New York Law Journal

SERVING THE BENCH AND BAR SINCE 1888

WWW.NYLJ.COM

An ALM Publication

VOLUME 256—NO. 54

FRIDAY, SEPTEMBER 16, 2016

INTERNATIONAL BANKING

Expert Analysis

Work Continues on Addressing Correspondent Banking Decline

By Kathleen A. Scott

The transfer of the trillions of dollars that regularly move around the globe is accomplished through the use of accounts that the banks maintain with each other to settle those transfers, as well as for other banking services. These accounts, called correspondent accounts, are critical to the efficient functioning of the world's financial system. Most of these accounts are maintained at large international banks ("correspondents")—many of which are in the United States, European Union, Canada and other industrially developed countries. But banks in other countries ("respondents") need accounts at those banks to handle funds transfers, other payments, etc., and if those large banks are reluctant to maintain accounts for them because the bank and/or the country are seen as a greater risk, then they may cut them off or charge them a larger fee to maintain the account.

There has been a troubling trend toward some banks terminating their correspondent banking account relationships with banks in certain areas of the world, and potentially to all the banks in particular countries, essentially isolating them from accessing the international financial system and adversely affecting that country's own local banking system. For example, for banks in those countries that have had their ability to maintain correspondent banking relationships with banks in other parts of the world reduced, the decline in correspondent banking services may impede the flow of much-needed personal remittances coming to their residents from relatives in other countries.

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Trying to address this troubling trend, in November 2015, the Financial Stability Board (FSB), a group of international banking regulators, proposed an action plan to the G20, the group of international finance ministers and central bank governors, to address this issue and established the Correspondent Banking Coordination Group (CBCG).[1] The FSB submitted its latest progress report[2] to the G20 in conjunction with its just-concluded meetings in China. The communique issued after the meeting included a statement in support of the FSB's action plan, to address "the decline in correspondent banking services so as to support remittances, financial inclusion, trade and openness."[3]

This month's column will discuss some of the progress the FSB has made thus far.

It is a four-point action plan:

• **Further examining the dimensions and implications of the issue.** In July, the Committee on Payments and Market Infrastructures (CPMI) of the Bank for International Settlements, another group

KATHLEEN A. SCOTT *is senior counsel in the New York office of Norton Rose Fulbright.*

of international banking regulators, published a report detailing the reduction in the number of banks providing correspondent banking services.[4] The report showed an increased concentration in correspondent banking relationships. While there has been an increase in the actual volume of payments, there is a clear downward trend in the number of active correspondent accounts across regions. There is speculation that payments were switched to flow through other channels or rerouted through third countries.

Work still to be done includes: (i) continuing to encourage collection of data by international organizations on the decline in correspondent banking and the cause and effect of such decline, (ii) undertaking a deeper analysis of the causes and consequences of the decline by looking at the specific markets where the decline in correspondent banking appears to be concentrated, and the impact such decline may have on a particular market's financial stability and costs of cross-border transfers of funds, and (iii) reviewing how the structure of correspondent banking by the banks that have lost access has changed, such as those banks' need to rely on smaller correspondent banks rather than the large global banks that are the major correspondent banks.

• **Clarifying regulatory expectations, as a matter of priority, including more guidance by the Financial Action Task Force (FATF).** CBCG is working on a clarification of regulatory expectations, and international organizations such as the Financial Action Task Force (the international anti-money laundering and counter-terrorist financing (AML/CTF) group) and the Bank for International Settlements also are working on this issue. The FSB notes in the Report that clarifying these expectations "will support common understandings amongst relevant agencies, supervisory staff and banks, both nationally and internationally."

The FSB has developed a list of areas for clarification, including (i) the definition of "correspondent banking" itself and its risk profile, and the processes undertaken to terminate a particular respondent bank's account; (ii) due diligence procedures for correspondent banks to gather and update information on their respondents; and (iii) the practice of so-called "nested correspondent banking," where one correspondent bank with an account at a large global correspondent bank will provide correspondent services to other banks. In addition, another concern with a need for clarification is the absence of standards as to when a correspondent bank needs to conduct due diligence on the respondent bank's customers—the so-called Know Your Customer's Customer (KYCC) issue. Updated guidance on correspondent banking from some international organizations, such as Financial Action Task Force, is due by the end of 2016.

According to recent IMF and World Bank surveys cited in the November 2015 action plan, the regions most affected by the reduction include the Caribbean, Eastern Europe, Central Asia and the East Asia Pacific region. The banks terminating those relationships are primarily from the United States, European Union and Canada.

