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Overview of Correspondent Banking and "De-Risking" Issues

What Is Correspondent Banking?

In broad terms, correspondent banking refers to formal agreements or relationships between banks to provide payment services for each other. It is often used to effectuate cross-border payments, and as such, plays an important role in the international financial system. The value of global cross-border payments is estimated to increase from almost $150 trillion in 2017 to over $250 trillion by 2027, according to the Bank of England. Correspondent banking represents a significant portion of this (e.g., the European Central Bank reported roughly $746 billion worth of daily transactions channeled through correspondent banking arrangements within Eurozone countries alone in 2019), as it underpins trade finance, migrant remittances, and humanitarian flows. A typical correspondent banking arrangement is one in which two financial institutions (*respondent banks*) employ a third party, a separate financial institution known as a *correspondent* or *service-providing* bank. The various types of services correspondent banking provide include wire transfers; check clearing and payment; trade finance; cash and treasury management; and securities, derivatives, or foreign exchange settlement, among other services. **Figure 1** shows the settlement of a payment from respondent Bank A to Bank C via a correspondent Bank B. Because Banks A and C do not hold accounts with each other, they use Bank B, which holds accounts for both Bank A and Bank C.

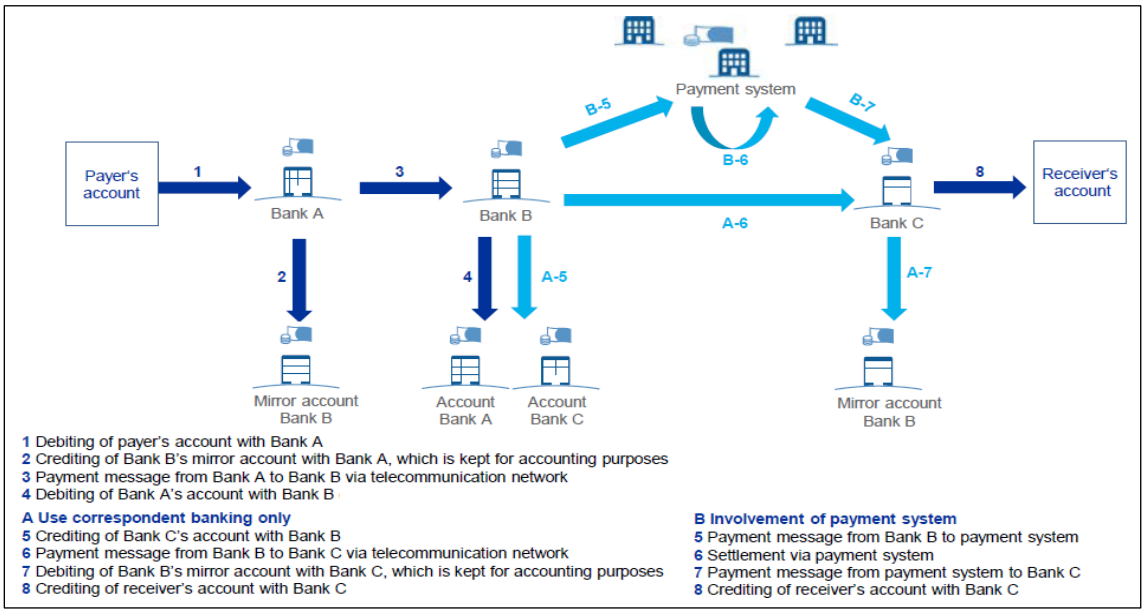
Although these transactions provide significant benefits, they also present several challenges. Two interrelated primary policy issues involved with correspondent banking are: (1) what types of anti-money laundering (AML) and countering the financing of terrorism (CFT) controls should be in place to prevent illicit payments? (2) how to prevent excessive industry reaction to such controls, called "de-risking"?

"De-Risking" and Its Implications

The United Nations Office on Drugs and Crime estimates the amount of money laundered globally in one year is 2-5% of global Gross Domestic Product. An IMF report estimated the amount at $1.6-$4 trillion annually. To address illicit finance concerns, the United States has a robust AML-CFT framework that also applies to correspondent banks due to their key role in international financial transactions.

Under the current regulatory approach, correspondent banks may bear liability, regulatory and reputational risk for AML-CTF violations by the respondent banks. As a result, in recent years, concerns on the part of large international banks about regulatory compliance with AML and customer due diligence (CDD) requirements have led some banks to shed their correspondent banking relationships with some smaller banks, often in emerging markets viewed as "high-risk" for AML. This phenomenon is known as "de-risking," and according to the Bank for International Settlements (BIS), rising costs and uncertainty about how far CDD should go to avoid regulatory sanction are cited by banks as among the main reasons for it. Other factors in the decision to curtail correspondent relationships include profitability considerations and concerns over potential liability and reputational damage. Also, the need to safeguard against cyber risks has led to the development of new standards that have increased the cost of correspondent relationships, further reducing their appeal.

Figure 1. Correspondent Banking: Illustrative Settlement of Payments



Source: European Central Bank, *Tenth Survey On Correspondent Banking In Euro 2016,* February 2017, at https://www.ecb.europa.eu/pub/pdf/other/surveycorrespondentbankingineuro201702.en.pdf?651487aa2ace9afbac36d8d7e7784203.

