De-Risking/De-Banking
"The Reality Facing Caribbean Financial Institutions"

By

Morvin G Williams

Director of International Banks and Trust Corporations

Financial Services Regulatory Commission

Antigua and Barbuda

Abstract

Financial institutions in the Caribbean have seen their operations affected by the phenomenon of de-risking. According to the Financial Action Task Force (FATF) in one of its releases in 2015, “de-risking refers to situations where financial institutions terminate or restrict business relationships with categories of customer.” This seemingly unexpected severing of correspondent banking relationships has impacted the performance of the four key macroeconomic sectors: real, fiscal, monetary and external within these jurisdictions.

Key Words: derisking, financial regulation, financial supervision, AML/CFT risk management, tax reform, oligopoly, crypto currencies, Basel II, regulatory and supervisory reform

1. Introduction

Particularly over the last five years, the operational landscape of many banking institutions as well as non-banking financial institutions has changed significantly due to the ongoing phenomenon of de-risking. Arguably this phenomenon has mostly affected institutions in emerging and developing economies primarily those in the Caribbean. According to the Financial Action Task Force (FATF) in 2015, derisking refers to "situations where financial institutions terminate or restrict business relationships with categories of customer." Invariably, based on the foregoing definition, such a situation can be at the individual/natural person level, the institutional level or at the country level whereby an institution(s) may decide not to offer banking services to a country. In the case of financial institutions such as commercial banks, this has resulted in the loss of correspondent banking relationship.

As defined by the Bank for International Settlements (BIS, 2016), "through correspondent banking relationships, banks can access financial services in different jurisdictions and provide cross-border payment services to their customers, supporting international trade and financial inclusion." Therefore, given the potential impact of this phenomenon on the macroeconomies of countries so affected, it has gotten the attention of international bodies such as the International Monetary Fund (IMF), the World Bank and the FATF. For small open economies such as those in the Caribbean where international transaction flows play a critical role in their economic development, a complete closure or near closure to the international financial payment system would have crippling effects on these countries.

In light of the topical nature of this phenomenon, this paper examines the key drivers of de-risking, then discusses some of the direct institutional impact of this phenomenon and offers a critical review of the justification offered by the drivers of derisking. This paper then offers practical solutions to counter the negative impact of de-risking on economic growth. The solutions proffered include the use of alternative payment mechanisms such as crypto-currency, ongoing reform of the regulatory and supervisory frameworks and institutional initiatives such as ongoing enhancements to the AML/CFT risk management framework in the general management of operational and regulatory risks.

2. Factors Driving De-risking

Based on research by international bodies such as the World Bank, the IMF and the Commonwealth Secretariat, the trend of de-risking is being driven by a number of factors related to compliance and business costs. Arguably, financial institutions providing such a service are faced particularly with a situation where the returns from transaction volumes are not commensurate with the **perceived** risk and associated costs. Notably banks are pressured from regulatory bodies to strengthen their oversight and controls for combating financial crimes, or face harsh penalties. Given the underlying profiteering drivers of these institutions in the business decision making, these banks are therefore hard-pressed to continue offering a service if the returns are not positive.

Though not pervasive, another factor driving the phenomenon of derisking is what may result through mergers and acquisitions (the “silent factor”). This factor tends to manifest itself whereby this service which was once offered by an acquired bank is stopped by the acquiring institution; often due to a change in a business model to the one of the acquiring institution. Such a situation would have manifested itself recently when Banco Santander SA of Spain agreed to buy the lending operations of Portugal's Banif-Banco Internacional do Funchal SA (See Reis and Macarena 2015). As a result of the takeover, notably, some banks in the Caribbean both commercial and offshore (international) banks would have seen the severing of their correspondent banking services with Banif.

It is undoubted that the establishment and maintenance of correspondent banking relationship by respondent banks would have been affected by the annual publication of the International Narcotics and Control Strategy Report (INCSR) by the State Department of the United States of America. History would have shown that there tends to be a "Knee Jerk Reaction" by correspondent banks on the basis of the content of these reports leading to a termination or near termination of services.

