

Remarks By Under Secretary Nathan Sheets At The Center For Global Development

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WASHINGTON – Thank you, Nancy, for your kind introduction and to the Center for Global Development for hosting me. I also want to recognize my friend Clay Lowery for his work steering the CGD’s report, which rightfully poses some tough questions.

In my remarks today, I want to focus first on the important role played by correspondent banks and money service businesses, or MSBs, in supporting economic growth and financial inclusion. I then want to examine what the available data tell us about the evolving interconnectedness of the global financial system, and explore concerns that some of the changes taking place may impede some individuals and businesses from accessing financial services. I will conclude by discussing the steps that Treasury, along with the broader global financial community, is taking to address these issues.

Correspondent Banking and MSBs in the Financial System

At the most basic level, financial intermediation mobilizes funds from suppliers of capital to users of capital. The ability of financial intermediaries – be they banks, MSBs, or other institutions – to carry out this function efficiently and at scale requires broad linkages to other financial institutions and markets.

Correspondent banking relationships serve as important arteries in the circulatory network of the global financial system, through which resources can flow both within and across economies. Banks rely on their correspondent relationships to access financial services in different jurisdictions and to provide cross-border payment services for their customers. These relationships are essential to facilitating international trade, conducting cross-border business and charitable activities, providing U.S. dollar financing, and fostering global economic growth.

Likewise, MSBs – that is, businesses that transmit or convert money – play a vital role in providing financial services worldwide, particularly to populations that have been excluded from the traditional banking sector. To do this, MSBs rely on access to the global banking system.

Let me highlight that MSBs are an important channel for remittance flows. The value of remittances is greater than 10 percent of GDP in over two dozen developing countries – and in nine of these countries such flows total more than 20 percent of GDP. In many developing countries, remittance inflows surpass the level of official development assistance. Last year, the value of global remittances exceeded \$580 billion, with the United States the largest single source. And, importantly, remittances have been shown to be the least volatile class of financial flows.

De-Risking

Against this backdrop, there is a growing concern that some large banks are terminating their correspondent relationships and restricting the access of MSBs to bank accounts. When this issue is raised, the term “de-risking” is often used. While this means different things to different people, I see de-risking as a situation in which a financial institution indiscriminately terminates or restricts broad classes of customer relationships without a careful assessment of the risks and the tools available to manage and mitigate those risks.

What is clear is that banks have reassessed a number of their activities and exposures. As part of this process, some accounts have been closed. There are a variety of factors that influence this process, and the evolving supervisory and enforcement environment appears to be one of them. In my remarks today, I will touch on data collection efforts that are deepening our understanding of how these issues are playing out. I will also discuss efforts by regulators to clarify expectations, and a range of ongoing public-private dialogues that are helping to improve communication between U.S. and foreign financial authorities and market participants.

I see this discussion as involving two core goals: first, our commitment to supporting an efficient global financial system that facilitates the flow of economic resources and supports financial inclusion; and second, a commitment to ensuring the integrity, soundness, and safety of the financial system. These two goals should be viewed as complementary. Financial exclusion and driving people out of the regulated financial system would undermine the integrity of the entire financial sector. It is imperative to find approaches that achieve both of these goals.

What Do We Know: The Data

We know that over the past few years many large banks – in the United States, the United Kingdom, and elsewhere – have reassessed their exposure to correspondent clients and MSBs.

Our ability to effectively address this issue depends on how accurately we understand it. To that end, Treasury is working with multiple international organizations, such as the World Bank, the Financial Action Task Force (FATF), and the Financial Stability Board (FSB) to get greater clarity on the magnitude, breadth, and drivers of the problem. I’m particularly grateful to the World Bank for allowing me to share with you today some results from its recently completed surveys on de-risking, ahead of their official publication.

The World Bank surveys represent an important step forward in both the scale and rigor of data analysis that has been applied to this issue: responses to its survey on the withdrawal of correspondent banking services were received from 91 banking authorities, 20 large banks, and 170 local and regional banks. That said, we should avoid over-interpreting the results, given the limited sample size and the potential response bias.

Roughly half of the banking authorities that responded to the survey indicated that they were seeing a decline in correspondent relationships in their jurisdiction. Three quarters of the large banks indicated that they had reduced the number of their correspondent accounts in recent years. On the respondent side, a majority of local and regional banks reported a decline in the number of their

correspondent accounts, with MSBs and small clients particularly affected. The vast majority of affected banks reported that they were able to find replacements, though often at a higher cost. It appears that this is happening mainly through deeper integration with banks in their region, rather than through global banks.

