FRESH IDEAS ABOUT BUSINESS IN EMERGING MARKETS
EM Compass

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Increased Regulation and De-risking are Impeding Cross-Border Financing in Emerging Markets

Correspondent banking relationships connect banks and people across borders and are critical to finance and trade. They are a vital link between emerging markets and the broader global economy. Yet efforts to combat money laundering and the financing of terrorism have increased compliance requirements for banks. Difficulties adhering to these requirements and increased costs associated with them threaten the ability of banks to serve their customers, while also eroding the number and quality of correspondent banking relationships. A recent IFC survey shows that many banks are feeling the pressure of increased regulation and de-risking, and emerging market banks are bearing the brunt of it.

Banks enable virtually every part of a market to function by facilitating the availability and the formal transfer of money. Correspondent banking, the channel through which banks provide payment services and foreign currency settlements to each other, represents a vital link that connects local firms and citizens to the global economy, giving them access to new markets and foreign exchange. Correspondent banking also supports remittances, a major source of income for many families.

Research has shown that efficient and competitive financial flows bolster economic growth and bring additional people into the financial system in a formal and transparent manner.[1] However, when transactions go unmonitored, it can create financial systems that are rife with illicit activity.

De-risking

In the wake of the 2007-2008 financial crisis, global banks have faced a combination of challenges that have changed their decision-making calculus. There is greater complexity in the global risk environment with significant geopolitical dynamics, as well as concerns about the use of the financial sector to finance terrorism and launder money.

According to the Financial Action Task Force on Money Laundering (FATF) and the Wolfsberg Group, "de-risking" refers to financial institutions terminating or restricting relationships with customers to avoid risk. Changes in capital reserve requirements have contributed to financial system resiliency, but have also limited the amount of capital banks have to invest in cross-border banking relationships and their customers. The introduction of new international banking standards under Basel IV could exacerbate this development.

Greater efforts to bolster anti-money laundering (AML) efforts and to combat terrorism financing (CFT) have been consequential. FATF has proposed global standards for AML and CFT that follow a risk-based approach that allows banks more flexibility to develop their own risk assessment and response processes and procedures to identify and address money laundering and terror financing risks.

These international standards are then implemented at the national and sometimes subnational level, with each country interpreting and adapting them to local conditions. Emerging market banks are subject to the resulting ambiguity, as well as variance and inconsistencies between jurisdictions. These often leave banks to absorb, manage, and apply regulations that deliver a significant set of complexities.

These shifts in the compliance landscape may help combat money laundering and terrorism, yet they also increase

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costs for many banks in multiple ways. Improvements in customer due diligence are undeniably beneficial to financial system stability, but the increased risk of large penalties for violations has created a new class of "compliance risk" that must be managed.

This compliance risk raises costs for financial institutions in four areas. First, the threat of penalties raises the potential cost of cross-border exposure. Second, the additional scrutiny of some banks' customers raises costs, particularly for adding new customer relationships or markets. Third, a lack of harmonization in compliance requirements raises costs as banks seek to understand and apply requirements across jurisdictions. Fourth, there are situations where regulations are changing on a monthly or even weekly basis. As banks spend more on compliance, the typically lower-margin correspondent banking business line is more vulnerable to supply pressure. **Thus, de-risking threatens to inhibit critical financial flows into smaller and poorer markets.**

Money transfer organizations (MTOs) are struggling to offer their services, as they rely on correspondent banking to move funds across borders. The importance of MTOs to a financial sector is amplified in some jurisdictions, including small countries, where there are a limited number of banks in operation. MTOs support remittances and international wire transfers, among other person-to-person transactions, which both families and non-governmental organizations rely on to gain access to finance needed for critical aspects of aid, assistance, and basic goods critical to survival.

Bank-intermediated trade finance, which supported more than $6 trillion of global trade in 2013, is vulnerable to declines in correspondent banking relationships.[2] There is already a considerable gap between trade finance demand and supply: Financial institutions have been unwilling to provide $1.4 trillion in trade finance,[3] which threatens global economic growth by disrupting trade and financial flows that move through banks affected by the loss of correspondent banking relationships.[4]

Increasing concerns over banks' capacity to settle in U.S. dollars, combined with increasing transaction times or costs for U.S. dollar settlements, raises the costs of cross-border capital account flows, including most forms of portfolio flows, foreign direct investment, and cross-border bank lending based in U.S. dollars, euros, or other currencies.

