SIGMA RATINGS

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"International and Domestic Implications of De-Risking"

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Chairman Luetkemeyer, Ranking Member Clay and distinguished Members of the House Financial Services Subcommittee on Financial Institutions and Consumer Credit. I am honored by your invitation to testify before you today.

De-risking is a phenomenon that has had dramatic impacts on the international financial system over the last decade. The practice of "de-risking" can take several forms. These forms include: the closure of bank accounts for certain high risk individuals and companies, the termination of correspondent banking relationships in high risk markets and the restriction of banking services to money service businesses and remittance firms. These practices have impacted the concentration of trade flows and cross-border payment activity, which challenges financial stability and inclusion for affected markets. For the United States specifically, a decline in dollar-denominated transactions and flows through U.S. financial institutions has potential implications on commerce, as well as, the United States' competitive position.

I am the Co-Founder and Chief Operating Officer of Sigma Ratings, a company founded to address de-risking by highlighting and incentivizing good corporate behavior globally. I began my career as an attorney at a global law firm and subsequently spent several years as in-house counsel at a development finance institution, working in over 30 countries across Africa, Asia and the Middle East. Today, my testimony will focus on the international impacts of de-risking that resulted from the termination of correspondent banking relationships.

The Role of Correspondent Banking in the International Financial System

A correspondent banking arrangement involves one bank – typically a global bank referred to as the "correspondent bank" – providing a deposit account or other liability account, and related services, to another bank – typically an emerging or frontier market bank referred to as the "respondent bank". The arrangement allows for transactions to be settled between the correspondent and respondent bank.

Respondent banks utilize their correspondent banking relationships to provide a range of services such as cash management, trade services, and foreign exchange to a variety of customers that include individuals, corporations, governments and other financial institutions. Correspondent

banking relationships also support the channeling of small payments or remittance flows on which emerging economies are reliant.

The IMF estimates that U.S. dollars account for about 50 percent of correspondent banking transactions[1], making U.S. dollar correspondent banking relationships critical for access to the global financial system and U.S. banking regulation at the center of the de-risking discussion.

Drivers of De-Risking

There are many drivers of de-risking, including profitability and reputational risk concerns, and these drivers may vary from country to country. However, fears of regulatory enforcement actions and fines, as well as, the costs associated with complying with anti-money laundering, counter-terrorist financing and sanctions regulations, are consistently highlighted as the primary drivers of de-risking - irrespective of jurisdiction.

Regulatory fines imposed since 2012 against global banks reached many billions of dollars and have had a chilling effect on the robustness of global correspondent relationships. The magnitude of these fines has instilled fear in many global banks and resulted in the re-assessment of risk appetites in an effort to avoid regulatory scrutiny of how an institution manages certain relationships. In many cases, the result is a pull back from entire countries or regions. As a result, value transfer finds new forms of movement, including underground.

Another key driver is cost. Global banks are spending billions of dollars a year on compliance with some banks individually spending over a billion dollars per year[2]. These costs are associated with a variety of compliance tasks that are required when opening an account for a new customer and for conducting ongoing monitoring of an existing customer. These compliance tasks include requirements such as identification of beneficial owners, negative news screening, investigations of suspicious transactions, filing of suspicious activity reports, document verification and on-site visits. While much of banks' spending is for critically

[1] International Monetary Fund. *Recent Trends in Correspondent Banking Relationships*, 2017. https://www.imf.org/~/media/Files/Publications/PP/031617.ashx.
[2] Reuters Staff. "U.S., E.U. Fines on Banks' Misconduct to Top $400 billion by 2020." Reuters, September 27, 2017. https://www.reuters.com/article/us-banks-regulator-fines/u-s-eu-fines-on-banks-misconduct-to-top-400-billion-by-2020-report-idUSKCN1C210B.

important tasks, many costly compliance tasks are repetitive and may distract institutions from the intended outcome of detecting and ultimately stopping illicit activity.

The combination of regulatory fears and associated costs has led many large, global financial institutions to reassess the upside of doing business in emerging and frontier markets. In other words, many institutions determined that the costs and risks associated with maintaining certain relationships are no longer worth the revenue generated. The result has been the termination of those relationships.

Smaller financial institutions, such as regional banks, may have lower revenue thresholds than large global banks and therefore, have a willingness to absorb terminated relationships. However, the compliance burdens are frequently too high for those smaller institutions to take on and actively manage those relationships. This has left terminated respondent banks – and the customers they serve - with limited or no means to reconnect to the international financial system and access services previously available.

Consequences of De-Risking

Financial Exclusion

There have been short and long term consequences of de-risking. Research has demonstrated that de-risking has had financial inclusion consequences on emerging economies. In a World Bank report from November 2015 on the impact of withdrawals from correspondent banking, consequences such as decreases in lending, international wire transfers, cash management services and check clearing are highlighted among some of the most significant impacts at the local level[3]. According to a research report conducted by the Global Center on Cooperative Security and Oxfam in November 2015, decreased services have had "a ripple effect on financial access for the individuals and populations served by [terminated] businesses… effectively

[3] The World Bank Group, *Withdrawal from Correspondent Banking – Where, Why and What to Do About It*, 2015. http://documents.worldbank.org/curated/en/113021467990964789/pdf/101098-revised-PUBLIC-CBR-Report-November-2015.pdf.

cutting off access to finances" and "isolating communities from the global financial system"[4]. Additionally, an IMF report from March 2017 indicates that small countries with low volumes of transactions in Europe, Central Asia, the Caribbean, Africa, and the Pacific Islands have experienced increased costs for remittance transfers.[5] These impacts have direct financial implications for individuals and businesses operating in these markets.

