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# CIBAFI BRIEFING

## *De-risking and Correspondent Banking Relationships*

*This Briefing considers how de-risking has affected financial institutions and attempts to understand its causes, its implications on the financial industry, including Islamic financial institutions, and suggests ways to tackle it as an increasingly important area of focus.*

## Introduction and CIBAFI's Role

***CIBAFI is pleased to present its fifth "CIBAFI Briefing" which is an outcome of its members' recommendation to address de-risking as one of the important areas that requires awareness among the stakeholders of Islamic banking and financial industry. This Briefing explores why institutions de-risk, its impacts, regulations around de-risking, and also suggests strategies to mitigate effects of de-risking on economies and financial institutions.***

"De-risking" as defined by the Financial Action Task Force (FATF) refers to "the phenomenon of financial institutions terminating or restricting business relationships with clients or categories of clients to avoid, rather than manage, risk in line with the FATF's risk-based approach". The World Bank quotes the FATF definition, and notes that "global financial institutions are increasingly terminating or restricting business relationships with remittance companies and smaller local banks in certain regions of the world."

International supervisory and regulatory authorities have been making attempts to address the issue of de-risking; however it continues to affect jurisdictions all over the globe. De-risking has disproportionately affected small countries with developing financial regulatory environments, and therefore the banks located in them. It has a potential to discourage customers and to drive capital into riskier environments. CIBAFI, as the global umbrella organisation for Islamic Financial Institutions (IFIs) is mandated to spread awareness regarding issues like these not only for the development of Islamic financial industry but also to share and learn best practices from the global financial industry.

Since de-risking has affected financial institutions around the globe regardless of their mode of operations i.e. Islamic or conventional, this Briefing may be treated as general awareness for the Islamic financial industry. There may be instances where de-risking may affect Islamic financial institutions (IFIs) somewhat more than their conventional counterparts. However, de-risking is an issue that needs to be tackled in a prudent, collective and consultative manner among the larger stakeholder groups of affected jurisdictions.

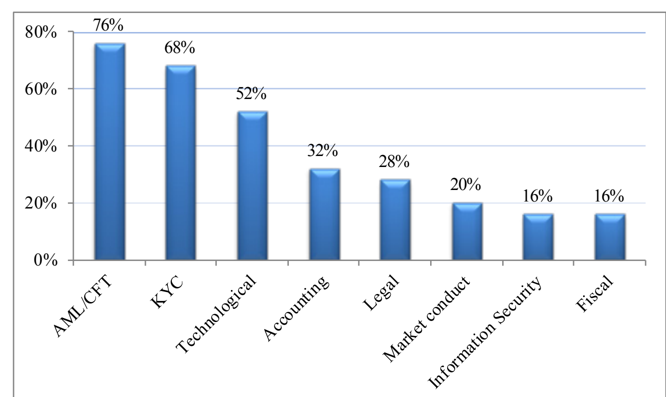
## Why do institutions de-risk? – Understanding the decline in correspondent banking relationships

"De-risking" as defined above is driven by several factors. FATF identified relevant factors as: profitability; reputational risk; lower risk appetites of banks; and regulatory burdens related to the implementation of anti-money laundering and counter-terrorist financing (AML/CFT) requirements; the increasing number of sanctions regimes; and regulatory requirements in the financial sector. In recent years there has been a rise in fines and criminal prosecutions involving financial institutions and this has prompted them to reassess their risk management practices. Many of these fines and penalties were found to be related to non-compliance of AML/CFT rules. The Committee on Payments and Market Infrastructures (CPMI), in its July 2016 report on correspondent banking, noted that banks cite increasing regulatory pressure to know their customers' customers (KYCC), and uncertainty about how much due diligence is expected in this regard, as among the main reasons for cutting back their correspondent banking relationships (CBRs). Asian Development Bank (ADB) in 2015 pointed out that 70% of 253 banks from 86 countries it surveyed[1] said that they declined transactions due to the cost or complexity of compliance, while 45% terminated their CBRs for the same reason.

Many banks, including large multinational ones in developed countries, partly as a response to these punitive actions, began to re-evaluate their foreign banking relationships, mostly in emerging, developing and underdeveloped markets, and started to terminate them.

