THE CENTRAL BANK OF THE BAHAMAS

Summary Findings: Correspondent Banking Survey 2

Bank Supervision Department

November, 2016

CORRESPONDENT BANKING SURVEY

Executive Summary

The Bahamas, as well as other countries within the region, continue to face the threat of the de-risking of correspondent banking relationships. In the extreme, this refers to the outright termination or restriction of Correspondent Banking Relationships (CBRs), with clients or categories of clients to avoid risk, because the correspondent banks have determined that the risk posed, or the potential costs of providing such services outweigh the returns or benefits of providing those services. Such relationships are vital to international finance, as correspondent banks either transmit or settle payments on behalf of other banks (respondent banks), including for payment of international goods and services. The ultimate payers and payees are often the business and individual clients of respondent banks who originate such international transactions.

In August 2016, the Central Bank of the Bahamas (CBOB) issued its second correspondent banking survey (CBS 2). The purpose of this survey was to build on the existing data obtained from the first survey (CBS 1) issued in 2015 which sought to assess the impact of de-risking in The Bahamas and its subsequent effect on banks' correspondent banking relationships (CBRs). The survey was distributed to all public bank and/or trust companies, credit unions and non-bank money transmission service providers (MTBs). Responses were received from fifty-four (54) supervised financial institutions (SFIs), representing an overall response rate of 56%.

The survey was expanded from 17(CBS 1) to 36 (CBS 2) questions in an effort to adequately capture the extent of declining CBRs in the country while also obtaining, more specific information on the adjustments made within financial institutions as it relates to contingency planning. Additionally, the CBOB sought out institutions' feedback on targeted measures that could be implemented to reduce the overall threat of de-risking in The Bahamas.

A full report of the results, together with some objective conclusions are provided below. Careful management of these trends is warranted, given the important impact on local commercial banks, and stand-alone international banks. The collective initial impact is more extensive than first assessed in 2015. The CBOB will continue to work with the sector to mitigate these adverse developments, and to sensitize stakeholders to the multifaceted approach to reducing The Bahamas' perceived risk profile. Proactive intervention includes the expected implementation of The Bahamas' National Risk Assessment strategy on anti-money-laundering (AML) and combating of financing terrorism (CFT), as well as further strengthening of the regulatory enforcement means to compel AML/CFT improvements.

The CBR survey results indicate the following:

- Fourteen (14) licensees indicated that they had been impacted by de-risking and/or the loss of a correspondent banking relationship. Of the impacted licensees, three (3) were commercial banks, one (1) was a non-bank money transmission service provider and the remaining ten (10) were international banks.
- Banks within this jurisdiction generally rely on a small number of CBRs. As such, evidence suggests that further declines in correspondent banking relationships could potentially pose significant threat to the jurisdiction, particularly with respect to the more vulnerable segments of our banking system (i.e. our indigenous banks and standalone international banks).
- Licensees affected by the loss of a correspondent banking relationship seem to have found it difficult to find replacements. Where no replacements were found, the business line affected was able to be funneled through existing relationships or the parent company.
- When asked about the main drivers/causes of declining correspondent banking relationships in The Bahamas, most licensees indicated that money laundering/terrorist financing concerns and the overall risk appetite of foreign financial institutions have been the main factors.
- With respect to operational losses, the vast majority of licensees did not report any resulting dollar—value loss related to terminated/restricted correspondent banking relationships.
- As it relates to contingency planning, 71% of respondents indicated that they had a contingency plan in place, in the event of a correspondent banking relationship being severed.
- With respect to mitigating the effects of de-risking, most licensees emphasized the importance of developing effective contingency plans, clarifying regulatory expectations, and the strengthening of regulation and supervisory frameworks.
- While the withdrawal of CBRs has gained some traction, it has not yet reached a critical level to threaten the overall stability of the banking sector.

Summary of Survey Responses

1) The results of the second correspondent banking survey (CBS 2) generally suggest that most licensees (particularly in the international sector) have not had any of their foreign correspondent banking relationships terminated within the last three years (see Figure 1), consistent with the findings of the first correspondent banking survey (CBS 1). In CBS 1, six (6) licensees indicated that they had been impacted by de-risking and/or the loss of a correspondent banking relationship. In CBS 2, fourteen (14) licensees indicated that they had been impacted.

