TIGHTENING THE NOOSE - FUTURE OF CORRESPONDENT BANKING

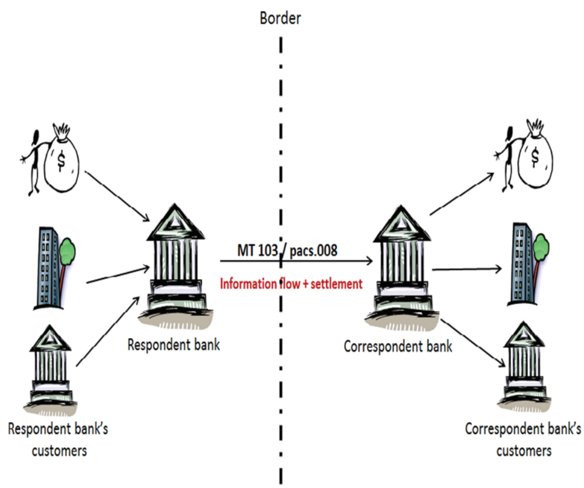
R Naguleswaran
Assistant Vice President
Correspondent Banking
DFCC Bank

Introduction

Correspondent Banking is very important mainly to support all cross border transactions. However, at present context correspondent banking landscape is challenged mainly due to financial crime compliance and de-risking. According to available evidence there is a decline in correspondent banking relationships. Correspondent Banking should be reshaped with new business models not only to face the increasing global regulatory and compliance requirements but also to cater to the demand of present and future generation of payment makers in line with changing technological dynamics.

What is Correspondent Banking?

Figure 1



Source – CPMI – Correspondent Banking – Consultative Report – October 2015

As depicted above in Figure 1 Correspondent Banking could be defined as the provision of banking related services by one bank (correspondent) to an overseas bank (respondent) to enable the respondent to provide its own customers with cross-border products and services.

A more detailed definition by the Wolfsberg Group establishes that ''Correspondent Banking is the provision of a current or other liability account, and related services, to another financial institution, including affiliates, used for the execution of third-party payments and trade finance, as well as its own cash clearing, liquidity management and short-term borrowing or investment needs in a particular currency". The Wolfsberg Group is an association of 13 global banks which aims to develop guidance and frameworks for the management of financial crime risks with respect to Know Your Customer (KYC), Anti-Money Laundering (AML) and Combating Financing of Terrorism (CFT) policies.

Correspondent banking may include various services, such as international fund transfers, cash management services, check clearing, loans and letters of credit or foreign exchange services. There are several ways of providing these services:

• In traditional correspondent banking as depicted below in Figure 2, a respondent bank enters into an agreement with the correspondent bank in order to execute payments on behalf of the respondent bank and its customers. The respondent bank's customers do not have direct access to the correspondent account, but they transact business indirectly.

• Nested correspondent banking as depicted below in Figure 3 refers to the use of a bank's correspondent relationship by a number of respondent banks. The latter have no direct account relationship with the correspondent bank but conduct business through their relationships with the bank's direct respondent bank to execute transactions and obtain access to other financial services (Example a local bank conducts correspondent banking business indirectly via its regional savings bank.

• Payable-through accounts, also known as ''pass-through'' or ''pass-by'' accounts, are similar to nested correspondent banking but, in this case, the respondent bank allows its customers to directly access the correspondent account to conduct business on their own behalf.

Figure 2.

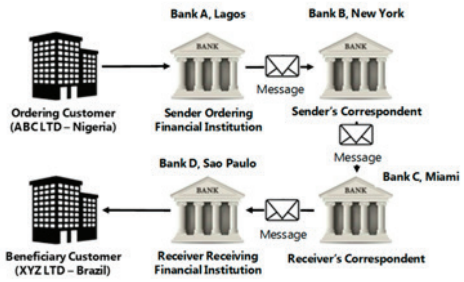
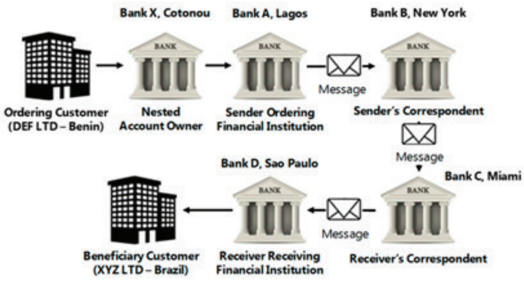


Figure 3.



