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DE-RISKING BY BANKS IN EMERGING MARKETS – EFFECTS AND RESPONSES FOR TRADE

Emerging evidence suggests that de-risking is a reality. Increased capital requirements, coupled with rising Know-Your-Customer, Anti-Money-Laundering, and Combating-the-Financing-of-Terrorism compliance costs have resulted in the exit of several global banks from cross-border relationships with many emerging market clients and markets, particularly in the correspondent banking business. A subset of this business, trade finance, is also at risk, with potential consequences for segments of emerging market trade. The emerging market trade finance gap was significant before the crisis and has since likely expanded. Those involved in addressing the de-risking challenge must focus on compliance consistency and effective adaptation of technological innovations.

Of all of the components of a financial system, banks are the driving force. They are the actual mechanisms that transmit money to individuals and businesses that need it to operate and grow; they provide formal channels to store and invest wealth; and they are integral to monetary policy initiatives. They are essential to basic economic function, stability, and growth. Banks also work across borders to provide clients with access to foreign exchange and foreign markets and, in many cases, goods produced outside of their country. Thus, banks are critical to linking emerging markets to the global economy.

Financial Sector De-risking

Yet banks across the globe have had to deal with a surge of regulatory activity in a compressed time period. While many of these regulations have increased financial system resilience and helped to identify suspicious client behavior, they have also imposed increases in both reserve capital requirements and compliance costs. As a result, banks find it more difficult to do business with certain markets and clients. So-called "de-risking" refers to banks terminating or restricting their relationships with clients or categories of clients in order to avoid risk.[1] De-risking is of particular concern when cross-border links between banks are severed.

Increased Capital Requirements. Financial sector regulatory reforms, imposed over the past decade, were intended to reduce the frequency and severity of financial shocks. Following the 2008 financial and 2010-2011 Eurozone crises, multiple regulatory reforms by governments and international bodies have sought to quantify systemic risk and promote greater transparency. Of particular note, the Basel III accord attempted to strengthen financial sector regulation, supervision, and risk management to increase bank resiliency through additional disclosure requirements and guidelines pertaining to leverage ratios, capital requirements, and liquidity. The result has been higher reserve capital and liquidity requirements. And with more capital in reserve, banks generally have less to lend, and so are allocating increasingly scarce capital to more profitable products, markets and customers. Relationships that generate lower returns or more challenging risk are more likely to be cut.

Increased Compliance Costs. At the same time, there have been greater efforts to combat money laundering and terrorism financing. The Financial Action Task Force on Money Laundering, or FATF, has proposed standards that follow a risk-based approach,[2] holding banks to an incident-based standard as opposed to a process standard. This allows some flexibility for banks to develop their own processes that monitor and assess client risk, but leaves them subject to unspecified and potentially large fines should incidents occur. In some cases, regulators have aggressively prosecuted global banks and imposed significant fines.[3] For example, HSBC was fined $1.9 billion for allowing possible money laundering to occur through its institution.[4] The international standards are then implemented at the national level, with each country adapting them to local conditions. This has created variance between jurisdictions for anti-money-laundering (AML), combating-the financing-of-terrorism (CFT), and know-your-client (KYC) requirements, often leaving banks to interpret applications.

As a result, the financial effects of compliance risk have become more material for banks. Compliance risk increases costs for financial institutions in four areas. First, the risk of large penalties for violations raises the potential cost of cross-border exposure.[5]

Second, the additional scrutiny of banks' clients dramatically raises costs, particularly for adding new client relationships or markets.[6] Banks are unable to execute transactions without bearing the costs of putting new processes, procedures, and

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tools in place that link customer due diligence to transaction monitoring systems that raise flags and investigate suspicious activity continuously in real time.[7] These costs may not be recovered if market and client returns are relatively low.