   This apparent rise, however, also seems to reflect better coverage since the first survey, given that:

   a. 33 % of licensees that responded to this survey **did not** participate in the last survey; and
   b. for varying reasons, seventeen (17) banks that participated in the first correspondent banking survey did not participate in CBS 2.

   The extent of the impact of de-risking in The Bahamas appears therefore to be more extensive than first assessed.

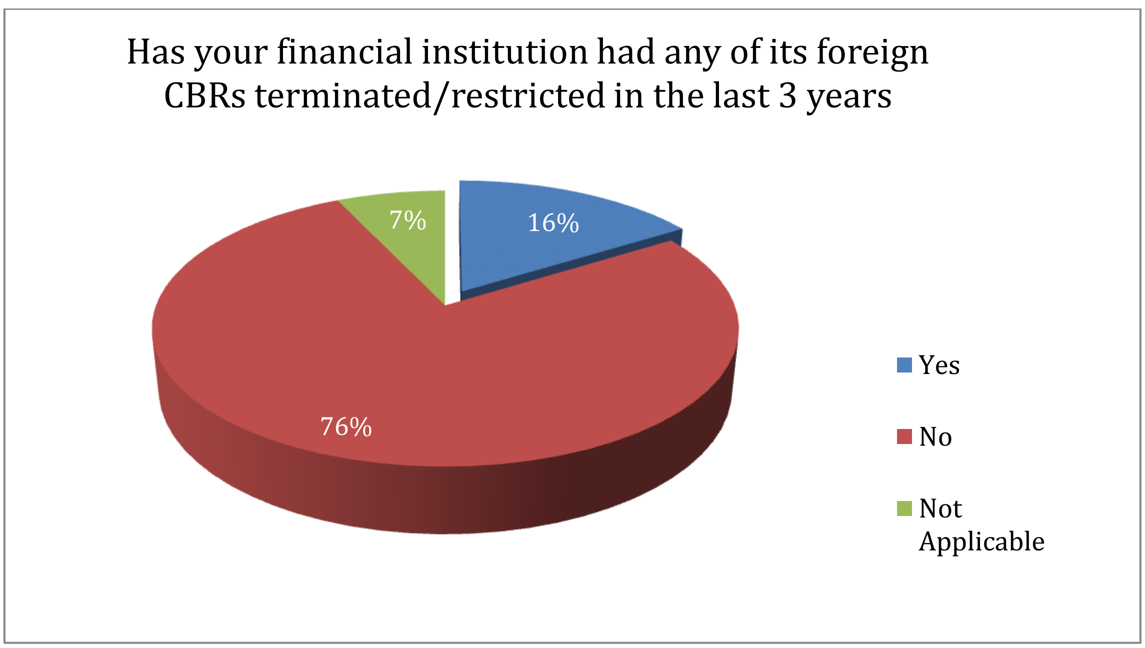

Figure 1

2) Of the impacted licensees for CBS 2, three (3) were commercial banks, one (1) was a non-bank money transmission service provider and the remaining ten (10) were international banks. Of the fourteen (14) institutions who reported to have been affected and/or impacted by the loss of a correspondent banking relationship, six (6)

were standalone banks, seven (7) were subsidiaries of a parent bank and one (1) was a non-bank money transmission service provider.

Of the entire surveyed population, 67% (or 35 licensees) reported to have maintained 1 to 4 correspondent banking relationships (CBRs), compared to 11.54% who maintained 5 to 10 CBRs and 7.69% who maintained over 10 CBRs. This finding is indicative, that banks within this jurisdiction generally rely on a small number of CBRs. As such, further declines in correspondent banking relationships could potentially pose a significant threat to the jurisdiction.

The most frequently used currencies are indicated at Figure 2 below. The average dollar value of correspondent banking transactions underscores the significance of correspondent banking operations to The Bahamas.