Sources: CPMI (2015a), Wolfsberg Group (2014).

What are the Money Laundering Risks in Correspondent Banking?

The Correspondent often has no direct relationship with the underlying parties to a transaction and is therefore not in a position to verify their identities. Correspondents often have limited information regarding the nature or purpose of the underlying transactions, particularly when processing electronic payments or clearing cheques. For these reasons, correspondent banking is in the main non face-to-face business and must be regarded as high risk from a money laundering and/or terrorist financing perspective.

Correspondent banking relationships, if poorly controlled, can allow other financial services firms with inadequate AML/CTF systems and controls, and customers of those firms, direct access to international banking systems.

A Correspondent handling transactions which represent the proceeds of criminal activity or terrorist financing will end up in paying high regulatory fines. This will also damage its reputation.

How to Assess the Elements of Risk in Correspondent Banking?

Correspondents will be exposed to high risks if their respondents are offshore banks because those are limited to conducting business with non residents or in non local currency, and are not subject to robust supervision of their AML/CTF controls. Correspondents also prone to high risks if respondents are domiciled in jurisdictions with weak regulatory/AML/CTF controls.

Correspondents must not maintain relationships with respondents which are shell banks and also with any respondent which provides banking services to shell banks.

Enhanced customer due diligence must be undertaken on respondents using a risk-based approach.

The following risk indicators should be considered both when initiating a relationship, and on a continuing basis thereafter, to determine the levels of risk-based due diligence that should be undertaken:

The Respondent's Domicile

The jurisdiction where the respondent is based and/or where its ultimate parent is headquartered may present greater risk (or may mitigate the risk, depending on the circumstances). Certain jurisdictions are recognized internationally as having inadequate anti-money laundering standards, insufficient regulatory supervision, or presenting greater risk for crime, corruption or terrorist financing. Other jurisdictions, however, such as many members of the Financial Action Task Force (FATF), have more robust regulatory environments, representing lower risks. Correspondents should review pronouncements from regulatory agencies and international bodies such as the FATF, to evaluate the degree of risk presented by the jurisdiction in which the respondent and/or its parent are based.

The Respondent's Ownership and Management Structures

The location of owners, their corporate legal form and/or a lack of transparency of the ultimate beneficial ownership are indicative of the risk the respondent presents. Investigation should be carried out whether the respondent is publicly or privately owned; if publicly held, whether its shares are traded on a recognised market or exchange in a jurisdiction with a satisfactory regulatory regime, or, if privately owned, the identity of any beneficial owners and controllers. Similarly, the location and experience of management may indicate additional concerns, as would unduly frequent management turnover. The involvement of Politically Exposed Persons (PEPs) in the management or ownership of certain respondents may also increase the risk.

The Respondent's Business and Customer Base

The type of business the respondent engages in, as well as the type of markets it serves, is indicative of the risk the respondent presents. Involvement in certain business segments that are recognised internationally as particularly vulnerable to money laundering, corruption or terrorist financing, may present additional concern. Consequently, a respondent that derives a substantial part of its business income from higher risk customers may present greater risk.

Correspondent Banking Management

The type of transactions permitted with a correspondent bank under the correspondent banking arrangements and its country regulations are necessary to ensure that only permitted transactions are requested from the correspondent bank in order to manage activities and the transactions are within the country regulations.

The person in charge of correspondent banking management should know the various credit limits and terms & conditions for a correspondent bank, for any given type of transaction. This will ensure that credit limits are managed within the approved limits and correct pricing applied for the transaction. The responsible person designated for correspondent banking management will also select the correct correspondent bank for the required transaction.

Society for Worldwide Interbank Financial Telecommunications (SWIFT) plays a major role on correspondent banking. Today, banks establish multiple correspondent relationships throughout the world via SWIFT Relationship Management Application (RMA). The RMA is a messaging capability enabling members of the SWIFT network to exchange messages over the network.