Ultimately, de-risking has the potential to impact many cross-border banking activities, particularly those underpinned by correspondent banking relationships (CBRs). De-risking can limit the contribution that banks and financial systems can make in strenthening a country's stability and macroeconomic growth, as financial sector development matters for economic development and poverty reduction.

De-risking effects on emerging market banks

Survey findings suggest that the drivers and effects of de-risking are subtle, complex, and pervasive. Results show that emerging market banks in countries at all stages of development are at risk of being de-banked, due to compliance ambiguity and correspondent-banking relationship stress. In fact, all 450 segments—regions, poorest countries, fragile country states, World Bank income classes, oil exporters, investment grades, GDP levels, total imports, percentage of imports to GDP, bank assets, bank customers, bank equity, and bank risk rating—of IFC's 2017 report face difficulties in correspondent banking. Such difficulties potentially separate people, businesses, and eventually entire countries from access to critical aspects of cross-border finance.

Seventy-two percent of banks globally and 80 percent of banks in Sub-Saharan Africa are noting the impact of external impediments. These findings suggest that a diminished ability of banks to serve their customers is a widespread phenomenon.

SURVEY
92 markets, over 300 banks, $5 trillion in assets

In 2017 IFC launched a survey, capturing responses from client banks in 92 emerging market countries to gather quantitative and qualitative data on the impact of de-risking. Results were detailed in this 2017 IFC report: Starnes, Susan, Michael Kurdyla, Arun Prakash, Ariane Volk, and Shengnan Wang. 2017. "De-Risking and Other Challenges in the Emerging Market Financial Sector: Findings from IFC's Survey on Correspondent Banking." IFC, World Bank Group, Washington D.C.

Over 300 emerging market banks representing combined assets of nearly 5 trillion responded to the survey. According to an IFC extrapolation from Moody's and IMF data survey participants represented approximately 10 percent of emerging market banking assets and approximately 30 percent of assets in Sub-Saharan Africa.

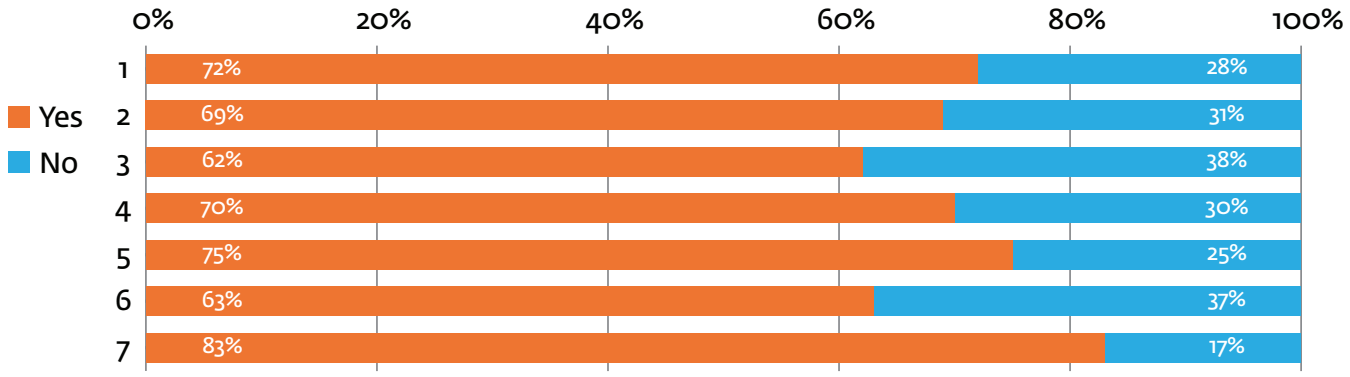

FIGURE 1 Banks reported that external challenges hindered their ability to serve customers

Source: Susan Starnes, Michael Kurdyla, Arun Prakash, Ariane Volk, and Shengnan Wang, 2017, "De-Risking and Other Challenges in the Emerging Market Financial Sector: Findings from IFC's Survey on Correspondent Banking," IFC, World Bank Group.

Challenges limit EM banks' ability to serve customers

Banks faced challenges that decreased their ability to serve customers in 2016. The most frequently cited driver for a reduction in banks' ability to serve their customers was compliance requirements, followed by correspondent banking stress, and market competition and prices. A quarter of banks faced more than three challenges, and 12 percent faced five or more challenges.