Third, a lack of harmonization in compliance requirements raises costs for banks as they seek to understand and apply local requirements.[8] Banks face a shortage of appropriately skilled people to track and manage various compliance requirements, and constant skills development is required.[9]

Fourth, regulations are changing on a monthly or even weekly basis.[10] Ongoing changes to and tightening of compliance requirements in any single jurisdiction, along with divergence in levels of enforcement, require additional time, resources and costs to adapt.[11] An analysis of national AML/CFT regulations found at least nine emerging markets had made one or more significant changes in 2015 alone.[12]

Surveys of banks conducted since 2014 show a clear trend of rising spending on compliance. Anti-money-laundering compliance costs have risen 53 percent since 2011, according to a 2014 KPMG survey.[13] That study estimated that expenditures on such programs will exceed $10 billion within the next two years. A 2016 survey of financial services compliance professionals worldwide by Dow Jones and the Association of Certified AML Specialists found that most respondents had increased their AML investment by up to 24 percent since 2013.[14]

Most respondents said they anticipated additional increases of up to another 24 percent over the coming three years. The Institute of International Finance and Ernst & Young's annual survey of banks in October 2016 found that increased focus on non-financial risks, including money laundering and sanctions, was placing greater financial strain on their businesses.[15]

As a result of simultaneous reserve capital and compliance requirement increases, banks are de-risking from certain markets and clients. In the same IIF/E&Y survey, banks said capital, liquidity, and leverage changes under Basel III are causing them to rethink their business models.[16] Over 48 percent said they have exited or are planning to exit business lines, and 27 percent said they are leaving specific countries.

In many emerging markets, local banks are also caught in a de-risking cycle. As their cross-border counterparty banks face the financing challenges outlined above, local banks are finding it difficult to absorb regulatory compliance requirements as well.[17] And in most cases local banks do not receive explanations for terminated correspondent banking relationships (CBRs), hindering their ability to respond or adjust.[18]

Downward Pressure on Correspondent Banking

Correspondent banking involves agreements or contractual relationships between banks to provide payment services for each other,[19] a function that is essential to cross-border payments, foreign currency settlements, and access to foreign financial systems.[20] With more complex regulatory risk, the typically lower margin correspondent banking business line is more vulnerable to supply pressure. There is growing evidence that global banks are terminating or limiting correspondent banking relationships in emerging markets.

A 2014 IFC survey, among the first to assess the sentiments of global and regional correspondents, found signs of potential de-risking in correspondent banking activity.[21] Rising compliance costs and country or counterparty risk factors were the most commonly cited reasons. Some 70 percent of respondents said they saw a rise in compliance costs in the last three years, and 66 percent expected compliance costs to continue to rise in the next six months. Three-quarters of large correspondent respondents in a 2015 World Bank survey said they had reduced their correspondent relationships.[22] Banks in the United States, the United Kingdom, the European Union, and Canada were responsible for a significant portion of such terminations. Other surveys noted similar trends. A 2014 British Banking Association survey of 11 international clearing banks found that since 2011, many thousands of correspondent relationships were closed with an average per-bank decline of approximately 7.5 percent.[23]

SWIFT data analyzed by the Committee on Payments and Market Infrastructures in 2016 showed that there was at least some decrease in the number of active correspondents in over 120 countries, with the decline exceeding 10 percent for some 40 of them.

Responses from smaller regional and local banks also point to a decline in the number of correspondent relationships. In roughly half of 91 jurisdictions covered by the 2015 World Bank survey, banking authorities and/or local and regional banks indicated a decline. An IFC follow-up survey of 210 emerging market banks in 2016 noted a significant increase in pessimism about the availability of correspondent lines.[24] Globally, the percentage of bank survey respondents anticipating very near-term decreases rose from 3 percent to 22 percent year-on-year. In Sub-Saharan Africa this trend is greatly pronounced: The percentage of banks with a negative outlook increased from 0 percent to 27 percent. According to a 2016 survey by the International Chamber of Commerce, 35 percent of respondents reported experiencing termination of correspondent banking lines.[25]

The IMF warns that, if not contained, the aggregate decline of correspondent banking threatens to result in negative effects on financial inclusion, stability, growth and development goals.[26]

And a significant impact on financial inclusion has also been noted.[27]

Downward Pressure on Trade Finance

Trade finance, an important subset of correspondent banking, is also at risk. Trade has long been recognized as a key driver of development, and its importance to a country's overall economic performance is well-documented. While individual trade transactions are short-term, the accumulated development impact of trade is significant and long-term. Emerging countries that trade successfully tend to have made the most progress in alleviating poverty and raising living standards.[28] Openness to the world economy, including trade participation, was one of the key elements of sustained high growth identified by the 2008 report of the Commission on Growth and Development.[29]