Average annual dollar value of correspondent banking transactions (*within a given year*)	**$2.8 Billion**

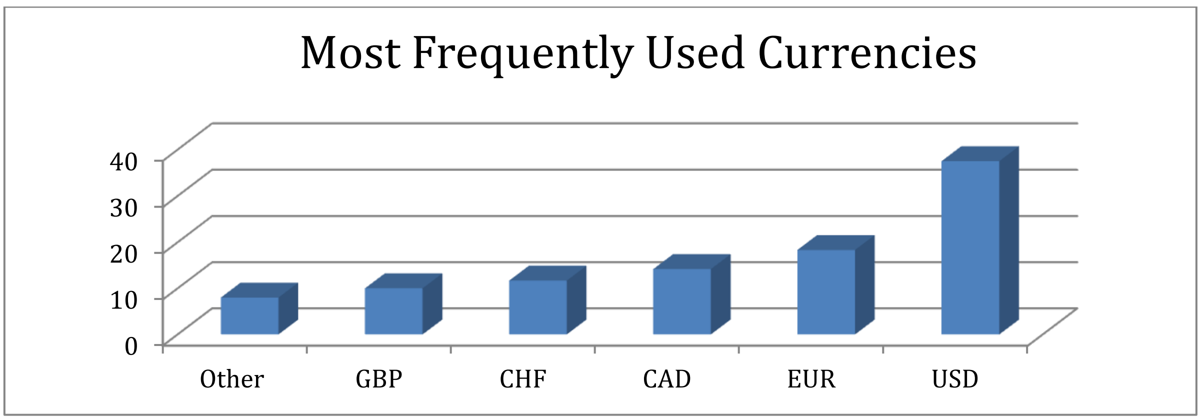

Figure 2

3) The survey asked respondents to indicate how many foreign CBRs had been terminated since the last survey, and whether or not there had been any additional AML/CFT requirements imposed by their correspondent banker. Six (6) banks advised that they had lost at least one (1) correspondent banking relationship since the last survey.

Where correspondent banking relationships were maintained, 71% of the surveyed population advised that additional AML/CFT requirements were imposed by their correspondent banker. Some of the more notable requirements cited are as follows:

- Provide additional procedures and policies on AML/KYC and internal audit;
- Expansion of certifications and questionnaires;

- Personal interviews with the Director of Compliance focusing on on-boarding process and screening, sanctions programs, identification of ultimate beneficial ownership, due diligence of high risk clients, monitoring of high risk clients; and
- More scrutiny of each transaction.

While AML/CFT requirements have been enhanced, licensees generally indicated that this has not significantly impacted their operations.

4) Furthermore, licensees affected by the loss of a correspondent banking relationship seem to have found it difficult to find replacements. In fact, of the licensees that have lost correspondent banking relationships, 57% (or 8 banks) have not been able to find replacement correspondent banks or alternative arrangements.

5) With respect to operational losses, the vast majority of licensees did not report any resulting dollar—value loss related to terminated/restricted correspondent banking relationships. However some licenses have had to increase investments in automated transactions monitoring systems, and at least 3 remittance firms were impacted.

6) Seven (7) institutions who reported a loss of CBRs indicated that the reason for the termination was in fact provided to them by their former correspondent bank, while three (3) banks reported no explanation was provided. The rationale behind the loss of CBRs appears to be consistent with views expressed by global banks in the international community, such as, reduced risk appetite, strategic decisions and relatively small transaction sizes, leading to low profit margins. The responses suggest that correspondent banks have restructured their profit driving strategies, and have deemed the revenue earned too little to justify the risk/costs involved.

7) When asked what the main drivers/causes of declining correspondent banking relationships in The Bahamas were, most licensees indicated that money laundering/terrorist financing concerns and the overall risk appetite of foreign financial institutions were what primarily led the charge. This was followed by changes to the legal, regulatory and supervisory requirements that have implications for maintaining CBRs, and the apparent lack of profitability associated with certain foreign CBR services/products (see Figure 3 below). Moreover, licensees indicated that the products most severely impacted by declining CBRs related to cash management services (e.g. deposit accounts, payable through accounts) and international wire transfers, in addition to draft clearing.