Banks are adapting their offerings in response

Banks noted a multitude of adaptations made in 2016 to adjust their business models in response to a changing environment. The two most common adaptations were a reduction to or limits on overall customer lending, and increased rates or fees charged to customers. Others reported reductions in the number of customers served, of which importers and exporters were most severely hit.

More than a quarter of survey participants noted that the number of their active CBRs in 2016 decreased. More than 20 percent of banks in all regions except for South Asia saw a decline in CBRs, which is a material difference from bank experiences in prior years. Across regions, Sub-Saharan Africa, Latin America and the Caribbean, and Europe and Central Asia reported declining correspondent banking networks with the greatest absolute frequency.

Regions that had relatively lower frequency of reported CBR reductions still reported different and significant challenges regarding both compliance and CBR stress. This reflects the complexity of this broader challenge on a global scale.

Compliance costs continue to rise

Despite significant investment in AML/CFT systems and processes in 2016, banks expect compliance costs to rise substantially in 2017. Along with their global peers, most emerging market banks are tackling several compliance issues. These include expensive implementation of software or system upgrades; limitations in customer information; a lack of harmonization in global, regional and local regulatory requirements; variable data requests from multiple cross-border correspondent banks; and a shortage of training or knowledgeable staff.

Regulatory challenges contribute to growth obstacles

The survey also offers insight into more general barriers to business growth overall in the current global environment, beyond obstacles related specifically to compliance.

When asked to identify general growth barriers (beyond compliance and correspondent banking stress), regulatory requirements and costs were still the second most common challenge globally. Institutions in low- and lower-middle-income countries were more likely to report regulatory driven growth challenges than those in high-income countries. It is noteworthy that banks that face regulatory challenges are often already dealing with business environments that have difficult macroeconomic conditions, internal business barriers, and intense market competition. One-quarter of all banks indicated that the implementation and/or costs of international or domestic regulations regarding compliance or capital reserve requirements represented a significant barrier to business growth.

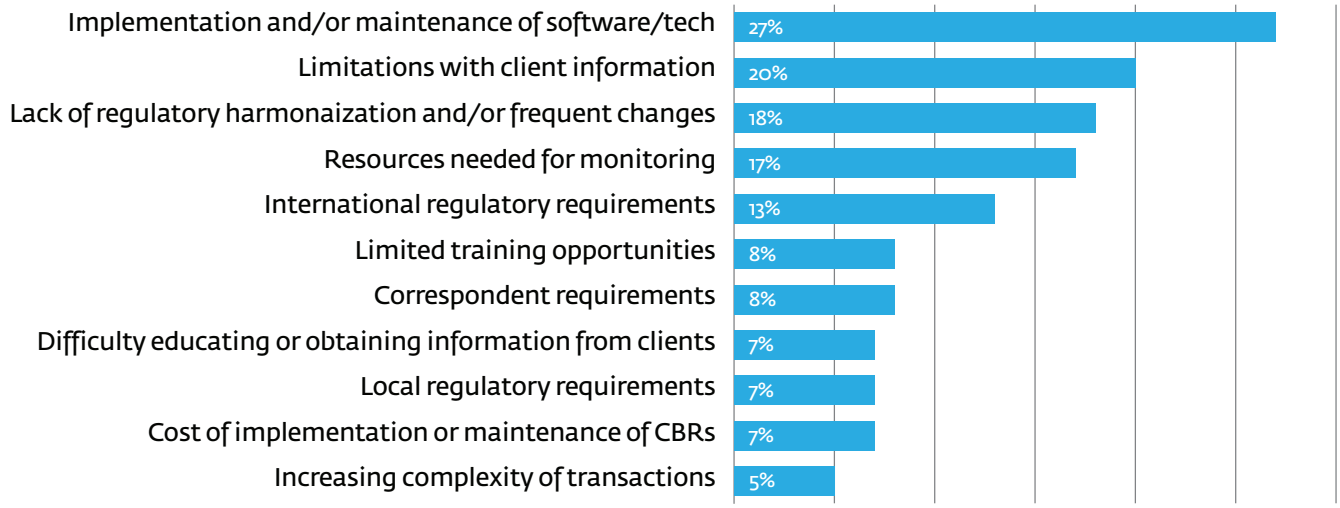

FIGURE 2 Most challenging aspects of AML/CFT/KYC implementation

Source: Starnes et al., 2017, "De-Risking and Other Challenges in the Emerging Market Financial Sector: Findings from IFC's Survey on Correspondent Banking," IFC, World Bank Group.