A 2019 BIS study found a continued decline in the number of correspondent banking relationships; between 2012-2019, active relationships in the global network declined by about 20%, though reductions varied across regions. At the same time, the total volume of payment messaging has not fallen, indicating that banks in smaller countries might be seeking out intermediary banks to conduct correspondent banking for them, in what is known as *lengthening the payment chain*. Moreover, the correspondent banking market continues to be a concentrated market, with a few key players accounting for the majority of transaction volumes serviced. A March 2020 BIS paper cautioned that a continued decline in correspondent banking could send users into less regulated "shadow payments" such as cryptocurrency and cash, potentially adversely affecting global financial integrity.

The Role of Wire Transfers and SWIFT

Correspondent banking relationships are fundamentally about moving money and effectuating payments, and many such payments involve wire transfers. The Society for Interbank Financial Telecommunication (SWIFT) is one of the most commonly used means of sending cross-border transactions, facilitating over 46 million financial messages daily. Thus, issues affecting SWIFT can impact correspondent banking.

SWIFT provides the standards enabling member banks to exchange financial information needed to make payments. It is organized as a cooperative under Belgian law and is owned and controlled by its shareholders, and as of 2020, it served over 11,000 financial and corporate entities in over 200 countries. It is neither a bank nor a clearing and settlement institution, and does not manage accounts or hold funds. SWIFT's regulatory challenges include complying with a large number of AML/CFT regimes while trying to remain neutral on sensitive policy issues, such as sanctions. On March 20, 2022, SWIFT disconnected seven Russian banks from the SWIFT network, citing diplomatic decisions by numerous countries regarding Russia's invasion of Ukraine.

Regulatory Requirements

A central U.S. AML/CFT requirement for wire transfers and SWIFT payments is the "travel rule" issued by the Financial Crimes Enforcement Network (FinCEN) in 1996, which requires financial institutions to pass on certain information with a wire transfer. It was designed to help law enforcement agencies detect, investigate and prosecute money laundering and other financial crimes by preserving an information trail about persons using fund transfer systems.

Banks are also required to conduct due diligence on customers opening accounts, with special attention to foreign correspondent banking account relationships. Special record-keeping and certification requirements apply to foreign correspondent banking accounts. A bank that maintains a correspondent account in the United States for a foreign bank also must maintain records identifying the individual owners of each foreign bank, and must ensure it is not a "shell bank" without bona fide banking activities. Some banks have complained these requirements make it costly to open and maintain correspondent accounts, particularly for banks in countries with high civil unrest, strife, or criminality—and that that has led to de-risking. Others argue that foreign correspondent accounts have been used at times to circumvent U.S. sanctions and in illicit payments, and deserve special scrutiny to safeguard the financial system.

The U.S. sanctions regime can also affect correspondent banking. Title III of the 2001 USA PATRIOT Act (P.L. 107-56) to a degree extends the obligation to comply with sanctions lists of the Office of Foreign Assets Control to some foreign banks, particularly through correspondent banking relationships with U.S. banks, thereby increasing the reach of U.S. regulation. Under Section 311 of the USA PATRIOT Act, FinCEN is authorized to impose "special measures" on U.S. financial institutions to mitigate money laundering threats associated with foreign jurisdictions or institutions found to be "of primary money laundering concern." These measures range from additional

recordkeeping, reporting, and information collection requirements to prohibiting the opening or maintaining of correspondent accounts.

In an attempt to address problems stemming from de-risking, the Office of the Comptroller of the Currency (OCC) issued guidance in 2016 to banks regarding the withdrawal of correspondent banking relationships. It advises banks to conduct periodic risk reevaluations of foreign correspondent accounts and to consider any information provided by foreign financial institutions that might mitigate risk, and provide institutions with "sufficient time to establish alternative banking relationships before terminating accounts, unless doing so would be contrary to law, or pose an additional risk to the bank or national security, or reveal law enforcement activity." The guidance, however, does not otherwise relieve banks of their AML requirements. It notes that the OCC does not encourage banks to terminate entire categories of customer accounts "without considering the risks presented by an individual customer or the bank's ability to manage the risk." It is unclear, however, what impact, if any, the OCC's guidance has had on banks' practices.

Another Title III of the USA PATRIOT Act provision, codified at 31 U.S.C. § 5318(k), authorizes the Treasury Secretary and the Attorney General (AG) to subpoena correspondent account-related records held by foreign banks that maintain correspondent accounts in the United States. Section 6308 of the Anti-Money Laundering Act of 2020 (AMLA; P.L. 116-283) significantly amended this provision to expand the scope of the U.S. government's ability to obtain foreign bank records from banks with U.S. correspondent accounts by authorizing the issuance of a subpoena "to any foreign bank that maintains a correspondent account in the United States and request any records relating to the correspondent account *or any account at the foreign bank* (emphasis in italics added), including records maintained outside of the United States," that pertain to a U.S. law enforcement investigation or civil forfeiture action. The amended provision provides that potential conflicts with foreign bank secrecy laws cannot be the sole basis for a foreign bank's relief from subpoena. The AMLA also increases civil penalties for failing to terminate a correspondent relationship, if directed to do so by the Treasury Secretary or AG, and for failing to comply with a Section 6308 subpoena.

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