The Threat of De-Risking in The Bahamas

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Introduction

Good afternoon ladies and gentlemen.

I would like to thank the executives of the Grand Bahama Chamber of Commerce for inviting me to speak. You have been very patient, as we first arranged this presentation two weeks ago, but had to reschedule because of the uncertainty surrounding the weather and what eventually turned out to be Hurricane Hermine.

Today, I am going to speak on the topic of de-risking. I will focus on the origins of this phenomenon, the impacts and implications for our financial system and on how we can all act to mitigate its effects.

As to the outline of the presentation, first I will give you an overview of the correspondent banking model—integral to this topic—and then discuss key international drivers behind the current trends. I will also look at the implications for our jurisdiction, give some insights on how the Central Bank has been engaged in various international forums on this issue, and then discuss both what we are doing to tackle matters from a strategic and policy perspective. You will hear me raise in this regard, the importance of reforms to achieve more formal integration of all economic actors into our financial sector—with appropriate risk-based safeguards—as well as touch on the importance of strengthening the information trust bonds between banks and their customers.

I hope that my remarks will inform even more constructive national dialogue on this topic. This is an emerging and evolving issue that affects us all. If we react appropriately, there would be no cause for panic.

Defining De-Risking

When we speak of de-risking in a banking context, it means that the institutions have purposely stopped providing certain services to subsets of their clients, because they determine that the risk or potential costs of providing such services outweigh the returns, or the benefits of providing the services. In the case of correspondent banking it has taken many forms:

- Some banks have exited the business all together
- Some have ceased to offer the service in either in some sectors, some countries or certain regions
- Some have terminated the services on a client by client basis
- Some have modified or restricted the terms of services that they continue to provide

The Role of the Correspondent Bank

What purpose do correspondent banks serve?

Correspondent banks accept deposits from other banks, called respondent banks. The respondent banks write checks or make wire payments against these deposits to settle international or other payments—which could include payments on behalf of ultimate customers. The flows includes those for international goods and services, foreign investment financing, or transfers of deposits from one location to another. Even a credit and debit card payment settlements could be involved if they have to be routed through intermediate channels before they reach their intended payee.

Ordinarily, correspondent banks would deploy any idle deposits of the respondent banks to earn short-term returns either in the money markets or other settings. They could also earn fees from processing flow-through payments. These all speak to the returns or rewards from this business model.

The risks in the correspondent relationships are in part of a regulatory and compliance nature. These entities have to guard against being used as channels for illicit activities such as money laundering and terrorist financing. When there are regulatory violations, and depending on the severity, banks can face sanctions of varying degrees, some civil in nature and others criminal. Convictions for criminal offenses can even result in imprisonment for bank officers. There is also the potential damage to the reputation of banks from having any such violations publicised.

These risks are made more acute because of the intermediary role that correspondents play, relative to the downstream clients of respondent.

Origins and Consequences of "De-risking"

Now we can begin to discuss how the risk and reward in the correspondent banking environment have changed, with seemingly disproportionate impacts on certain jurisdictions such as in the Caribbean, Africa, parts of Latin America and the Pacific.

De-risking has been a response to regulatory compliance factors, as well as the state of the global economic environment.

First on the return side, the correspondent banking model has become less profitable given the generally low and often negative interest rate environment, in which holding excess deposits offer limited or no prospect for positive returns. Returns have also been squeezed from more demanding capital and liquidity standards for large bank—otherwise justified prudential enhancements to make the financial system less vulnerable to future crises.

Next, more stringent anti-money laundering (AML) and combating the financing of terrorist (CFT) initiatives, which stress the concerted global effort to deter the use of the financial system for criminal purposes have added significant compliance costs. Moreover, the penalties tied to AML/CFT breaches or deficiencies are often assessed as being excessive when measured against the return prospects generated in certain markets.

It is in the case of AML/CFT risks that The Bahamas and the region have been particularly impacted. In some instances respondent banks have not been able to preserve correspondent relationships, even with voluntary offers to pay higher fees for the facilities. Such incidences have affected both indigenous and international banks.

In the Caribbean region, we continue to believe that the assessment of the risks which our jurisdiction pose to the outside world is based on exaggerated perceptions about weaknesses in the standards being observed. Also, being labeled as "offshore" centre has been judgmentally damaging, as regard perceptions about the transparency of regulatory systems in place.

The Bahamas' Experience

The evidence on de-risking that is being accumulated is shedding more light on the contours of the problem. In the summer of 2015, the Central Bank obtained survey feedback from 53 banks and trust companies on how they were being affected. Here are some highlights:

- Impacts were felt mainly within standalone banks (local and international)
- At least 6 banks had lost a relationship—even though they were able to find replacements under heightened scrutiny and additional reporting requirements
- Four banks confirmed impacts on some aspect of their remittance services
- Relationships were primarily terminated by US and Canadian correspondent banks
- Most respondents operated with less than 3 correspondent banks
- Formal contingency planning around how to address the loss of a correspondent banking relationships was not widely in place

These trends mirror what is happening in other affected jurisdictions, although not on the same level of severity in some such territories. Still the pattern is often one in which respondent banks have only managed to preserve their correspondent relationships at significant added costs. Among other outcomes, some have faced new minimum activity thresholds (below which the account is closed), higher due customer diligence costs, and sometimes pressures to limit their exposure to certain categories of customers.