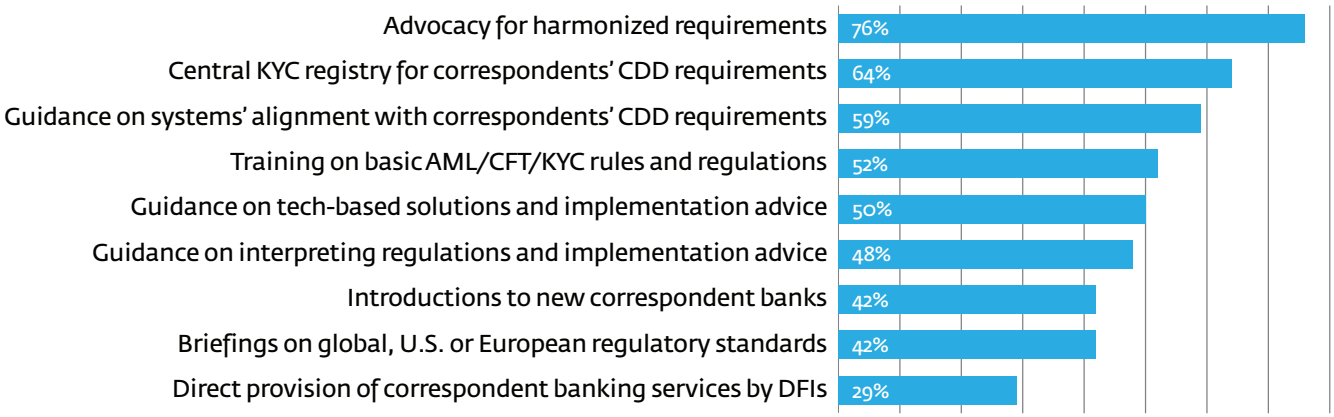

FIGURE 3 Banks identified compliance-related solutions that could help them grow

Source: Starnes et al., 2017, "De-Risking and Other Challenges in the Emerging Market Financial Sector: Findings from IFC's Survey on Correspondent Banking," IFC, World Bank Group.

Systems and technology are among the most challenging aspects of regulatory implementation

IFC asked its emerging market bank partners about the most challenging aspects of their compliance efforts. Most prominently, systems and technology implementation were a concern, which underlines the need for advanced and accessible technology for banks. The most frequently mentioned challenge was implementation or maintenance of software and technology required to monitor for compliance or lack of automation in this area. Several banks indicated they were in the process of implementing formal compliance reporting and/or systems and noted that, in the absence of these systems, they were required to manually verify customer identities. Banks in Latin America and the Caribbean and Middle East and North Africa were particularly concerned about software and technology implementation.

Incomplete or inadequate customer information was the second most commonly cited aspect across all participants. Many banks operate in an environment where there is no centralized database to validate customer identities or national data privacy laws that limit information sharing between regulators and banks. In some countries, formal client addresses are not as common as in more advanced economies. This complicates the fulfillment of regulatory requirements. In addition, legal and financial architecture gaps make it more difficult and time-consuming to identify the corporate ownership structures and, thus, the ultimate beneficial owners.