Many of the largest international banks located in the major financial centers of the world serve as correspondents for thousands of other banks. The management of correspondent banks, which is a specialized subject, is referred to as correspondent banking management. Prudent correspondent banking management is essential, to ensure the smooth functioning of international trade transactions. International trade and cross border transactions are not one-off transactions. Therefore you need to manage the correspondent banking on a continuation basis with all the know-how and also maintaining good cordial relationships with your correspondents. Globally correspondent banking management is considered as one of the key areas for all cross border transactions because financial institutions should incorporate RMA due diligence standards into their Financial Crime/AML/KYC programmes.

Knowing certain regulations of United States of America (USA) is a key for the correspondent banking management. Due to America's prominence in international trade and the high demand for United States Dollars (USD) in international trade, banks need to have accounts in the United States to do the transactions in USD. Respondent banks have to comply with US Patriot Act and Foreign Account Tax Compliance Act (FATCA) in order to retain the USD account relationships in the USA.

In response to the September 11th terrorist attacks in 2001, USA Patriot Act was implemented in the same year. However, there are arguments that even before regulators in the U.S. and elsewhere have singled out certain categories of individuals and entities that are either strictly forbidden to hold accounts with financial institutions or, more routinely, require enhanced reviews by the institutions in which the accounts are maintained. For example accounts for "shell banks" are forbidden. ''Shell Banks'' are foreign banks without a physical presence in any country. According to law, U.S. financial institutions may not maintain accounts for such entities.

One way for correspondent institutions to manage their risks more effectively from the outset is to enter into a written agreement with the respondent institution before correspondent services are provided. This is consistent with the Financial Action Task Force (FATF) Recommendation 13 that requires a clear understanding of the respective responsibilities of each institution. The content of the agreement should include how the correspondent institution will monitor the relationship to ascertain how effectively the respondent institution is applying Customer Due Diligence (CDD) measures to its customers, and implementing AML/CFT controls.

Challenges in Correspondent Banking

There are many complex challenges faced by the correspondent banking industry. However, main challenges are financial crimes compliance and de-risking.

Financial Crimes Compliance

Regulations on anti-money laundering, client due diligence and sanctions screening are very important to testify the integrity of the financial system. While major correspondent banks are making significant efforts and investments to comply, many challenges remain. Ambiguous regulations can result in inconsistent interpretation and application and consequently potential breaches and ensuing penalties. This is further compounded by a general lack of understanding of regulatory expectations of the developed markets amongst banks in the emerging markets. Today, banks are tasked not only to be responsive to potentially suspicious transactions, but also to take preventative action which is far more difficult to achieve in practice and where failures can attract significant penalties.

De-Risking

Banks around the world are reviewing and rationalising their correspondent banking relationships. This trend, known as de-risking, is primarily driven by concerns about meeting regulatory obligations in areas such as AML and CFT; another contributory factor to this dynamic is the cost associated with maintaining multiple relationships.

In the wake of the global financial crisis and countries' response to it, the international community has been increasingly concerned about de-risking. The Financial Action Task Force (FATF) understands this term to mean situations where financial institutions terminate or restrict business relationships with entire countries or classes of customer in order to avoid, rather than manage, risks in line with the FATF's risk-based approach (RBA). This is a serious concern for the FATF and the FATF-style regional bodies (FSRBs) to the extent that de-risking may drive financial transactions into less/non-regulated channels, reducing transparency of financial flows and creating financial exclusion, thereby increasing exposure to money laundering and terrorist financing (ML/TF) risks.

Recent Trends in Correspondent Banking Relationships and their Impact

World's largest global banks and others are cutting back on their correspondent banking relationships with local banks in other countries particularly developing countries. After the global finance crisis global banks began applying a stricter cost-benefit analysis to these relationships largely due to a new assessment of risks. Enhanced regulation pertaining to money laundering, terrorist financing and economic sanction with respect to US regulations and others have added to the cost of maintaining correspondent banking relationships.

