WHEN MONEY CAN NO LONGER TRAVEL

Correspondent banking relationships, which facilitate global trade and economic activity, have been under pressure in some countries

Andreas Adriano

Angola, the third-largest economy in Africa, relies on imports to keep its economy running. It is a heavyweight exporter of oil, diamonds, and iron ore, but it imports food, medicine, construction materials, vehicles and parts, and capital goods. Many sectors dependent on imports, like construction, are at risk of coming to a halt because importers often find it more difficult to pay their international suppliers. Why? Because Angola has undergone *derisking*—a term that describes a complex, multifaceted problem affecting mostly, but not only, small developing economies whose connections to the global financial network have been under threat.

Imagine if international airlines, like Air France, American, Lufthansa, and United, suddenly stopped serving a country with no national airline that relies on these companies as its link with the rest of the world. The people and the economy would suffer: airlines that still served the country would raise their fares, making it costlier to import and export and for people to travel. Fewer direct flights and higher prices would discourage tourism.

Money travels around the world in more or less the same way as people, and through some of the same city hubs. Someone traveling from Luanda, Angola, to San José, Costa Rica, could fly to Europe, then to a US airport, then to San José (or to São Paulo, then Panama City, then San José). A wire transfer between two countries also hops around the globe and makes several connections, traveling usually within the networks of large global banks—Bank

PHOTO: ISTOCK / LEOPATRIZI; ISTOCK / NYS444 of America Merrill Lynch, Citibank, Deutsche Bank, Standard Chartered, and many others.

Derisking happens when global banks stop providing international payment services such as wire transfers, credit card settlements, and even hard foreign currency to a country's local banks. In the world of payment systems, provision of these services is generically referred to as correspondent banking. Without it, a bank—and therefore its clients, i.e., people and companies in that country—loses access to the global financial grid.

It's not hard to see the consequences for a developing country in a highly integrated global economy if money cannot travel. Just imagine a country heavily dependent on tourism, as in the Caribbean, in which hotels all of a sudden are unable to process guests' credit card payments or airlines can't pay for fuel. In fact, Caribbean countries have been among the most affected by loss of correspondent banking relationships.

According to a survey earlier this year by the Caribbean Association of Banks, 21 of 23 banks in 12 countries have lost at least one correspondent banking relationship. Eight were operating with a single provider. Most are able to find alternative arrangements. Countries in Africa, eastern Europe, the Middle East, and the Pacific islands have also lost some relationships, as has the central bank of Belize. In Angola a scarcity of US dollars has impacted trade activity. Even large emerging market economies such as the Philippines and Mexico have been affected. A survey of Arab countries found that 39 percent of 216 banks had a "significant" decline in the scale of correspondent banking relationships.

Motivating factors

Banks are required by law to try to prevent the possibility of seemingly routine cross-border payments disguising money laundering, terrorism financing, tax evasion, and corruption proceeds. In most countries, and in particular in the United States, regulation and enforcement of these requirements has been a lot more rigorous, as is enforcement of economic and trade sanctions. Banks are directed to "know your customer." The necessary compliance structure can be so costly that correspondent banking, a large-scale low-margin service, could stop being profitable.

Remember the post–9/11 days, when even toddlers were frisked at airports? Or how, after the shoe bomber incident, shoe removal became standard practice at US airports? It's much the same with global payments. Banks are liable for all international transactions traveling through their networks and must "pat down" transactions from clients that are considered risky—and obviously stop those on the "no-fly list." The reputational risks are significant, and fines can be in the billions of dollars. "The penalties and reputational damage can be terrible," an anti-money-laundering expert in a global US bank tells *F&D*. The whole set of circumstances "creates a toxic environment in the financial industry."

For banks, it's a simple risk-reward analysis in one portion of their many business lines. But for a small flower exporter in a landlocked African country, it may be the difference between doing business or not. Remittances are another potential victim. Already costly for poor people to send, they may become more expensive if there are fewer providers. And in this case the trend is not just from global to local banks. Republic Bank, one of the Caribbean's largest institutions, decided to withdraw from the money transfer business and closed the accounts of large global providers such as Western Union and MoneyGram. "These companies were the favorites of the Barbados diaspora in Canada and the United States, so people might have been affected," Ian de Souza, CEO of the Barbados subsidiary, tells *F&D*.

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According to the World Bank's Remittance Prices Worldwide database, sending $200 to Jamaica costs 7.4 percent from the United States and 10.1 percent from Canada, on average. The same amount from South Africa to Angola can cost up to 20 percent. The World Bank estimates that if remittance costs fell by 5 percentage points across the board

recipients in developing economies would get an extra $16 billion every year.

According to a recent IMF paper, cross-border payments have so far remained stable and economic activity has been largely unaffected. However, in a limited number of countries, financial fragilities have been accentuated as their cross-border flows are concentrated through fewer correspondent banking relationships or maintained through alternative arrangements. These fragilities could undermine affected countries' long-run growth and financial inclusion prospects by increasing costs of financial services and negatively affecting bank ratings.

Belize Bank, the largest in the country, had relied on Bank of America as its sole correspondent for 35 years. In 2014, the US bank terminated the relationship with a 60-day notice. "They never gave us a specific reason; they just said that their strategy was not aligned with doing business with us anymore," says Filippo Alario, deputy CEO and chief risk officer, in an interview with *F&D*.