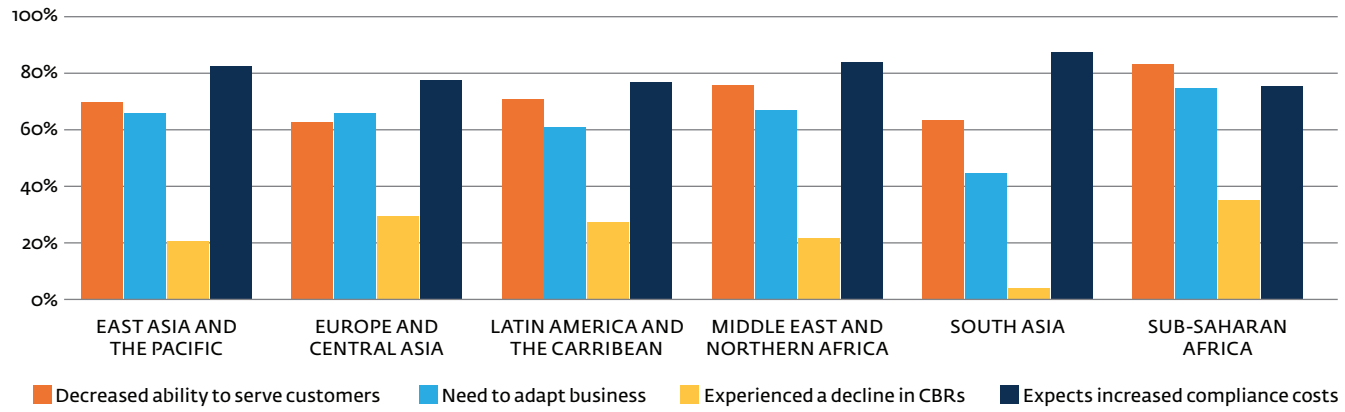

FIGURE 4 Challenges described by banks vary by region

Source: Starnes et al., 2017, "De-Risking and Other Challenges in the Emerging Market Financial Sector: Findings from IFC's Survey on Correspondent Banking," IFC, World Bank Group.

A lack of adequate and sequential numbering of residences and businesses, along with the problem of verifying identities and addresses, compound the issues with monitoring compliance risks and responding to correspondent banks' compliance-related queries. The complexity of customer due diligence required by correspondent banks increases transaction processing time, which deterred customers or limited respondents' ability to process entire classes of transactions. The lack of regulatory harmonization between banks and countries represented a significant compliance hurdle, together with frequent changes in legislation. Regulatory differences across jurisdictions have resulted in cases where requirements in one country are in direct conflict with those in another. This creates confusion for banks.

In addition, early adopters of regulatory change face a form of "regulatory arbitrage," as customers abandon banks for competitors rather than bear more stringent reporting requirements and the higher service costs associated with them.

Notable regional differences emerge

Sub-Saharan Africa appears to be facing the greatest challenges overall, along with the Middle East and North Africa, Europe and Central Asia, and Latin America and the Caribbean. Among all regions, Sub-Saharan African banks most often reported a decreased ability to serve their customers, the need to adapt their businesses, and a reduced capacity to meet customers' requests for international banking services (Figure 4). However, the data show that every region faces its own set of challenges.

While countries of all sizes and risk levels are affected, certain subgroups of respondents appear more vulnerable.

We note increased concern over smaller economies, import-dependent countries, and countries with lower income per capita, as well as relatively smaller (but still creditworthy) financial institutions and importers/exporters.

Even regions that appear to have fared better, such as East Asia and the Pacific and South Asia, indicate that their offerings are not keeping pace with increasing demand. In East Asia, Europe and Central Asia, Latin America and the Caribbean, and Sub-Saharan Africa, banks more frequently reported increased demand than increased capacity to meet that demand. Furthermore, individual respondents from South Asia also highlighted challenges with throughput speed of transactions and a higher percentage of transaction refusals with correspondent banking counterparts, despite the maintenance of open lines.

While much of the research to date has focused on smaller or more "at-risk" markets, these survey results make clear that the challenges associated with both correspondent banking and compliance are pervasive. Solutions need to help financial sectors across all emerging markets shore up their capacity to serve their customers as well as their capacity to meet the growing demand for international banking.

Banks need harmonization, advocacy and support

To help manage some of the potentially detrimental consequences of compliance regulations on cross-border banking, IFC asked banks which actions that address de-risking would be most valuable to emerging market financial institutions. Three responses stood out.

First: Over three-quarters of respondents said that advocacy for harmonized regulations across jurisdictions would be helpful. Emerging market banks are clearly

looking to international organizations to advocate for their interests and voice their concerns before global regulatory bodies. This was the most frequently requested solution for banks in every global region except South Asia, where banks expressed greatest interest in advice on financial technology, or fintech.

Second: Nearly two-thirds mentioned a centralized registry for due diligence data. Emerging market banks note that they have to devote more and more resources to managing information requests from correspondents due to the high frequency, irregularity, and significant differences in requests from correspondent to correspondent. Building a central registry to hold respondent data, applying a standardized format to that data, and ensuring that the data is regularly updated would reduce the reporting burden faced by many respondents and make it easier for correspondents to assess the risks of doing business with them and facilitate the development of new correspondent-banking relationships.