According to International Monetary Fund (IMF), Correspondent Banking Relationships (CBRs), which facilitate global trade, have been under pressure in several countries. This could affect those countries' long-run growth and financial inclusion.

Due to huge fines and regulatory measures global banks have reduced the number of correspondent banking relationships they maintain particularly in low-income economies. Banks have cut back services for correspondent banks that do not generate sufficient volume to counteract rising compliance costs, which are located in jurisdictions perceived as too risky or which provide payment services to customers where the necessary information for risk assessment is not available.

The expectations placed on banks boards and their compliance officers are intense and rising. They are expected to ensure their organizations meet their own high compliance standards and then apply same to their counterparties as well. The complexity of global transactions is also increasing. On top of it a dominant theme ''Ultimate Beneficial Ownership (UBO) '' has emerged. This new theme requires you to know who is behind the organization you are doing business with. Who ultimately controls your counterparty or your counterparty's counterparty? What are their connections or other interests?

The current Wolfsberg AML Questionnaire is perceived to be outdated and no longer fit for purpose as a means of approaching due diligence requirements for correspondent banks. This is due to dynamic changes and enhancements in regulatory requirements. This is evidenced by the fact that a majority of financial institutions use the questionnaire but add a significant number of additional questions, which have developed over time and often as a result of perceived expectations emanating from enforcement actions, leading to an inconsistent approach and an unduly burdensome process.

The impacts of the above trends are uneven across jurisdictions and banks. Some correspondent banks justify their relationships by comparing the business volume generated and the profits made out of it. Some correspondent banks do offer their service to cross sell other products. Some relationships are maintained or terminated based on the perceived degree of risk in the respondent bank's jurisdiction. As a result they will go out of international payment networks.

Initiatives on Correspondent Banking by International Bodies

The following international bodies have taken a few initiatives in the field of correspondent banking:

- The Financial Stability Board (FSB) is closely cooperating with the World Bank mainly to analyse the impact of the reduction of correspondent banking relationships on financial inclusion.
- The World Bank is conducting surveys pertaining to closure of accounts and restrictions on correspondent banking relationships.
- The Financial Action Task Force (FATF) issued public statements on de-risking.

Initiatives on Correspondent Banking by SWIFT

SWIFT has initiated few products and services to streamline the workflow imposed on correspondent banks. In order to carry out the enhanced due diligence correspondent banks use different sets of questionnaires. These are not unique and it is a very time consuming and tedious procedure to fill out these questionnaires. According to SWIFT data base there are more than 1.3 million bilateral correspondent relationships. Banks find it difficult to manage these relationships as per enhanced due diligence requirements.

The KYC Registry was launched by SWIFT in December 2014.It provides a shared platform to manage and exchange Know Your Customer data. The KYC Registry meets the need for an efficient, shared platform for managing and exchanging standardized KYC data. SWIFT has worked with the world's largest correspondent banks to define a set of data and documentation that addresses KYC requirements across multiple jurisdictions. It is completely free to upload your documentation to the registry and share it with the institutions you select. SWIFT validates the data and informs you if it is incomplete or needs updating and alerts your correspondents whenever your data changes. Over 3,000 banks in over 175 countries are already using SWIFT KYC Registry to exchange their KYC data.

SWIFT has transformed cross-border payments as same day settlement via SWIFT global payment innovation (gpi). This new service will allow corporates to track their cross border payments from start to finish, get transparency on fees, and above all, have clarity over when the transaction will be completed and the money is in the account. It is designed to address end-customer needs without compromising bank's compliance obligations and other requirements. International payments are made by combining real-time payments tracking with the speed and certainty of same-day settlement. Since January 2017, global banks have begun actively using or implementing the SWIFT gpi service.

LEI and Correspondent Banking

Correspondent banking requires a robust mechanism for identifying the parties involved in payment processing for a variety of reasons: risk management, regulatory requirements and in particular the smooth processing (Example: clear routing information to ensure straight through processing).