As argued, within many Caribbean jurisdictions the INCSR reports which tend to have a damning effect on the economies are based in some cases on unsubstantiated facts or information which do not reflect the current state of these economies. For instance, a jurisdiction such as Antigua and Barbuda which annually is described as a major financial centre by virtue of its gaming and international banking sectors would have witnessed a significant decline in the number of licensees since the early 2000s to present. Having juxtaposed the associated decline in the contributions of these two sectors to the domestic economy and the associated risk factors, the viability of these sectors has even become questionable.

The issue of tax transparency which is a central theme of the Global Forum on Transparency and Exchange of Information for Tax Purposes more so in recent times has become one of the issues central to the phenomenon of derisking. This matter has become of primary concern for banks operating in jurisdictions that are labelled by the international community as being “tax havens”. The “Panama Papers” and the information contained therein would have compounded the concerns over jurisdictions which one may considered to offer a more favorable environment by the basis of their tax structure for either domiciling business or personal asset management.

Following the September 2011 events in the United States, the need to implement international best practices, laws, regulations and guidelines relating to financial regulation and supervision gained momentum. Though necessary, the specificity of some laws have led to the severing of correspondent banking relationship in some jurisdictions. Against this backdrop, the risk of doing business with certain institutions has transcended from it being a direct institution cost to that at the individual level. Reference can therefore be made to the proposed AML/CFT Regulations in the New York Area which inter alia:

- Requires annual certification by senior compliance officers as to an institution’s compliance with regulations.
- Subject Compliance Officers to individual criminal liability. See also DiBari (2015), “Liability Issues for Compliance Officers.”

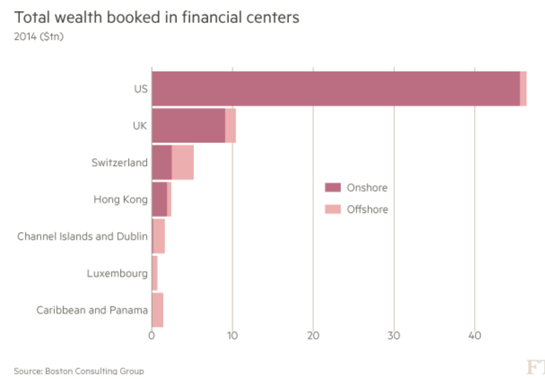
For small states in the Caribbean which conduct most of their international trade with North America albeit flows related to services such as tourism or physical goods, such a development is particularly concerning.

3. Direct Institutional Impact

Of the direct institutional impact from the phenomenon of derisking, stricter AML/CFT enforcement has increased correspondent banking business costs. Of note, respondent banks are thereby forced to dedicate more resources human and otherwise to ensure compliance. Arguably, the devotion of these resources is being done at the expense at what could have been channeled into other operational areas geared at enhancing performance and efficiency within these institutions. The institution costs is also compounded by the fact there is now a shift in compliance and associated cost, as respondent banks are now required to Know Your Customer Customer(KYCC). Given the underlying profit motive of banks, this will ultimately lead to increased costs for the consumers of the products and services.

4. Applicability of Risk Factors

While small states such as those in the Caribbean are at risk of being shut out of the global financial system, it is highly questionable as to whether there has been an escalation in the perceived risk factors which is leading to the severing of correspondent banking relationships. Of note is the fact that the financial services sector in some jurisdictions has declined over the last 10 years as reflected in direct employment and the contribution to gross domestic product (GDP). In Antigua and Barbuda for instance, the interactive gaming and wagering sector has declined significantly to what can be considered a few licensees employing several hundred persons in comparison to the quantum in the early 2000s which employed thousands of persons. Notwithstanding the foregoing, in the 2015 INCSR it was stated that for Antigua and Barbuda, "… a large financial sector, and a growing Internet gaming industry likewise add to its susceptibility." However, as evidenced in the embedded chart, while the assets under management within Caribbean jurisdiction the wealth managed in jurisdictions that have been the key drivers of derisking would have increased significantly.



Another development which brings into question the applicability of the risk factors as a rational for derisking is that most jurisdictions have overhauled their regulatory and supervisory framework. This overhaul would have resulted in the strengthening of regulation and supervision aimed at assessing safety and soundness, including that of AML/CFT compliance. These developments would have ensured consistency with the requirements of the international community such as what is set by the Basel Committee on Banking Regulation and Supervisory Practices.