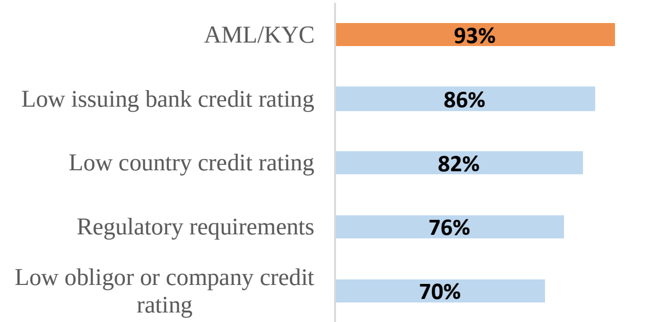
Evidence shows that a one percent increase in a country's trade share raises income per capita by two percent.[30] Furthermore, trade supports the availability of goods critical to economic function and life. Some 21 countries in Sub-Saharan Africa rely on imports for more than 90 percent of their energy needs.[31] And half of the top 20 rice importers globally are from among the poorest countries in Africa.[32] In addition, domestic producers often require imports of agricultural inputs, such as seeds, fertilizer, agrichemicals, irrigation, and equipment during pre-planting phases and throughout the crop cycle.

In many cases, trade in emerging markets would not occur without trade finance, the short-term financial obligations and related documentation taken on by banks transacting cross-border. Bank-intermediated trade finance supported one third of the $19 trillion in global trade in 2013, according to estimates by the Bank of International Settlements.[33] Furthermore, data collected between 2005 and 2011 indicate that a one percent increase in trade credit extended led to a roughly 0.4 percent increase in a country's real imports.[34] Reductions in the availability of trade finance have been found to affect trade. It is estimated that credit shocks related both to working capital and trade finance accounted for between 15 and 20 percent of the decline in trade during the 2008 crisis.[35]

Trade finance instruments, intermediated by commercial banks, are designed to address the risks rising from the lack of familiarity between buyers and sellers, the timing differences of cash needs and cash flows, and other risks—real or perceived—of a country or counterparty. Trade finance instruments are premised on an existing credit relationship between counterparty banks.[36] International banks, which are often required to "confirm" the payment to the exporter if documents conform to that required by the letter of credit, take on the reimbursement risk related to local emerging market banks. Thus, in order for goods to be shipped, a confirming bank must be willing to take the payment risk of the local bank. This may not be possible if exposure constraints exist for the client or the country, or the potential return on this exposure does not merit the risk taken.

In today's environment, many international banks with trade finance expertise face increased risk-based capital constraints and other regulatory pressures that have an impact on their emerging market operations (*Figure 1*).

Figure 1. Trade Finance Impediments Identified by Banks



Source: ICC Global Survey on Trade Finance, 2016.

Trade finance is typically considered to have lower financial risk due to a near-zero global loss history and relatively short tenors, among other factors. Still, it appears to be vulnerable to de-risking. In a 2015 International Chamber of Commerce study, roughly two thirds of respondent banks said that the implementation of Basel III regulations has affected their cost of funds and liquidity for trade finance.[37] In a similar 2016 survey, increased costs for KYC/AML continued to be a challenge: 93 percent of respondents said that these factors continue to be a strong impediment to facilitating trade finance and 62 percent noted they had seen trade finance transactions decline due to KYC/AML considerations.[38] Seven in ten respondents to the 2015 survey said that implementation of KYC/AML regulations was already resulting in their bank's decreased support for trade transactions.