The Central Bank is now compiling the results from a follow-up survey, conducted in July and August of 2016 to assess how the landscape has changed. More specific information is being requested on the adjustments that have been made within financial institutions, and more feedback is being solicited on contingency planning.

Why De-Risking is a Concern

The concerns about de-risking arise on a number of levels.

First, as an international financial centre, we want to ensure that stand alone operations remain viable as business structures, so that The Bahamas can continue to earn economic benefits from this sector. To deflect the threats to the sector we have to tackle the misperceptions about the regulatory quality and transparency of our regime. The Bahamas' has a documented record of increasing regulatory cooperation and transparency, including under a significant number of tax information exchange agreements. This jurisdiction is also committed to implementing enhanced information sharing arrangements under the common reporting standards of the OECD's Global Forum and the regulators are continuing to deploy strategies to improve the AML/CFT regime.

The concerns about potential adverse effects on our domestic financial system and the economy are also noteworthy. Similar to the stand alone international banks, our indigenous banks are also more vulnerable, because they start out by having less access to independent global banking networks. Indigenous banks often serve niche markets overlooked by foreign banks. Their viability impacts the access of such niche customers to financial products and services.

Limited or encumbered international banking arrangements could undermine the ease of doing business. Such encumbrances would impede foreign currency payments for a variety of external transactions. Our economy also depends on a large community of expatriate labour, for whom the cost and ease of repatriating their income could be called into question.

Response from the Global Regulatory Community

It is fair to say that global attention to such threats is increasing, even though the countries and regions that are at risk have rallied for much swifter action. The force of the advocacy has increased, thanks to the work of multilateral organisations such as the IMF, World Bank and the Commonwealth Secretariat that have drawn more attention to the unintended negative consequences particularly on the poor in developing countries.

From the international regulatory perspective, there is now increased emphasis on clarifying guidance provided on the global standards that should apply for AML/CFT systems, which ought to stress risk-based deterrence. There is, however, still some gap that has to be closed in terms of how financial institutions interpret what needs to be done to adjust their risk and compliance systems, given very punitive sanctions and enforcement regimes.

Regulatory bodies that are active in trying to respond include the following:

- The Financial Stability Board (FSB)
- The Basel Committee for Banking Supervision (BCBS), which is a body connected with the Bank for International Settlements (BIS)
- The Committee on Payments and Market Infrastructures (CPMI), also connected with the BIS
- The Financial Action Task Force (FATF), the principal global body overseeing the development and implementation of AML/CFT standards

- (and the less heard of) Legal Entity Identifier Regulatory Oversight Committee (LEI ROC), which focuses on developing common international standards for uniquely identifying business enterprises

Among these bodies the work is centred on providing clearer guidance in areas such as the following:

- The kinds of due-diligence systems that financial institutions should have in place to gauge their exposure risk to illicit financial flows
- How risk quantification could vary according to the jurisdiction where the flows originate or terminate
- How risk quantification could relate to the nature of information on the identity and character of the parties involved in the transactions

These and other factors distill in large measure the "know-your customer" (KYC) systems that banks must have in place. They also more recently stress knowing the customers of the clients, or "KYCC".

This process has been iterative, particularly in terms of the consultative framework used by the FATF and the committees connected with the BIS. There has also increasing input and response from national regulatory agencies, such as the US Treasury Department and Justice Departments.

None of these agencies advocate termination of banking arrangements as the first line of defense against possible risk exposures. They stress risk mitigation. But the risk-based approach can lead to precisely some of the outcomes that are occurring—not just enhanced due diligence but also the severing of relationships.

The Regional Reponses

Jurisdictions, banks, individuals and firms that are on the receiving end of these processes, effectively have to adapt and be able to demonstrate that they do not pose unmanageable risks to their correspondent or other banking relationships. That is the position in which we are now.

The advice we receive from the international community is that we should improve safeguard and enforcement systems; make them more transparent and take advantage of technical assistance, where possible, to make improvements. While there is always room for improvement, we have rightly pushed back, because of false perceptions that also feed into the profiling of our risks. There is indeed a documented track record throughout the Caribbean of improvement in our systems of deterrence, transparency and cooperation.

Accepting that there is a perception issue as well, The Bahamas along with the rest of the Caribbean have also been vocal in asking our global counterparts to be more forthcoming in identifying where counterparts still see gaps that need to be closed in our AML/CFT systems.[1]

Aside from the concerted interventions at the political level in the Caribbean, regulators, starting with the group of central bank governors and senior bank supervisors have been engaged in broad stakeholder dialogue which have brought together in the same forum the members from the Regional Consultative Group of the FSB, US Regulators (including the Treasury and Justice Department), Canadian and US correspondent banks, and Bahamian regional commercial banks. These have helped to promote common understanding and, particularly, to spotlight the compliance challenges which correspondent banks face, relative to scrutiny received from their own regulators.