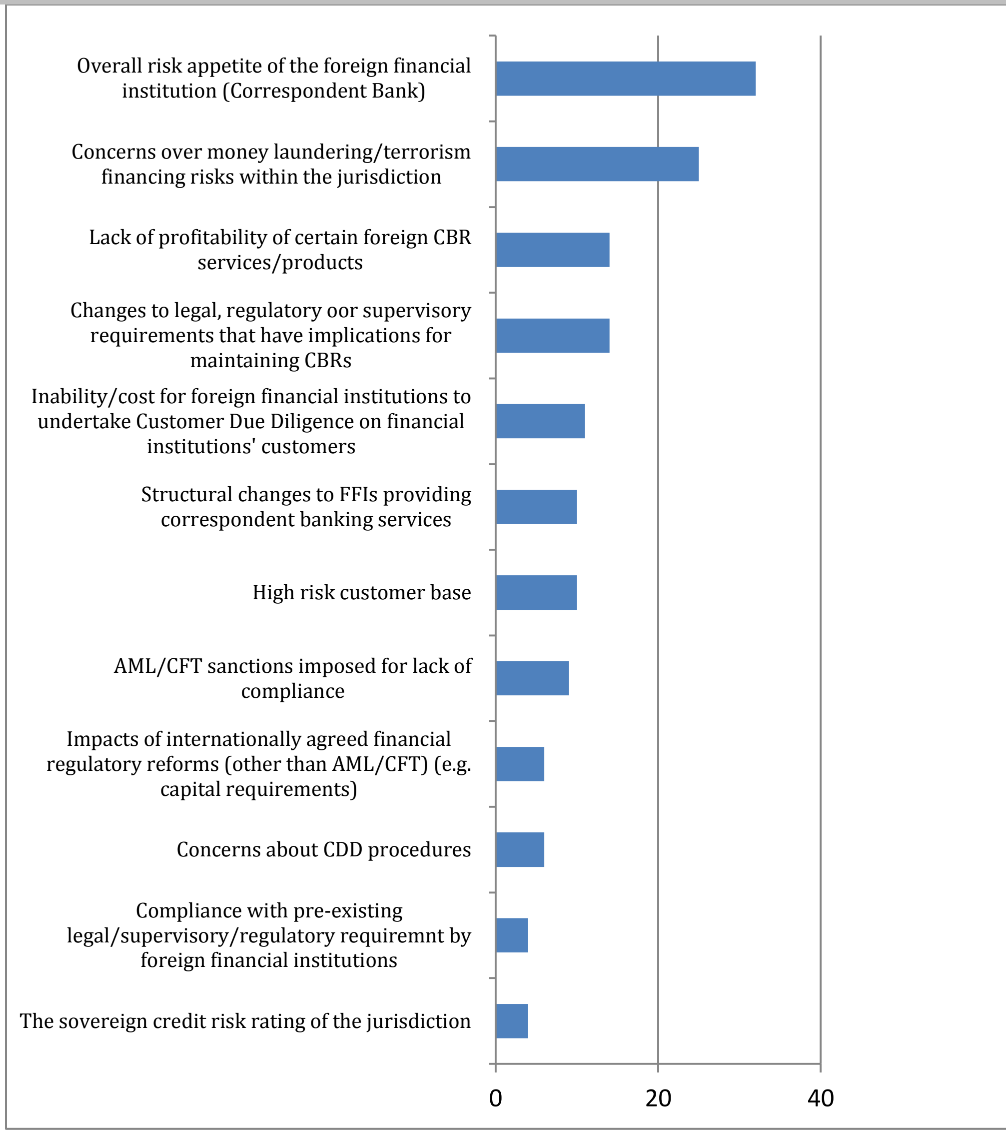

Figure 3

Contingency Plans

8) As it relates to contingency planning, 71% of respondents indicated that they had a contingency plan in place, in the event of a correspondent banking relationship being severed. This is a significant improvement from the last survey, where only 30% of licensees indicated they had a contingency plan in place. As seen in Figure 4 below, for most licensees, these contingency plans consisted of relying on existing correspondent banking relationships (e.g. Parent/Head Office), establishing *new or alternative* correspondent banking relationships.