While derisking remains an issue in 2016, within the Eastern Caribbean Currency Union (ECCU) for instance, in 2015 there was the passage of a new domestic banking act throughout the member states. This new piece of legislation would have strengthened the regulatory and supervisory standards for domestic banks in areas relating to inter alia licensing criteria, capital adequacy, onsite examinations and corporate governance. See Banking Act 2015. Further, in Antigua and Barbuda for instance, there has been a gradual overhaul in the regulatory and supervisory framework within the international banking sector[1] with the most recent being the implementation of an International Banking Act. This Act contains similar provisions as what can be found in the domestic banking so as to ensure consistency across both platforms. Such a development prevents inter alia the possibility of financial arbitrage.

Other countries which would have been engaged in ongoing regulatory and supervisory reforms include Trinidad and Tobago, particularly following the BAICO/CLICO failures. In 2016, Jamaica which has had a history of reforms dating back to its financial crisis in the 1990s, has now embarked on a series of reforms aimed at improving regulation and supervision in its banking, securities, pension funds and insurance sectors. While it may be argued that the series of reforms mentioned may be reactive and would have followed the failure or near failure of financial institutions the efforts within the region must be recognized.

Apart from the implementation of legislation and regulation to ensure the supervisory framework in jurisdictions such as Antigua and Barbuda remains consistent with the international community requirements, the country has since moved away from being a non-taxable jurisdiction. Currently taxes are now levied on the international banking sector. As a matter of policy, such a development would stymie the labelling of the jurisdiction as a tax haven. Additional tax reform measures would have been implemented within this jurisdiction and other countries within the Caribbean Community with the signing for instance of Multilateral Competent Authority Agreements (MCAA) for the

[1] In Antigua and Barbuda, there is a two tiered regulatory and supervisory framework with the Eastern Caribbean Central Bank having oversight of the domestic backing sector and the Financial Services Regulatory Commission having oversight of the international banking sector.

automatic exchange of information for tax purposes. In relation to the Foreign Account Tax Compliance Act (FATCA), jurisdictions within the region have made steady progress in signing bilateral Inter-Governmental Agreement (IGA) with the United States, which is designed to improve international tax compliance. The most recent country within the Caribbean Community region to have signed such an agreement is that of the Co-operative Republic of Guyana.

Consistent with the reforms with jurisdictions, at the institutional level, risk monitoring and risk mitigation mechanisms have become more robust. As articulated in the Basel Committee on Banking Supervision paper "Sound Management of risk related to Money Laundering and the Financing of Terrorism" (2014), one of the primary thrusts of financial institutions within the region is to ensure the AML/CFT compliance framework adequately addressed the essential elements of sound ML/FT risk management. These ongoing reform initiatives at the institutional level have sought to address areas such as customer acceptance, ongoing monitoring, reporting of suspicious transactions and the assessment, understanding, management and mitigation of risks.

Notwithstanding the fact that the perception remains that the vast majority of jurisdictions within the Caribbean remain highly vulnerable particularly for money laundering, most jurisdictions have received satisfactory ratings overtime from bodies such as the Caribbean Financial Action Task Force (CFATF). Notably, following the mutual various mutual evaluation exercises that were done by the CFATF, jurisdictions within the region have made steady progress in addressing any deficiencies in their AML/CFT framework. Of note most of these jurisdictions would have gradually found themselves being removed from any non-compliance listing. Currently, most of the CFATF jurisdictions are engaged in National Risk Assessment Exercises ahead of their next mutual evaluations, commencing in 2017.

Despite the progress made in ensuring the regulatory and supervisory framework remain consistent with national and international requirements, the Caribbean remains challenged by the ongoing phenomenon of derisking. The potential impact on regional economies has been compounded by the fact that some institutions are operating with one correspondent bank; some banks have recently lost correspondent banking relationships; national banks within the ECCU and other Caribbean countries have been given recent notices of termination; and some respondent banks have been advised of increased fees for the services. Given the foregoing, the challenges require practical responses as international flows cannot be regressed to a medium of exchange solely based on paper money.