While de-risking is mostly understood to have been associated with ML/FT, FATF has said that there are other important factors, at work. This is supported by a report published by the Association of Supervisors of Banks of the Americas (ASBA) in March 2016 entitled The Impact of Compliance/Regulatory Risk in Financial Activity in the Americas (figure 1). AML/CFT was the leading cause (76%) for de-risking cited by supervisory agencies, with Know Your Customer (KYC) policies of banks in second place (68%), followed by technological, accounting and other reasons.

**Figure 1: Regulatory Issues Generating De-risking**




*Source: Association of Supervisors of Banks of the Americas, March 2016*

De-risking is having negative consequences especially in countries that are heavily reliant on international banking relationships, inward remittances etc., leaving them with limited options to receive and transact financially with the outer world. De-risking also affects economies where IFIs operate in considerable numbers. As a result, Islamic banks face similar risks and consequences as conventional financial institutions in these jurisdictions.

1. Trade Finance Gap, Growth and Jobs Survey 2015

***A World Bank Survey in 2015 on de risking involving banking authorities, large banks, small local and regional banks found that 75% of large international banks and 60% of local and regional banks experienced a decline in CBRs.***

A survey by the International Monetary Fund (IMF) and the Union of Arab Banks (UAB) in the same year concluded that withdrawals of CBRs had an impact on money transfer service providers, and on jurisdictions that are subject to trade and economic sanctions. The IMF-UAB survey suggested that about 40% of the banks in 17 Middle East and North Africa (MENA) countries were facing higher compliance costs, and that some money or value transfer services were affected as their relationships were terminated as a consequence of de-risking by the correspondent banks[2]. This meant higher cost of remittances, which encouraged the use of non or ill-regulated channels of money transfers. This reportedly also increased the cost of doing business in the region.

A report published by the Arab Monetary Fund (AMF), IMF and the World Bank in September 2016, showed similar conclusions. The survey indicated countries under sanctions have been particularly affected and that about 10% of banks had closed their relationships with respondent banks in MENA countries that were hit by sanctions or where AML/CFT systems were weak[3].

The CPMI report cited above indicated that the number of active correspondents have decreased in the period from 2012 to 2015. The majority of OIC countries have seen a decline in number of CBRs, although the change in volume or value does not necessarily correspond to the change in the active correspondents (figure 2). The overall changes in value and volume show no clear trend in correspondent banking activity, however the overall volume of payments sent increased between 2011 and 2015. The report concludes that there has been an overall trend towards concentration in correspondent banking activity. Although the pattern is not uniform, countries such as Bangladesh, among others, have become reliant on fewer providers of services, and hence more vulnerable.

The Financial Stability Board (FSB) said in a report in 2015 that about half of the emerging and developing markets saw a decline in CBRs because of de-risking. It saw political and regional security issues as contributing towards big banks severing or reconsidering their relationships with banks in countries considered risky. The withdrawal of correspondent banking relationships and the broader issue of de-risking have been raised frequently in the FSB's regional consultative groups, such as for Asia[4] and the Americas[5]. Like the IMF and UAB, the FSB saw an increase in the cost of remittances, especially from developed countries such as United Kingdom and United States of America to African countries, including Islamic financial markets.

**Figure 2: Changes in the number of correspondents, volume and value for selected OIC countries from 2012 to 2015**

| | Selected OIC member states | Change in number of active correspondents | Change in volume | Change in value |
|---|---|---|---|---|
| 1 | Yemen | -28.7% | -53.9% | -41.2% |
| 2 | Iran | -17.9% | 53.2% | -47.7% |
| 3 | Egypt | -12.9% | -2.5% | -15.6% |
| 4 | Jordan | -11.2% | -7.3% | -34.0% |
| 5 | Bahrain | -9.3% | 3.3% | -16.8% |
| 6 | Lebanon | -9.0% | 5.2% | -10.2% |
| 7 | Tunisia | -6.6% | 7.9% | -35.7% |
| 8 | Oman | -6.5% | 12.1% | 18.6% |
| 9 | Saudi Arabia | -5.6% | 8.8% | 3.8% |
| 10 | Pakistan | -5.1% | 27.2% | 26.0% |
| 11 | Algeria | -4.4% | 26.2% | -7.6% |
| 12 | Indonesia | -4.0% | -2.7% | 128.2% |
| 13 | UAE | -1.5% | 21.5% | 40.7% |
| 14 | Morocco | -1.2% | 12.9% | -9.4% |
| 15 | Malayisa | 1.2% | 4.1% | -3.6% |
| 16 | Qatar | 2.0% | 47.8% | -22.1% |
| 17 | Turkey | 3.9% | 27.9% | 16.8% |
| 18 | Kuwait | 3.9% | 18.6% | 12.1% |
| 19 | Bangladesh | 8.7% | 52.0% | 59.6% |
| 20 | Nigeria | 11.6% | -25.1% | -4.8% |

