.

The winners from the correspondent banks’ retreat are informal money-transfer networks such as hawala (for more details of the hawala scheme, see Ballard R, “Migrants’ money lifeline”, *FW*, October/November 2014), and some new digital currencies, such as Ripple, at the smaller ticket end. For larger

‘Turning customers away can reduce transparency’

sums, the launch in 2014 of the Single Euro Payments Area, which includes non-eurozone and non-EU European states, is taking low-volume, high-value business, at least in those instances when banks can use the payments system without having to set up correspondent accounts. It might be expected that services such as PayPal and Google Wallet would start to make inroads into the market but they run on bank networks, which means they are faced with the same constraints as the banks themselves.

Swift, the agency that provides secure global messaging systems for banks, is making its own efforts to revive correspondent banking. It is launching a “global payments initiative” backed by 45 international banks, including Barclays, HSBC, Citibank, Deutsche Bank and Bank of China. “The time is right for innovation,” says Stanley Wachs, Swift’s global head of banking. “We looked at the inefficiencies of the traditional model: payments can be slow and expensive, there is limited transparency on price and it’s difficult to know when the transaction has reached the end-user.”

Swift’s new service will be piloted this year and rolled out in 2017. It includes same-day availability of funds, a guaranteed fee structure and end-to-end payment tracking. A cynic could argue that the bank payments system of which Swift is an integral part is being forced to change. Customers are getting used to fast payments, and national payments systems are being modernised. The BoE, for example, has just announced a review of its real-time gross settlement system, and Australia is already working on the “closer integration of payments with other networks”. International payments would appear to offer many opportunities for new entrants to cut costs with the use of “big data” – particularly as internet usage continues to grow around the world.

Like some big banks, including Goldman Sachs, Swift has looked at longer-term technology solutions, such as blockchain, the technology behind bitcoin. But, says Wachs: “We want to have a pragmatic approach so we’re leveraging the existing technology.”

The phalanx of financial watchdogs is seeking its own ways to revive traditional correspondent banking, including technological solutions. Recognising the “knowing your customer’s customer” fear, the BIS’s committee on payments and market infrastructures produced a report last November recommending better data analysis. This includes information-sharing initiatives and know-your-customer tools based on accurate and up-to-date records provided by all banks.

The report also advocates adding details of the end-users’ ownership to the names and geographical base on “legal-entity identifiers”, the 20-digit codes that identify all parties to transactions. Few banks use these codes, however, and changing would be expensive. The BIS committee accepts that this is a long-term measure. There are also other snags, including data protection, privacy and competition issues – and individuals do not have 20-digit codes.

Regulators also recommended that correspondent banks give their respondents at least three months’ notice of termination so that alternatives can be explored. Telling the respondent the real reason for ending the relationship is another suggestion – although

on money-laundering or terrorism issues, this might be seen as breaching “tipping off” rules. This lack of honesty could explain why, in the World Bank survey, so many correspondent banks cited those issues for cutting back but so few that terminated respondents gave those reasons. Another possible solution that has been discussed is for banks to deal parent-to-parent, rather than involving local subsidiaries whose own business, or whose location, is questionable.

The watchdogs also suggest that banks take a more risk-based approach, rather than ending all links to particular countries. But they also argue that nations

in danger of losing correspondents could up their game to become more attractive. The World Bank is offering its anti-money-laundering advice to such states.

Mexico, for instance, has changed its laws to remove barriers that prevented local banks from sharing information on clients: correspondent banks that register with the Ministry of Finance can now receive this intelligence. The government in Mexico is also developing a database that will store information on all cross-border transactions by its banks.

But the easiest way to stall the decline on correspondent banking might be to allay the banks’ fears. Even the different watchdogs are uncertain whether (or when) banks must know their customers’ customer. To end the confusion, the FATF is being asked to clarify its money-laundering and terrorism rules.

The FSB says that the FATF recommendations require customer relationships to be terminated only where the risks cannot be managed and that, with exceptions, banks do not have to perform due-diligence on respondent banks’ customers. Others read the rules differently, allowing no exceptions.

The World Bank concludes that there must be “an unequivocal statement from national supervisors that there will be no zero-tolerance approach for failures to detect money laundering”. It further calls for guidance on what constitutes a reasonable risk-assessment for establishing correspondent-banking relationships so that banks have the comfort they currently lack. That would apply also to dealing with countries covered by sanctions. “The mere fact that a bank dealt with tainted funds is not in itself sufficient to conclude that the bank in question ‘should have known’,” says the World Bank.

Several European banks would have avoided paying billions of dollars to US authorities if they had been allowed the defence of proving that they had taken reasonable precautions.

The future for correspondent banking is still fluid, however. The BIS is considering responses to its suggestions. The World Bank will report to the FSB in September and the FATF aims to finalise its plans by October. Plans to promote legal-entity identifiers should be completed by December. Meanwhile, commercial banks are voting with their feet and the World Bank admits that it does not know whether the exodus from correspondent banking has peaked.

The decline may be stalled if banks’ fears are allayed

Financial watchdogs are seeking ways to revive the sector



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