5. Realistic options to the Challenge of Correspondent Banking

Central to the response in attempting to deal with the correspondent banking challenge had been the thinking that as a region the possibility of establishing a bank in the USA should be explored. While this can be considered a novel idea, within the same vein it is one that can be considered a bit farfetched. This observation is indicative of the processes involved when seeking approval for a federal or state charter.

Of the more realistic options, the mergers of institutions can be considered a practical response especially in cases where the reasons given for the non-offering of correspondent banking services is related to transaction volumes. On the flip side however, one has to be cautious in this approach and its potential impact on market conduct given the likely deepening of the oligopolistic market of banks operating within the region. Of note is the fact that within the region we operate in an environment where the fees for banking services are largely un-regulated.

Given the rapid growth in e-commerce globally, one of the more practical questions that must be asked within the region is whether there is a role for crypto currencies/digital currencies to deal with the correspondent banking challenge. Such an approach has already gained some traction within the region with the Barbados based Fintech firm Bitt Inc is a good example. Further, the Bank of Jamaica has approved certain electronic payment platforms.

While crypto currencies/digital currencies may be considered as an alternative payment mechanism, one has to be cognizant of the fact that like any conventional method of financing transaction, in using crypto-currency there is the risk of money laundering, terrorist financing, tax evasion and fraud. Therefore prior to any consideration being given there must be the development and implementation of a licensing, regulatory and supervisory framework within jurisdictions. See IMF (2016) "Virtual Currencies and Beyond: Initial Consideration."

As a further response to the phenomenon of derisking at the macro level, the Regulatory and Supervisory Framework must remain dynamic within the region. This inter alia requires the ongoing adoption of best practices and standards as recommended by the international community. Specific to our banking sectors this should for instance entail the adoption of supervisory framework such as Basel II. Efforts within the ECCU and further afield in forging ahead with the implementation of Basel II must be recognised. Despite resources constraints, regulatory and supervisory Institutions ought to ensure staff members are equipped with the requisite skills to effectively regulate and supervise institutions (See Williams (2010).

At the political level, there has to be the ongoing dialogue with key stakeholders. It is encouraged that in responding there ought to be the direct engagement of the diaspora more directly primarily in areas where there is a significant concentration. Other initiatives at the political level should include ongoing tax reform which entails inter alia executing TIEA.

At the institutional level, business survival requires ongoing enhancements to the AML/CFT risk management framework and the general management of operational and regulatory risks. Further it is recommended that institutions should seek relationships with non-USA institutions. The issue of “nesting” however becomes a concern. Finally, it is recommended that institution should engage their regulators and supervisors as part of the conversation with their correspondent banks. In so doing the representatives of these institutions will be able to get first-hand information regarding ongoing reforms for instance to the regulatory and supervisory landscape within jurisdictions.

6. Conclusion

In concluding, it evident that de-risking remains unabated. Given the impact of this phenomenon on the financial survivability of our economies, the Region has to be more proactive regarding its approach. Irrespective of the approach there is the requirement for all stakeholders to be on board.

References

BIS, 2014, "Sound Management of risk related to Money Laundering and the Financing of Terrorism."

BIS, 2016, "Correspondent banking."

Caribbean Financial Action Task Force (CFATF) 2016, "FATF Recommendations - Fourth Round of Mutual Evaluation Programme."

DiBari, D, 2015, "Liability Issues for Compliance Officers."

Dong He, K et al 2016, "Virtual Currencies and Beyond: Initial Consideration." IMF Staff Team (staff Discussion Note)

Eastern Caribbean Central Bank, 2015, "Banking Act 2015"

FATF, 2015 "Drivers for "de-risking" go beyond anti-money laundering / terrorist financing"

Government of Antigua and Barbuda, 2015, Banking Act - Antigua and Barbuda No. 10 of 2015."

Houlder V and K Scannell, 2016, "US tax havens: The new Switzerland." The Financial Times

Reis, A and Macarena, M, 2015, "Spanish Banks Circle Capital-Hungry Portuguese Lenders."

Williams, M, 2010, "The Changing Role of Financial Supervisor in Today's Financial Environment."