*Sources: CPMI; Deutsche Bundesbank; SWIFT Watch*

## The role of international bodies on De-risking

De-risking and reduction in CBRs is a cause of concern not only for IFIs but also for markets which are heavily dependent on inward international remittances and payments. International bodies including FATF, FSB, Basel Committee on Banking Supervision (BCBS) and the CPMI, have been working on developing frameworks and formulating robust mechanisms to ensure transparency of international transactions and protect the international financial system from misuse (figure 3).

The principal international standards on AML/CFT are FATF's 40 Recommendations. In 2013, FATF, considered the importance of balancing these recommendations with financial inclusion goals, and issued revised guidance to help countries develop regulations considering these goals. In 2016 it formulated new set of Guidance on how its Recommendations should be applied to correspondent banking, with the explicit aim of addressing de-risking[6].

2. Sanctions can arise due to measures taken by international bodies such as the United Nations or by individual countries. Sanctions imposed by individual countries (for example United States of America) may affect banks in other countries if those banks do business in the sanctioning country.
3.Bank in the foreign country from where remittance is made (usually a western country such as USA)
4.FSB Press Releases (2 December 2016)
5.FSB Press Releases (12 December 2016)
6.Seehttp://www.fatf-gafi.org/publications/fatfrecommendations/documents/correspondent-banking-services.html

**Figure 3: Timeline of International bodies addressing/raising de-risking as a concern:**

| | |
|---|---|
| May 2015 | IMF & Union of Arab Banks survey on De-risking |
| June & Oct 2015 | FATF public statement on awareness of De-risking |
| October 2015 | The World Bank Report on the G20 Survey on De-Risking activities in the remittance market |
| November 2015 | FSB report to G20 on decline in correspondent Banking |
| March 2016 | FSB established Correspondent Banking Co-ordination Group (CBCG) |
| June 2016 | IMF Staff Discussion Note - the Withdrawal of Correspondent Banking |
| July 2016 | CPMI report on Correspondent banking |
| August 2016 | FSB Progress report on Correspondent Banking |
| September 2016 | AMF, IMF and World Bank Report on withdrawal of CBRs in the Arab region |
| October 2016 | FATF Guidance on Correspondent Banking Services |
| November 2016 | FSB Report to G20 on decline of correspondent banking |
| February 2017 | BCBS Revised Annex on correspondent banking |

The IMF and World Bank Group have worked across a range of stakeholders to analyse de-risking, including World Bank Group surveys conducted on behalf of the G20 Global Partnership for Financial Inclusion (GPFI). Initiatives such as these have helped the international financial stakeholders to understand the complexity of the phenomenon.

De-risking and the decline in correspondent banking have been frequent subjects for discussion in FSB Regional Consultative Groups. The FSB has an action plan specifically for this area[7], incorporating those of other relevant international bodies, and a number of important deliverables are scheduled for 2017.

## Assessing impacts and implications of de-risking on the Islamic financial industry

A decline in CBRs significantly affects banks' ability to service clients and client segments such as Money Transfer Operators (MTOs), remittance companies, small and medium exporters etc. This also affects international wire transfers, clearing and settlement, cheque clearing, cash management services among others. In the joint study by AMF, IMF and the World Bank quoted above, 51% percent of banks that reported a decline in their CBRs also reported a major impact on MTOs and other remittance companies, while 46% said small and medium exporters had been significantly impacted. 58% of these banks reported significant impact on their trade finance/ letters of credit/ documentary collections activities, 55% on international wire transfers and the same percentage on clearing and settlements. This indicates there are adverse repercussions on trade related activities (figure4).

Apart from direct impact on businesses reliant on trade and remittance sectors, de-risking can have impact on charities, non-profit organisations, and others involved in delivering humanitarian services across countries. It also affects the trade supply chain indirectly making import and export of goods difficult. This will have an impact on levels of poverty and unemployment in the economies. De-risking is also considered as a major roadblock in promoting financial inclusion and hence needs to be looked at from humanitarian perspectives to bring unbanked and vulnerable communities into the fold of the global financial system.