The findings suggest that the situation varies significantly across geographies. High-risk countries, as well as small jurisdictions hosting significant offshore activities, appear to be the most impacted. The trend seems particularly pronounced in the Caribbean. Some larger economies in Asia and Latin America have also reported experiencing significant to moderate declines.

The findings on money service businesses are based on a more limited set of responses. But the results suggest that de-risking is constraining money remitters' access to banking services in G-20 countries to varying degrees, with account closures reported in certain jurisdictions in North America and Western Europe. The United States is often mentioned as being home to banks that are withdrawing from correspondent relationships.

These surveys are just a first step in improving our understanding of the situation, but they are suggestive of broad trends, and, for the most part, are consistent with what we have been hearing.

What Is Causing Account Closures?

Let me now return to the question of what is behind the reassessment of risk that has driven these account closures. We believe that a number of interrelated factors are at play.

First, and most broadly, we need to consider the economic climate, particularly the effect of operating in a low interest rate environment. Low rates generally tend to erode bank profitability by compressing margins. They also make correspondent banking, which is already a low margin business, less profitable by reducing the interest earned from respondent bank balances.

In addition, the more rigorous capital, liquidity, and leverage requirements introduced following the global financial crisis have appropriately increased banks' cost of holding risk on their balance sheets. Accordingly, the proposition of keeping high-volume, low-return, balance-sheet-intensive business is now less attractive. This has understandably contributed to a reevaluation of risk and profitability by banks across all lines of business.

However, the most frequently mentioned driver of account closures relates to AML/CFT compliance. Banks have raised concerns about (1) the cost of complying with AML/CFT regulations, (2) uncertainty about supervisors' expectations regarding what is appropriate due diligence, and (3) the nature of the enforcement and/or supervisory response if they get it wrong.

Let me address these issues.

Over the last year, Treasury has convened a number of public-private dialogues on this topic. The participants at each of these events have included large banks that had terminated relationships with either correspondent banks or MSBs.

The banks said that they made these decisions not so much because they were unable to manage the illicit finance risks but because the costs associated with taking on those risks had become too high. Beyond the compliance costs narrowly defined, banks also cited reputational risks and regulatory risks, the latter being the possibility that involvement with certain high-risk clients could increase the length, frequency, or intensity of regulatory examinations. These considerations had altered the risk-return tradeoff to such a degree that maintaining these relationships was no longer commercially viable.

There is no question that, in recent years, supervisors have – appropriately – required banks to improve their management of illicit finance risk by upgrading information technology systems, increasing staff and training, and strengthening controls for client onboarding and evaluation. These necessary and constructive developments make our financial system more resistant to criminal abuse, and ultimately more resilient. There is also no question that making these improvements requires sustained and necessary investment by the banks.

Some argue that the imposition of large fines by U.S. regulators, particularly after 2009, has triggered an across-the-board increase in AML/CFT compliance costs. However, it is important to emphasize that these large enforcement actions were taken in response to egregious cases involving banks that repeatedly broke the law, in some cases for more than a decade, and had significant and fundamental AML/CFT failings. Fear of such penalties should not color the decision-making approach of banks that are carrying out good faith efforts to abide by the law, maintain strong AML/CFT standards, and invest in the personnel and technology necessary to implement these standards.

Both the FATF and U.S. bank supervisors have underscored that it is not possible or practical for a financial institution to detect and report every potentially illicit transaction that flows through the institution. The U.S. Bank Secrecy Act and its regulations require financial institutions to, among other things, establish and implement programs that are reasonably designed to detect, prevent, and report suspicious activity. This does not imply a “zero failure” approach, and our standard is not “zero tolerance.”

However, there is a gap between what our supervisory agencies have said about the standards they hold banks to and banks’ assessment of those standards. There is still a perception among banks that supervisory and enforcement expectations lack transparency, predictability, and consistency.

This perception feeds into higher anticipated compliance costs. If banks are uncertain about when and how they might be penalized, they will invariably focus on worst-case scenarios. When banks input this perceived risk into their cost-benefit analysis, it may eclipse the potential economic gain of taking on a new relationship.

Transitioning to a New Equilibrium

With these thoughts as a backdrop, I will now make three further observations about this complex topic and then pose some questions that I believe merit consideration.

First, in regards to AML/CFT standards and practices, the global financial system is in the midst of a transition from an old equilibrium – in which banks maintained a broad network of correspondent relationships – to a new equilibrium. As this transition plays out, it may be necessary for banks to shed certain lines of business and relationships, if their business models require prioritization elsewhere or if they believe that their systems are unable to achieve proper risk management. This change may be temporary because once banks strengthen their systems, they may then be able to safely resume the relationships. In any event, there are steps that we can take to buffer the effects of this process on financial inclusion.