• **Domestic capacity-building in jurisdictions that are home to affected respondent banks.** The initial November 2015 report from the FSB to the G20 had noted that large global correspondent banks (not surprisingly) most frequently terminated correspondent relationships with banks from jurisdictions with weak supervisory and regulatory frameworks.

The action plan is aimed at developing effective AML/CTF networks by providing national and multilateral technical assistance to certain countries to identify and address their weaknesses in this area. The FSB also supports private sector dialogue between correspondent accounts and their respondents to improve their relationship such as by providing advice to respondents on how to avoid termination of their accounts. In addition, it recommends communication between banks and their regulators to work on joint initiatives to improve banks' AML/CTF compliance, risk assessments and information-sharing.

• **Strengthening tools for due diligence by correspondent banks.** The CPMI had several recommendations for improvements in the correspondent banking system. Regarding

"Know Your Customer" (KYC) standards, it recommended standardizing a respondent's KYC information and placing it in a central depository (referred to as a "KYC utility") that other correspondent banks could access to avoid a respondent having to submit the same standard voluminous amount of information each time it establishes a new correspondent account, although the CPMI acknowledges that a correspondent still may need additional information before opening the account.

The CPMI also encouraged both use of legal entity identifiers (LEIs, a method of "unambiguous" identification of legally distinct entities (but not individuals) that engage in financial transactions) that are linked to a centralized database currently maintaining identifying information on the entity such as name, legal form and location, and enhancement of the data that could be accessed through the LEI database.

Information-sharing by a respondent to its correspondent bank regarding transactions going through the correspondent account could be improved, although the CPMI acknowledged that current data protection laws may make that difficult or impossible in certain jurisdictions. Finally, the CPMI recommended that banks decide amongst themselves on a format for the payment messages that are sent between two or more banks to facilitate a funds transfer and consider the potential for being able to incorporate the parties' LEIs into the message; improving the quality of these messages may reduce the need to require follow-up information on transactions.

On a final note, the CBCG has begun exploring greater use of the public sector to support technical solutions, including possible use of central banks or other publicly backed vehicles as a last resort to provide correspondent banking services to banks in their jurisdictions that cannot find a private correspondent bank. However, the first step is for those weak jurisdictions to strengthen their compliance with AML/CFT standards, or those banks may encounter the same problems in accessing correspondent banking services as the private sector banks.

Conclusion

The global reduction in correspondent banking has been attributed, for the most part, to an aversion to risk due to a heightened concern on regulatory scrutiny with respect to doing business in certain countries or with certain businesses. According to recent IMF and World Bank surveys cited in the November 2015 action plan, the regions most affected by the reduction include the Caribbean, Eastern Europe, Central Asia and the East Asia Pacific region. The banks terminating those relationships are primarily from the United States, European Union and Canada.

The businesses most affected by terminating these relationships include check clearing, international wire transfers, cash management and even trade finance—all cross-border banking services that need correspondent banking relationships to settle these transactions. The FSB is working on a more comprehensive report that should be available by the end of the year, and as noted above, other international organizations also are working on revised guidance on correspondent banking relationships. In the meantime, individual regulators are working on guidance for their banks on correspondent banking relationships, and international banks operating in those jurisdictions should take note.[5]

1. Financial Stability Board, "Report to the G20 on actions taken to assess and address the decline in correspondent banking," Nov. 6, 2016, available at http://www.fsb.org/wp-content/uploads/Correspondent-banking-report-to-G20-Summit.pdf.

2. Financial Stability Board, "Progress report to G20 on the FSB action plan to assess and address the decline in correspondent banking," Aug. 25, 2016, available at http://www.fsb.org/wp-content/uploads/Progress-report-to-G20-on-the-FSB-action-plan-to-assess-and-address-the-decline-in-correspondent-banking.pdf.

3. "G20 Leaders' Communique Hangzhou Summit," Sept. 6, 2016, available at http://www.g20.org/English/Dynamic/201609/t20160906_3396.html.

4. Bank for International Settlements, Committee on Payments and Market Infrastructures, "Correspondent Banking," July 2016, available at http://www.bis.org/cpmi/publ/d147.pdf.

5. See, for example, "U.S. Department of the Treasury and Federal Banking Agencies Joint Fact Sheet on Foreign Correspondent Banking: Approach to BSA/AML and OFAC Sanctions Supervision and Enforcement," Aug. 30, 2016, available at https://www.treasury.gov/press-center/press-releases/Documents/Foreign%20Correspondent%20Banking%20Fact%20Sheet.pdf.