The gap between trade finance demand and supply was sizable pre-crisis, and many are concerned that it will continue to expand, impeding economic growth. Studies by the World Trade Organization, the Asian Development Bank, and the African Development Bank show a large, unmet demand for trade finance. The WTO estimates a global trade finance gap of $1.4 trillion,[39] with significant shortfalls in emerging regions like developing Asia, where trade finance demand exceeds supply by up to $425 billion.[40] In Africa the value of unmet demand for trade finance is estimated to be $120 billion, fully one third of the continent's trade finance market.[41] Because bank-to-bank relationships represent a key element in cross-border transactions, declines in correspondent banking relationships put trade finance, and thus trade, at risk.[42]

Smaller Markets and Firms Are Vulnerable

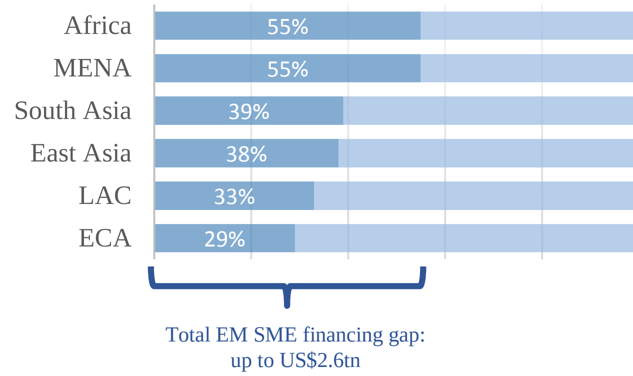
De-risking affects sectors and stakeholders across emerging markets, with some correspondents terminating over 60 percent of their correspondent banking relationships.[43] Data collected in the World Bank's 2015 survey of national regulatory bodies and local banks showed the global de-risking footprint and its resulting financial exclusion have especially affected smaller developing economies in Africa, the Caribbean, Central Asia, Europe and the Pacific.[44] The IMF has noted a similar impact in nations in the Middle East and North Africa region and that the limited number of banks operating in small Pacific states amplifies the risk and impact of the loss of correspondent banking. At least 16 banks across five countries in the Caribbean region have lost all or some of their correspondent relationships as of May 2016, according to the IMF.[45]

The Caribbean region, which relies heavily on cross-border funding for trade, offers a telling example of de-risking.[46] The region's capacity to conduct cross-border payments is being put at risk from the pressures that reduce correspondent banking. According to the Caribbean Development Bank, external trade for the export-oriented and oil-importing Caribbean countries accounted for approximately 94 percent of GDP in 2014. Countries in the region import a significant portion of their essential food, energy, and medical supplies and are beneficiaries of significant remittance inflows. Hence, a lack of access to cross-border payment systems could have ruinous consequences.

De-risking in the Caribbean has been closely examined and monitored by a cross-functional group that includes the Caribbean central banks, the Financial Stability Board, the World Bank, the IMF, and the Caribbean Community. The World Bank's 2015 survey found financial institutions in the Bahamas, Guyana, Haiti, Jamaica, and Trinidad and Tobago have experienced reductions in correspondent relationships.[47] In nearby Belize, only two banks have managed to maintain such relationships with full banking services.[48] Each country in this region is currently facing specific challenges due to de-risking, and most are also losing new business since available correspondent banks refuse to enroll new customers from this region, constricting new sources of economic growth.

Smaller Firms. Small and medium-sized enterprises, or SMEs, are among the clients that are likely severely affected by de-risking. Anecdotal evidence suggests the reason for this may be a so-called flight to quality. Globally, over half of trade finance requests by SMEs were rejected in 2015.[49] This is of consequence, as SMEs in emerging markets contribute 80 percent of total employment and almost 40 percent of total exports, both of which are critical to economic growth.[50] SMEs already face significant capital constraints, as the global financing gap for them was estimated by IFC and McKinsey to be as much as $2.6 trillion (*Figure 2*).

Figure 2. Capital-Constrained SMEs by Region (% of Total)



Source: IFC and McKinsey, 2014.

Addressing De-Risking

Multiple institutions, including at least 16 multilateral bodies, have engaged to support the clarification and consideration of broad guidance on compliance, application of said guidance by individual regulators, and the implications on participants in the formal financial system.[51] In the absence of systematic, comprehensive data, many of these bodies have attempted to quantify de-risking from multiple, often complimentary, perspectives. They have contributed to the evidence gathering effort, typically via surveys of national regulators and financial institutions. And many national regulators are continuing to evolve their application of the risk-based approach, clarifying and further developing their national AML/CFT strategies in conformity with international standards.