Alario says that most global banks are "not interested in Belize anymore," and to keep operating, his bank had to "be creative and do an incredible amount of networking." He does business now through small banks in other countries, some smaller than his own, and has different providers for various services. "We are managing, but don't have a strong long-term solution." He sees the problem affecting the entire economy: "Even US and British military training camps had problems receiving funds."

For Bank of America, it's basically a matter of scale, Stephanie Wolf, head of global financial institutions and public sector banking, tells *F&D*. She did not comment on specific cases, but she says that the bank's approach to global oversight of risk across different products and jurisdictions led it to focus on clients with more growth potential. "Not every client will be the right fit for us." Correspondent banking is still one of the leading businesses in their corporate banking practice, "very attractive both from the side of revenue and the diversity of portfolio." New clients have been added, and the bank even provides hard currency liquidity in many countries, one of the riskier parts of correspondent banking, she adds.

A mix of unclear or inconsistent regulatory expectations, enhanced efforts to combat money laundering and terrorism financing, weak compliance by correspondent banks, and countries with risky environments make derisking a complex problem. Banks have a long list of criteria to evaluate financial transactions' risks. Reputation counts a lot. For example, a bank may consider a Colombian client riskier in principle than one in Chile because of the former country's history of drug cartels, explains the US-based anti-money-laundering expert.

Certain businesses are riskier than others, like casinos. "A cash-intensive business is considered riskier than one relying more on electronic payments. Businesses with government contracts are riskier than private sector ones. A politician is riskier than a lawyer, who is riskier than a business manager," he explains. So-called politically exposed persons raise a red flag: cabinet members, lawmakers, and executives of public companies get deeper and more frequent scrutiny.

Most countries have strengthened their compliance with the recommendations of the Financial Action Task Force, the intergovernmental body that sets and enforces standards and practices for combating money laundering and terrorism financing. But a number are only partially compliant. Legislation that is indeed too lax, sometimes because of political circumstances, is a frequent problem, as is weak implementation. If too many politicians and their families are involved in business, it is not in their interest to approve local regulation of politically exposed persons. So it is harder for a foreign bank to vet a transaction properly, which could expose it to enforcement actions by its regulator. Some will however argue that international pressure may be the only way to force change in such situations.

Finding alternative routes

What's a derisked bank to do? Like an obstinate traveler, it will seek alternative flights and routes. In most affected countries, banks have figured out ways to continue doing business. One possible fix is to nest transactions with those of an intermediary bank that continues to have correspondent banking relationships. Angola is routing more transactions through South Africa and

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Portugal. Belizean banks have even resorted to Turkish providers. Diversifying foreign currencies if one becomes scarce is another possibility.

However, experts warn it may just be a matter of time before the process catches up with banks again. A global bank would likely ask a Portuguese bank about Angolan transactions folded in with domestic businesses. It's not implausible that the Portuguese bank could eventually lose its own correspondent banking accounts in the process.

Most important, the search for short-term fixes could lead companies and banks to resort to unorthodox schemes and less-than-reputable providers to continue operating. This may have the unintended consequence of pushing payments into informal channels.

A long-term, sustainable solution to the problem demands action on many fronts—and by a varied cast of policymakers in countries and international institutions, as well as in the private sector. Overall, it is key for the derisked bank to enhance its capacity to manage risks, and to communicate progress made, to build trust with global banks. If capacity cannot be achieved at the individual bank level, consolidating transactional traffic and terminating certain high-risk business lines may be needed to address correspondent banks' concerns about risk management. Some progress is already underway. Raising awareness about the complexity and seriousness of the problem was a first step, and not a trivial one. Belize Bank's Alario recalls that when his bank first raised the issue with US authorities and international institutions, "blame from every quarter was put on us."

Lobbying and joint action by countries, coupled with more research by international institutions, have already achieved significant improvements. Clarifying expectations by different regulatory bodies is an important step. Guidelines issued last August by the US Treasury Department that attempt to harmonize expectations among numerous US government regulators are widely seen as an important milestone. The guidelines clarify that there isn't a zero tolerance expectation and that many fines were applied in cases of deliberate wrongdoing.

Measures suggested to address the problem include lowering compliance costs through industry initiatives (technology can help banks know their clients better and offers alternative channels for remittances). Continued improvement in countries' standards for combating money laundering and terrorism financing is crucial to provide the level of confidence required by correspondent banks.

Banks have been active as well. Standard Chartered, a UK bank with a large presence in Asia, established a correspondent banking training program to help its clients, local banks, and the clients' clients comply with anti-money-laundering and terrorism financing rules. The program is active in 23 countries.

Mexico, a major emerging market economy also affected by the loss of correspondent banking relations, has been active on several fronts. In some countries, privacy laws forbid subsidiaries of the same global bank to exchange information about clients' risk profiles. So Mexico amended its legal framework to facilitate this cross-border information sharing. It also established a domestic US dollar payment system and uses the central bank's correspondent banking relations to facilitate transfers.

In the air transportation business, stricter security has usually meant small individual sacrifices in exchange for greater general safety. It can likewise be argued that, by cracking down on financial crime, tighter international regulations also achieve a global good. The problem is that these regulations may affect legitimate people and businesses as well, not just suspicious ones. Good money has had difficulty traveling, as have good people recently, and this should not happen. FD

ANDREAS ADRIANO is a senior communications officer in the IMF's Communications Department.