Regionally, it has also meant exploring what feasible alternatives exist. It is fair to say that pooling our transactions through an alternative regionally established correspondent bank would have limited success, if the actual or perceived risks are not directly addressed. Hence there has to be direct inward attention to raising our AML/CFT systems to uniformly higher standards. From a distance, relative deficiencies in any single jurisdiction could still generalise to being associated with the jurisdictions as a group.

Policy Responses and Imperative for The Bahamas

Inside the Bahamas the Central Bank has been active providing AML/CFT guidance to its licensees. In 2015, the Bank issued amended guidance notes, stressing the risk-based mechanisms which licensees ought to continue to perfect. These include the necessary due diligence in documenting the ultimate beneficiaries behind financial transactions and corporate vehicles, and further stress in client relationships on identifying the source of income and wealth of clients.

In terms of other reputation enhancing initiatives at the national level, there is an opportunity for further gains in terms of how we leverage strengths already identified in our AML/CFT regime coming out of the latest mutual evaluation that has been done by our regional peers. This assessment of The Bahamas is expected to be unveiled later in 2016. It will provide a yardstick against which further improvements can be made.

The Bahamas' national risk assessment (NRA) on money laundering and terrorist financing exposure will dove-tail with the regional peer assessment. The NRA will unveil a sector by sector approach to improving our AML/CFT system, and underscore the

[1] The US Treasury Department has actively been providing TA to requesting countries. The IMF, IDB and other multilateral organizations are also preparing to play some role in proving TA.

work-streams of each of the regulatory and enforcement agencies. Those agencies include the Royal Bahamas Police Force, the Office of the Attorney General, the Gaming Board, the Financial Intelligence Unit, Securities Commission, Compliance Commission, Insurance Commission, and the Central Bank.

The Central Bank's Policy Agenda

We will also have to promote changes in other areas of our society and economy. This includes policies to reduce the prevalence of cash-based activities; as such transactions are harder to trace, and more susceptive to being infiltrated by criminal elements. We also need to regularize un-banked activities and un-banked persons, having them more integrated into the financial sector.

The Central Bank is equipped to play a role in these respects, and has already incorporated such targets into its policy work agenda.

We have identified accelerated development of the payment systems as a priority. Work is underway to finalize the regulations for e-payments and mobile money, which would contain risks from external disruptions to domestic e-payments and promote more non-cash forms of transactions.

We are also putting more emphasis on the promotion of financial inclusion, through appropriate reforms either already within the scope of our regulatory mandate or through appropriate recommendations to the Government. We can promote financial inclusion by striving for more universal access to banking and banking services. This is true for documented and improperly documented persons within our borders. It is also true of licensed web-shop based or licensed web-shop linked operations.

In the case of web-shop activities, the Central Bank will work closely with the Gaming Board to promote comprehensive understanding of the adequacy of AML and compliance systems within the sector, and provide this exposure to the compliance units within local licensees. While the decision of who should be provided with services is still up to each bank, the Central Bank can ensure that the mutual exposure that is needed for both our licenses and gaming industry is facilitated, so that such outcomes can be driven by facts as opposed to anecdotes.

Embracing Change within the KYC Environment

Up to this point I have not said much about how enhanced AML/CFT regimes affect businesses that are already integrated into the formal financial system. For these enterprises it is the oft dreaded enhanced KYC due diligence procedures that bankers follow that cause angst. Understand that these are risk-based and that the gauging of risk is often related to the amount of disclosure that the proprietor/establishment might voluntarily or otherwise be able to share with their banker. Depending on the line of business undertaken by the proprietor/establishment the banker may also be curious on the profile of establishment's clients. Also depending on the size, frequency, currency denomination, origin or destination of funds passing through the account, the banker may periodically be compelled to undertake enhanced diligence of the proprietor or establishment.

Our system is designed to protect confidentiality in the context of legal and legitimate business transactions. Even within the confines of such privileges, reliable information about transactions and the customer profiles may need to be shared with intermediary institutions. Trust and openness in such exchanges is important. The banker might seem to be overly inquisitive, but it is precisely to safeguard the legitimate financial channels through which commercial transactions must be conducted.

Conclusion

It is not expected that the regulatory policies that drive the de-risking phenomenon will dissipate. Instead we are headed towards fostering better understanding among global regulators and stakeholders; towards adapted and more informed compliance mechanisms and likely towards a permanently reduced footprint for correspondent banking operations. Once the perception gap is closed, our institutions will remain under intense scrutiny. While this is may be a new reality, there are strategies that The Bahamas can implement to reduce uncertainty and, in the process, make our regulatory system more robust.