Second, during this period of transition, clear and effective communication will foster better outcomes.

Third, more and better data will improve our grasp of the problem and help us to tailor appropriate solutions.

In light of these observations, the following questions should be explored further.

First, how far along are we on the transition path? My sense from discussions with banks is that there is variation across financial institutions and across jurisdictions. Some banks have almost completed the transition, while others are in mid-stream.

Second, what will the new equilibrium look like? I see several potential endpoints:

- One possibility is that the cost of maintaining certain relationships in high-risk situations remains uneconomic for most banks, or for whatever reason, banks choose to refocus their resources elsewhere. In this scenario, some high-risk entities would become (or remain) unbanked, and there would be reduced global financial interconnectedness.
- A second possible outcome is one in which some banks decide to shed relationships, while at the same time, other banks take steps that allow them to absorb the risks associated with those relationships. The net effect would be a redistribution in the contours of how and where correspondent banking and MSB business is done. Under this scenario, cross-border flows would likely continue, but would be concentrated in a smaller number of institutions.
- A third outcome is one in which the vast majority of our major banks have strengthened their risk management systems, and at the same time expectations around compliance have been successfully clarified. In this scenario, banks are willing and able to prudently take on

relationships and lines of business that were formerly considered too risky or too costly. The clear result would be increased global interconnectedness and a safer international financial system.

We should seek to avoid the first of these scenarios and aim for the third. This leads directly to a final question: what steps can stakeholders, including banks, regulators, the U.S. government, and governments in other jurisdictions take to help guide us toward the desired outcomes? Such efforts should bear in mind our two core goals of fostering a global financial system that is simultaneously efficient and inclusive, as well as sound and safe.

What Can We Do: Next Steps

There is now broad consensus taking shape in the global financial community on the steps that policymakers need to take to address this situation.

First, as I have emphasized, we need to continue to improve our understanding of the scope, nature, and drivers of the problem through better data collection. The World Bank has done a great service in conducting an in-depth survey on de-risking, but we should move beyond relying on such surveys and consider ways to establish regular and systematic data collection.

Second, we need to explore the scope for FATF and financial supervisors to further clarify regulatory expectations regarding AML/CFT, while at the same time working to promote and help build the capacity for more consistent compliance with AML/CFT regulations in all economies, large and small.

With this in mind, Treasury will continue to explore ways to improve the effectiveness of our communication. In addition, FATF is working on guidance for the application of AML/CFT standards to correspondent banking and MSBs, including in scenarios where enhanced customer due diligence may be necessary.

In addition, Treasury is working both bilaterally and through our engagement with FATF to promote more consistent implementation of AML/CFT regimes. In particular, Treasury's Office of Technical Assistance currently works with seventeen countries in Africa, Southeast Asia, Latin America and the Caribbean, and the Middle East to help them improve their compliance with global standards. We are also working with the World Bank and other providers of technical assistance to meet the increasing demand for such programs.

Third, we need to facilitate effective communication among stakeholders across borders. This includes sharing AML/CFT information through a number of channels, including supervisor-to-supervisor, bank-to-bank, and supervisor-to-bank, in both directions. As I noted earlier, Treasury engages in public-private dialogues across a number of regions, including the Middle East and the Caribbean, as well as with Mexico. Each of these dialogues has sought to foster frank conversations about our cross-border relationships, including any barriers that might exist.

Finally, we need to find ways to reduce the cost of compliance with AML/CFT regulations, including through better harnessing available technologies. We look forward to participating in work coordinated by the FSB to explore whether use of new technologies, including know-your-customer utilities and a second generation legal entity identifier could help reduce compliance costs.

Conclusion

We take the challenges surrounding correspondent banking relationships and money service businesses seriously, and we are committed to addressing them in a way that protects our joint goals of supporting financial connectivity and inclusion and maintaining the integrity of the financial system. Both of these goals are essential.

We realize, however, that to achieve this outcome not only do banks have to commit significant resources and take on new responsibilities, but policymakers must do so as well. The U.S. Treasury Department has a special responsibility in this area, given our commitment to access and integrity and our role in supporting the healthy functioning of the U.S. dollar system.

I thank you for the opportunity to articulate our perspectives on this issue, and I look forward to working with a range of partners – including country officials, market participants, and international financial institutions – to carry this work forward.

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