Third: Assistance with understanding and adapting to new standards was high on the list of actions that would be helpful for banks. Respondents in emerging markets would benefit from training about the current requirements and how to interpret rules and regulations. Awareness and understanding of compliance expectations of local regulators in the markets in which they operate would also help respondent banks continue to support their customers with international banking services.

Conclusion

Banks in all corners of the world are vulnerable to having their cross-border banking connections severed. Emerging market banks are bearing the brunt of opaque regulatory guidance and disharmony in regulatory application. This can be harmful for banks and weaken economies. Failed or sluggish correspondent banking slows business growth, keeps people poorer longer, weakens links to the global financial system and markets, and disrupts the connections that countries desperately need.

Regulators need to address the web of regulatory applications that emerging market banks face—by clarifying those applications at the national and bank level, by synchronizing regulations across jurisdictions, and by making client information readily available through potentially national, regional, or global registries. Further, emerging markets need a consistent, systematic advocate, e.g., development financial institutions (DFIs) to ensure their voices are heard when global decisions are made.[5]

Competent and properly focused regulation is a must for a healthy financial sector, and recent efforts to strengthen the global financial system will ultimately contribute to greater financial stability and a safer world. However, the de-risking that has accompanied these efforts threatens to undermine economic stability and growth, financial inclusion, and poverty reduction.

Those best placed to address this challenge—through regulatory adjustments, funding, capacity building, knowledge sharing, and technological innovation—are rising to the occasion. The intention was never to hinder growth or harm the most vulnerable. The G20, along with many multilateral bodies, has worked to understand and address the challenges created. But the solution is not yet complete. ■

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[1] Lowery, Clay, and Vijaya Ramachandran. 2015. "Unintended Consequences of Anti-Money Laundering Policies for Poor Countries." Center for Global Development, CGD Working Group Report. https://www.cgdev.org/sites/default/files/CGD-WG-Report-Unintended-Consequences-AML-Policies-2015.pdf.

[2] Per estimates by Bank for International Settlements (BIS).

[3] WTO. 2016. "Trade Finance and SMEs: Bridging the Gap in Provision." World Trade Organization. www.wto.org/english/res_e/booksp_e/tradefinsme_e.pdf.

[4] As outlined in EM Compass Note 25, "De-risking by Banks in Emerging Markets: Effects and Responses for Trade," by Susan Starnes, Michael Kurdyla, and Alex J. Alexander, IFC, November 2016.

[5] See also proposed solutions that can be found in this op-ed by Philippe Le Houérou. 2017. "Financial abuse curbs weigh on emerging markets", Financial Times, ft.com, September 7, 2017.

Please also refer to EMCompass Note 22, "Mitigating the Effects of De-risking in Emerging Markets to Preserve Remittance Flows," by Vijaya Ramachandran, on how de-risking is a threat to the poorest, and EMCompass Note 24, "De-Risking by Banks in Emerging Markets–Effects and Responses for Trade," by Susan Starnes, Michael Kurdyla, and Alex J. Alexander, on how trade finance in emerging markets suffers from de-risking, as well as the IFC 2017 Correspondent Banking Survey: Susan Starnes, Michael Kurdyla, Arun Prakash, Ariane Volk, and Shengnan Wang (2017): "De-Risking and Other Challenges in the Emerging Market Financial Sector: Findings from IFC's Survey on Correspondent Banking," World Bank, IFC, Washington, D.C.

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IFC, a member of the World Bank Group, is the largest global development institution focused on the private sector in emerging markets. Working with more than 2,000 businesses worldwide, we use our capital, expertise, and influence to create markets and opportunities in the toughest areas of the world. In FY17 we delivered a record $19 billion in long-term financing for developing countries, leveraging the power of the private sector to help end poverty and boost shared prosperity. For more information, visit www.ifc.org.

As the largest private sector development institution in the world, IFC has built strong relationships with financial institutions, real-sector companies, government officials, and representatives of regulatory bodies throughout its 60-year history. To contribute to the global dialogue, identify solutions for the challenges presented by de-risking, expand financial inclusion, and ultimately increase its impact on financial sector development, IFC harnessed its global client network to collect data and capture the experiences from a broad set of private-sector emerging market banks through the 2017 Correspondent Banking in Emerging Markets survey, and analyzed responses of 300 correspondent banks in 92 countries and markets.