The Financial Stability Board is following a four-point plan which includes further examination of the issue, clarification of regulatory expectations, capacity building in jurisdictions where respondent banks are affected, and strengthening of tools for correspondent banks to perform due diligence checks. The Financial Action Task Force also recently provided additional guidance on correspondent banking services[52], among other topics, and it plans to provide guidance on best practices for customer due diligence to facilitate financial inclusion. [53]

Some development finance institutions are actively engaging as well. Among other areas of engagement, the World Bank has executed a survey on correspondent banking and plans to assess the effects of de-risking on real sector banking clients. It is also bringing financial sector participants, standard-setting bodies, and regulators to address the effects of de-risking on access to finance for more vulnerable parts of the financial system. The IMF has evaluated other market forces that affect de-risking; it has made recommendations to clarify, strengthen, and align regulatory and supervisory frameworks; and it has identified best practices in national policy responses. The IFC has a client network of over 500 financial institutions worldwide, which in turn hold approximately 10 percent of emerging market financial sector assets. The IFC continues to help clients improve AML/KYC processes. It also supports the availability of trade finance in emerging markets by enhancing existing emerging market trade finance channels and also investing directly. It continues to interact with its clients to better understand the implications of regulatory changes and cross-border de-risking.

The Way Forward

Despite the efforts of multilateral standard-setting boards, global task forces, multilateral agencies and national regulators, there remains a need to balance the prevention of access to financial services by illicit actors with the expansion of access to finance to companies, small businesses, households and individuals. The continued existence of variance and ambiguity with regulatory applications drives compliance costs to levels that make legacy compliance approaches unfeasible. An effective effort to address this will focus on clarifying and making consistent regulatory requirements across jurisdictions, as well as exploring and applying emerging technologies to improve efficiency and enhance risk assessments.

Clarity on Regulatory Application. While regulatory authorities note the importance of a risk-based approach to anti-money laundering and know-your-customer regulations, it is important that a clear set of policies, procedures, and standards are developed and enforced through an aligned agreement among banking regulatory bodies: multilateral, national and subnational. Collaboration would include standardized due diligence processes to assess risk for a particular customer or by actors along the payment process, including the trade finance supply chain, remittance flows, and others. Risk assessment criteria could include the establishment of identification and verification requirements for customers and businesses that track their use of funds.

Among the 333 bank respondents to IFC's 2014 survey, the most commonly identified initiatives that would help manage rising compliance costs were: (1) developing a central registry of respondents' data to facilitate due diligence, (2) harmonizing regulatory requirements across jurisdictions, and (3) providing guidance on how to meet regulatory requirements.[54] In parallel, banks remain responsible for ensuring consistent and adequate levels of customer monitoring via bank operations to verify those identities and relationships.

Technological Innovation. The emergence of new technologies from the private sector has significant potential to contribute to a reduction in compliance costs and an increase in risk assessment precision. There is a shift toward a customer-centric infrastructure that takes advantage of multiple disruptive technologies in the areas of enhanced identity verification (such as biometric and legal entity identifiers); transparency (distributed ledger technology such as the block chain, for example), interoperability (open-sourced, real-time global payment systems); and the use of big data for enhanced security. For instance, several of the largest global banks (including Barclays, Citigroup, UBS, Santander, and Deutsche Bank) are independently experimenting with different applications of block chain technology and smart contracts that might help resolve AML/CFT issues.[55] Multilateral and national regulatory engagement with advanced technology is also important.

Conclusion

As banks adapt to simultaneous increases in both reserve capital requirements and compliance costs, the feasibility of doing business with certain segments is expected to further diminish. Thus, the de-risking trend will likely continue, if not accelerate, in the near term. This separates people, businesses, and potentially entire countries from access to critical aspects of cross-border finance. In some cases it puts trade finance—and thus the goods and growth enabled by trade—at risk.

Enhanced collaboration among multilateral institutions, regulators, and private-sector financial institutions will need to achieve end-to-end transparency, efficiency, monitoring, and controls that effectively restrict the access to finance for illicit actors while reducing the limitations on access to finance for legitimate ones. The way forward will entail a concerted effort to enhance clarity on regulation and expedited technological innovation.

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