IFIs face similar impact as their conventional counterparts, perhaps a degree more because of fears that they may be associated with terrorist financing. As CBRs are terminated there are cost and time implications in finding alternative channels with similar, efficient and cost affective service providers. This may be a challenge as processing of routine transaction are restricted, assuming other banks may also be considering de-risking measures.

***De-risking significantly undermines and affects trade related transactions and can reduce exports and affect GDP of economies of countries that have sizable trade markets.***

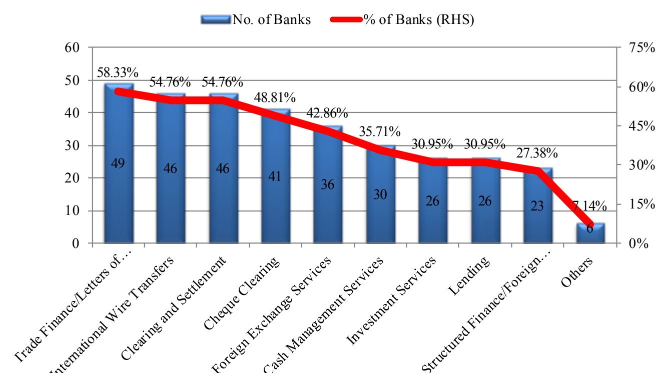
Many large OIC economies draw considerable revenue from trade activities such as Turkey, Egypt, Iran, Malaysia and Indonesia and are home to important Islamic finance markets.

**Major Impacts of de-risking**

- Impact Trade
- Effect Money Transfer Services
- Reputational loss
- Humanitarian impact
- Impact Banks profitability
- Reduce financial inclusion
- Impact growth
- Encourage growth of unregulated remittance channels

Banks in emerging markets including Islamic banks should be prepared for expensive CBRs in future. They should recognise the strains that global banks are facing as a result of higher capital, liquidity requirements; higher compliance costs; and lower interest rates which are affecting their inherent profitability. These financial pressures are leading global banks to reassess the value of CBRs, quite apart from any concerns they may have about AML/CTF.

**Figure 4: Products and services significantly affected in the Arab region by Derisking**




*Source: AMF, IMF and the World Bank Report (September 2016)*

7. See http://www.fsb.org/wp-content/uploads/FSB-action-plan-to-assess-and-address-the-decline-in-correspondent-banking.pdf.

## Exploring strategies to mitigate effects of de-risking

As international bodies agree that de-risking is an issue concerning the larger financial industry, some of the below measures, both long and short terms, can be adopted to ensure the effect of de-risking is tackled or minimised.

Stakeholders affected by de-risking can be encouraged to follow a risk-based approach (RBA) which involves financial institutions classifying and assessing their risks, and taking appropriate actions to mitigate them by allocating resources efficiently on higher risk areas. RBA was one of the major mechanisms that was introduced by FATF in 2013 and is a general underlying principle for ML/FT transactions. RBA must be complemented with clear rules with region/country/sector-specific guidance to provide clarity about compliance requirements involving high-risk stakeholders. The FATF 2016 Guidance on Correspondent banking services, while clarifying the application of the FATF standards in the context of CBRs and money or value transfer service (MVTS) providers, also emphasises the proper implementation of RBA in banking and MVTS sectors.

Islamic banks can make use of KYC utilities such as SWIFT KYC Registry which acts as a central repository of up-to-date due diligence documents and data of banks on the SWIFT platform. These utilities are platforms provided by a variety of third-party, consultancies, technology and data providers that aim to streamline and exchange data between banks and their clients. Examples include KYC Exchange, Swift, Depository Trust & Clearing Corporation (DTCC) etc. This will help provide Islamic banks with a fast and cost effective KYC solution that enables them to monitor, manage and grow their correspondent banking network.

Additionally, individual financial institutions need to proactively invest in and build robust KYC, customer on-boarding and other policies and procedures, including staff training to mitigate any possible risk of being targeted for de-risking by their correspondent banking institutions. Institutions and regulators can take help of state-of-the-art technologies in strengthening their reporting mechanisms and how they allow and conduct financial transactions in their countries, including digital and Fintech solutions, enhanced transaction monitoring processes, such as the KYC utilities discussed above. This will ensure relevant data is analysed, shared and is accessible in the best available form and frequency.