Decrease in Transparency

Beyond the direct financial impacts, it has been cautioned by the World Bank[6], the Financial Action Task Force[7] and other groups that de-risking may unintentionally drive financial transactions underground or into shadow markets resulting in a reduction in overall transparency. If money is removed from the international financial system and transferred into unregulated channels, it becomes much harder to detect and monitor, and the risks of money laundering and terrorist financing in turn increase. It is well documented that channels with a low likelihood of detecting illicit activity, such an unregulated industries, are the channels more frequently used by money launderers and terrorist groups for movement of funds. As regulated entities, banks have higher likelihood of detecting illicit activity. Thus, keeping funds within the financial system maintains transparency and improves the likelihood of detecting illicit activity overall.

Long-Term Impacts

There has been a decline in the practice of de-risking over the last few years, with most of the termination of relationships having occurred between 2012 and 2015. Yet, the effects of those earlier practices remain. In the last 6 months alone, myself and my team have met with regulators and financial institutions in dozens of countries across Europe, Latin America, the

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[4] Durnan, Tracey and Shetret, Liat. Global Center on Cooperative Security. *Understanding Bank De-Risking and its Effects on Financial Inclusion,* 2015. https://www.oxfam.org/sites/www.oxfam.org/files/file_attachments/rr-bank-de-risking-181115-en_0.pdf.

[5] International Monetary Fund. *Recent Trends in Correspondent Banking Relationships*, 2017. https://www.imf.org/~/media/Files/Publications/PP/031617.ashx.

[6] International Finance Corporation. *De-Risking and Other Challenges in the Emerging Market Financial Sector*, 2017. http://documents.worldbank.org/curated/en/895821510730571841/pdf/121275-WP-IFC-2017-Survey-on-Correspondent-Banking-in-EMs-PUBLIC.pdf.

7 Financial Action Task Force. *FATF Takes Actions to Tackle De-Risking,* 2015. http://www.fatf-gafi.org/publications/fatfrecommendations/documents/fatf-action-to-tackle-de-risking.html and http://www.fatf-gafi.org/documents/news/rba-and-de-risking.html.

Middle East and Africa. These countries and institutions continue to struggle to reconnect to the international financial system. And for those who are able to do so, they are often subject to higher fees and increased due diligence by their correspondents – leading to higher costs of doing business. Furthermore, the loss of correspondent banking relationships can create a long-term stigma. For example, rating agencies have started to consider loss of correspondent banking relationships as a factor for downgrading the rating of a financial institution[8]. These long-term impacts should not be ignored.

A Way Forward

With de-risking and its drivers receiving much attention over the last few years, both public and private sector players have presented potential solutions. A sustainable solution, however, will require a change in the overall cost benefit analysis for correspondents in high risk markets. This could be achieved by lowering costs and regulatory risk vis-a-vis the revenue potential of high risk business. Some possible approaches that could help enable this include the following:

First, greater sharing of risk information to improve overall transparency. Current due diligence practices require individual correspondents to collect information on a respondent from multiple data sources, keep that information up to date throughout the course of a relationship, monitor any changes in that information and then make assessments of what that information means about risk. The burden of these practices cause correspondents to overlook potential relationships and, rather than incur the time and cost to understand *individual entities*, make wholesale decisions based on *country risk*. Furthermore, given that correspondents typically share customers, the practice whereby each bank individually collects and assesses the available information results in industry wide redundancies. Greater information sharing – between both the public and private sector – improves information availability and transparency, which is a starting point to reducing the compliance burden.

Second, use of third-party providers of independent, standardized assessments of a respondent's compliance with global standards. The compliance burden can be further

8 International Monetary Fund. *Recent Trends in Correspondent Banking Relationships*, 2017. https://www.imf.org/~/media/Files/Publications/PP/031617.ashx.

reduced through the use of standardized, independent third-party assessments of potential respondents' risk and compliance with international best practice. An independent assessment could serve as a baseline for a correspondent to enter into a relationship, thus reducing much of the upfront and ongoing diligence processes. This would result in cost savings and greater efficiencies across the industry. Furthermore, use of standardized assessments would provide institutional comparability across jurisdictions for use by governments, as well as, financial institutions. This increased visibility into the risk and compliance practices of particular institutions would also allow for better allocation of capacity building resources.

Third, use of technology to lower AML/CFT compliance costs without the fear of regulatory backlash. The use of technology to enable financial institutions to better understand their clients and manage their risk should be welcomed. Permitted reliance on innovative, technology based approaches, under proper oversight of the correspondent, can make due diligence more efficient and cost effective. Establishing channels for regulatory approval and support of innovative, technological solutions for compliance may give correspondents greater comfort in changing their current compliance behaviors and re-evaluating their risk appetites.

Conclusion

In conclusion, it is in the immediate and long-term interest of the U.S. and the integrity of the international financial system to ensure fast, growing emerging markets stay connected and have access to the dollar. However, it is equally important to protect the integrity of this system. Where there are emerging market institutions who can demonstrate their commitment to complying with international best practice, combating illicit finance and transparency more broadly, we should create avenues for their participation.

Thank you for taking the time to hold this Hearing and for allowing me to share my perspective on this important topic. I look forward to your questions.