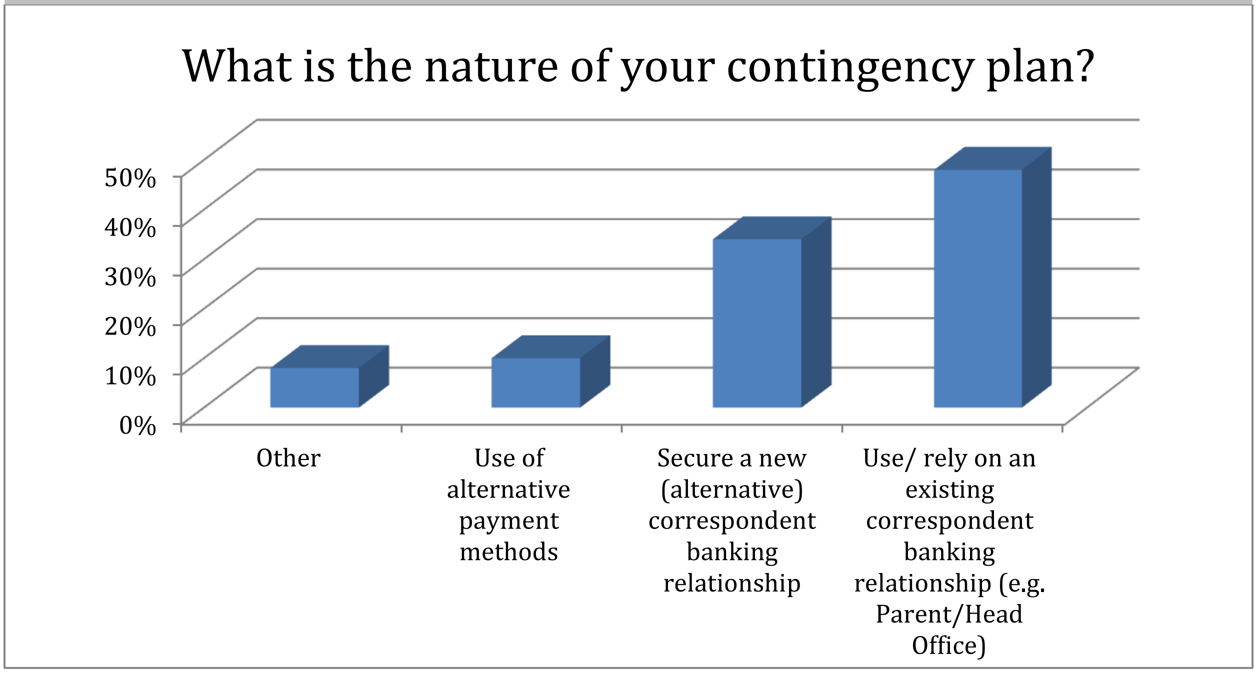

Figure 4

Solutions

9) In light of the potential impact of de-risking, the CBOB thought it important to seek the input of licensees, as to their views on potential actions to be considered to mitigate the effects of declining correspondent banking relationships. To this end, most licensees emphasized the importance of developing effective contingency plans (at 25%), and clarifying regulatory expectations (at 23%). This was followed by strengthening regulation and supervision (at 20%), so as to align the jurisdiction with international best standards. There were also some interesting proposals/suggestions that went a bit beyond the surface. One suggestion is the establishment of a centralized electronic KYC system that would be accessible by all licensees and which, subject to the appropriate domestic legal provisions, would facilitate the exchange of information with parties both inside and outside The Bahamas.

10) When asked what measures were already in place to minimize the effects of de-risking, most licensees responded with enhanced due diligence procedures/technology (at 39%), followed by 'the use of more efficient single repository KYC utilities' (at 18%) and 'research into new and innovative alternative technology' (at 15%). Other measures included maintaining banking relationships with many large banks in different jurisdictions and relying exclusively on head offices to facilitate cross border transactions.

Conclusions

11) The results of the second correspondent banking survey generally echo the sentiments of the first. The number of impacted licensees has increased, with some of this reflecting better coverage since the first survey. The incidence of de-risking within the local banking and financial sector is also pronounced, affecting both commercial banks and money transmission firms.

12) The majority of licensees appear to have established well-defined contingency plans to mitigate the effects of de-risking. Most contingencies include a reliance on establishing new correspondent banking relationships. This approach however must also be supplemented by trust building within the correspondent relationships.

13) CBOB continues to monitor this phenomenon and to provide guidance to licensees to mitigate its effects, with a strong emphasis on strengthening AML/CFT systems.

14) In addition to its own capacity building efforts, CBOB is actively participating in regional and global dialogue on de-risking drivers, impacts, and solutions. The Caribbean Financial Action Task Force (CFATF) and FSB Regional Consultative Group for the Americas (FSB/RCGA) have both identified de-risking as a global challenge with regional implications.

15) CBOB is also pursuing domestic financial inclusion policies so that the highest possible volume of consumers can function inside the regulated channels. This will increase transparency and enhance monitoring capabilities. As always, licensees are encouraged to follow a risk based approach. Once complete, the Bahamas' National Risk Assessment (NRA) will support that effort. The NRA will among other focuses, outline approaches to dealing with high-risk cash transactions and identify approaches to strengthening the regulatory enforcement mechanisms for AML/CFT.

Questions regarding the results should be directed to:

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