***Islamic financial stakeholders must partake in dialogue and discussions through policy and regulatory advocacy initiatives with the international regulatory bodies and committees such as BCBS, FATF, CPMI, IMF, World Bank etc. on these issues and assume a leadership role in creating awareness and develop and harmonise regulatory practices to improve compliance, and build trust across sectors and Islamic finance jurisdictions.***

IFIs should encourage regulators to support capacity-building in high-risk and low-capacity jurisdictions to improve compliance across the transactional chain and reduce ML/TF risks, which can help to build confidence and retain and even grow CBRs in affected countries. These initiatives may also include accelerating development of financial intelligence units at central banks, in order to build trust among international banks and regulatory authorities.

Both IFIs and regulators can study and evaluate previously de-risked CBR or MTO case studies and identify areas where policies can be strengthened in the light of their findings.

Islamic banks should increase their levels of transparency, especially where foreign banking relationships are involved and share up-to-date information with their foreign counterparts in order to address and close any possible compliance and risk gaps, including AML and CFT practices. For example: sharing details of originator/beneficiary in wire transfer transactions etc. In addition to these measures the checklist below provides areas Islamic banks can focus to mitigate risks arising from de-risking. These will also help those banks which lack strategies or plans to get a clear picture to address de-risking, and devise a road map to assess related risks and take steps to tackle it.

**Proposed Checklist for Islamic Banks to tackle de-risking**

1. Adopt FATF's recommended standard for originator and beneficiary details in payments messages (FATF Recommendation 16).
2. Increase levels of transparency in banks' foreign business lines, and their behaviour to attract and retain relationships.
3. Have timely communication with respondent banks to close compliance gaps in accordance with required level of disclosures.
4. Share adequate, consistent and up-to-date information with correspondent banking counterparts and with relevant industry stakeholders.
5. Share best practices and bridge gaps in the areas of technology, product and risk management.
6. Deploy resources to support capacity-building among the industry stakeholders to improve compliance to international standards.
7. Include full and comprehensive set of details in all cross-border transactions.
8. Train staff and task single department with creating and maintaining robust data sets for customer due diligence.

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9. Share repositories of customer data sets with the market that are efficient, standardised and sophisticated.
10. Register data with multiple utilities and ensure data provided in each case is accurate, consistent and up to date; for example data utilities such as Swift KYC Registry.
11. Inform stakeholders about their risk management enhancements through press releases and other information sharing platforms, such as bank's websites and portals.
12. Initiate and develop application of 'closed user groups' and 'private groups' in collaboration with respective central banks as central hubs for payments, that only the banks that have the strongest AML and CFT measures can participate.

## Conclusions

There is concern among industry stakeholders that the withdrawal of CBRs is unfavourable and may drive institutions to avoid the formal financial system in favour of less regulated and relatively opaque mediums of international financial transactions. Global and national bodies have dedicated substantial resources to encouraging an inclusive financial system worldwide; however, de-risking as a phenomenon may undo these efforts and shift stakeholders including Islamic financial institutions away from the mainstream financial system. It may also have a material effect on the legitimate business transactions of non-financial businesses, whether international trade or the remittances from migrant workers.

Although there are other drivers, de-risking generally seems to be understood by many financial institutions as a way to prevent ML and TF activities in foreign jurisdictions. One of the key areas that IFIs can focus on is formulating clear rules and guidelines as part of their risk-based approach involving high-risk clients and customers. Institutions can address the challenges of de-risking in a well-coordinated, multifaceted approach, while engaging with regional and international regulatory agencies within an agreed framework and in partnership with other bodies, whether Islamic or conventional.

## About CIBAFI

CIBAFI is an international organization established in 2001 and Headquartered in the Kingdom of Bahrain. CIBAFI is affiliated with the Organization of Islamic Cooperation (OIC). CIBAFI represents the Islamic financial services industry globally, defending and promoting its role, consolidating co-operation among its members, and with other institutions with similar interests and objectives. With over 120 members from over 32 jurisdictions, representing Islamic Banks, market players, international intergovernmental organizations and professional firms, and industry associations, CIBAFI is recognised as a key piece in the international architecture of Islamic finance. In its mission to support Islamic financial services industry by being the leading industry voice advocating regulatory, financial and economic policies that are in the broad interest of our members and that foster the development of the Islamic financial services industry and sound industry practices, CIBAFI is guided by its Strategic Objectives, which are 1. Policy, Regulatory Advocacy, 2. Research and Publications, 3. Awareness and information sharing and 4. Professional Development.

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