In the wake of the financial crisis, the importance and benefit of an unambiguous Legal Entity Identifier (LEI) became clear. Authorities worldwide acknowledged their inability to clearly identify parties to transactions across markets, products and regions. This hampered the ability to evaluate emerging risks, including systemic risk, as well as to identify trends, thus preventing stakeholders from being in a position to take corrective steps. Consequently, authorities, in close collaboration with the private sector, have developed a framework that allows for the unambiguous identification of entities through the issuance of unique LEIs, which may be also used for reporting and other regulatory purposes in the various jurisdictions. As of end-2014, more than 330,000 legal entities from 189 countries had obtained LEIs from the 20 Local Operational Units (LOUs) endorsed for issuing globally compatible codes after meeting defined standards.

Challenges for Banks in Sri Lanka

Correspondent Banking landscape is highly challenged in this part of the world. KYC due diligence is the key for establishing new relationships as well as for retention of existing relationships. This due diligence process is complex, costly, time-consuming and labour-intensive. Banks in Sri Lanka should strictly adhere to this due diligence process as required by all the correspondent banks. Therefore banks must train staff on how correspondent banking transactions may be used for ML/TF. Policies and procedures should be updated regularly to mitigate risks pertaining to ML/TF. Sophisticated AML systems should be in place for monitoring purpose. However, still global banks could cut down their relationships by citing their internal policy decisions.

Nostro accounts are being closed due to low business volumes routed through such accounts. Establishing new RMA's consume more time and there is no guarantee that required RMA could be established according to the needs of banks in Sri Lanka. At present context opening of new nostro accounts is also extremely difficult. RMA's are cancelled without proper notice to respondent banks. Correspondent bank charges are increased frequently. As a result banks will find it difficult to accommodate cross border transactions. These obstacles could lead to develop non-bank players to operate outside the regulatory framework.

Pressure on CBRs could disrupt financial services and cross-border flows, including trade finance and remittances, potentially undermining financial stability, inclusion, growth, and development goals.

Future of Correspondent Banking

The age of correspondent banking is coming to an end. New payment models offered by Fintech start-ups are increasing. They are offering customers cheaper and more transparent ways of moving money across borders. Banks will have to partner with Fintechs to remain competitive in the correspondent banking space.

We need to find the answers for the following questions for the future of correspondent banking.

- Globally domestic payment systems have been reshaped on real-time basis. Will correspondent banking respond for all global cross-border payments on real time?
- The diversified instant demand coming from all the stakeholders in cross-border transactions. Will there be a radical change to correspondent banking to meet this demand?
- Collaboration is the key amongst regulators, the banking sector and technology enabled players in the changing environment. Will the correspondent banking respond to exceed customer expectations?
- Global regulatory & compliance requirements are increasing. Will the correspondent banking align the compliance requirements to suit the business needs?

Conclusion

Correspondent Banking services are essential to carry out cross border transactions. However, due to various reasons correspondent banks are cutting down their relationships. As per recommendations made by world bodies respondent banks are trying their level best to adhere to the measures as discussed in this article. Correspondent banking relationships are very diverse in nature and therefore covering a large range of high risk levels. The level and nature of risk may fluctuate over the course of any relationship and adjustments should be made in the correspondent institution's risk management strategy to reflect these changes. This is why ongoing monitoring, including periodic reviews, is important, so that the correspondent institution is aware of when the level/nature of residual risk (i.e. the risk remaining after a financial institution's AML/CFT control framework is applied to a particular situation) changes.

Correspondent Banking landscape is still alive and we could see the present model is starting to fail to meet the requirements of the new generation of payment makers in the world. Two-day basis correspondent banking model will not serve the present generation who needs everything instantly. Therefore future of correspondent banking is questionable unless you create a new business model for correspondent banking to suit the present requirement of global trade and cross border payments.

References

- www.bis.org
- www.swift.com
- www.gleif.org
- www.accuity.com
- www.fatf-gafi.org | October 2016
- Wolfsberg Group. 2014, "Wolfsberg Anti-Money Laundering Principles for Correspondent Banking,"
- http://www.wolfsberg-principles.com/pdf/standards/Wolfsberg-Correspondent-Banking- Principles-2014.pdf
- Committee on Payments and Market Infrastructures (CPMI) – Correspondent Banking – Consultative Report – October 2015