



Disconnecting from Global Finance

De-risking: The Impact of AML/CFT Regulations
in Commonwealth Developing Countries



The Commonwealth

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Commonwealth Developing Countries



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Executive Summary

This report draws together work undertaken by the Commonwealth Secretariat on de-risking in the Commonwealth. It seeks to complement and enhance previous research undertaken by international organisations, such as the Financial Stability Board, the Financial Action Task Force and the World Bank, and by research institutes, such as the Center for Global Development. This report aims to improve understanding on the issues surrounding de-risking and, more importantly, to identify a number of practical solutions to the de-banking of legitimate banks, businesses and individuals.

Between September and December 2015, the Secretariat conducted a large-scale survey on de-risking among its membership. The survey revealed that the area of greatest concern for member governments in relation to AML/CFT regulations was the loss of correspondent banking relationships (CBRs). While the reasons for CBR closures varied, the majority of Commonwealth developing countries identified decreased profitability – resulting from the increased monitoring and compliance costs of AML/CFT regulations – as a key driver of de-risking. The survey also highlighted some regional trends. Caribbean and Pacific members, already reliant on a very limited number of banking relationships, identified further CBR losses as posing the most

significant risks to their countries. For members in Africa, concerns were greatest around the impact of AML/CFT regulations on remittance transfers. South Asian members identified high levels of financial exclusion and the prevalence of informal flows as major concerns (Commonwealth Secretariat, 2015a).

To address the wider issues of de-risking, this report presents a number of potential solutions to tackle the unintended consequences of AML/CFT regulations, namely:

- the creation of a global forum for regulators to ensure the incorporation of developing country perspectives in the development of international standards and regulation;
- the development of better guidance and risk-tolerance standards for banks;
- the creation of best practice standards for money service businesses; and
- the enhancement of capacity building to assist regulators and financial institutions in the implementation of AML/CFT regulations.

In addition to these solutions a number of initiatives proposed, or being actively pursued, by members to address de-risking are discussed.

1. Introduction

De-risking refers to financial institutions terminating or restricting business relationships with clients, or categories of clients, to avoid rather than manage risk. This phenomenon has grown significantly in recent years, leaving many banks, businesses and individuals in the developing world without access to much-needed financial services. As formal service providers disappear, financial transactions have been increasingly forced underground, reducing financial inclusion and transparency, and exacerbating money laundering and terrorist financing risks (Commonwealth Secretariat, 2015a; Financial Stability Board (FSB), 2015).

Strengthening capital flows to developing countries and ensuring the broader integration of these countries into the international financial system is essential for increasing long-term finance for development. It is in this context that 'de-risking' is of particular concern and poses significant risks to the growth and development of developing countries.

In order to find effective solutions to the challenges posed by de-risking, many international organisations have sought to better understand the drivers of de-risking. While a lack of available data precludes systemic judgements on the causes, there is increasing recognition that the implementation and interpretation of anti-money laundering and countering the financing of terrorism (AML/CFT) regulations is a major factor behind the de-banking of legitimate businesses and individuals (Center for Global Development (CGD), 2015; World Bank, 2015a).

To date a number of organisations have taken steps to address the problem of de-risking. The Financial Action Task Force (FATF) has been working to strengthen AML/CFT networks through mutual assessments and the provision of guidance. The Committee on Payments and Market Infrastructures (CPMI) has identified numerous technical measures to alleviate the costs and concerns associated with correspondent banking (CPMI, 2015). The World Bank Group investigated the impact of commercial banks' actions on non-bank international remittance service providers at the request of the G20 Global Partnership for Financial Inclusion. Additionally, the World Bank

has investigated the withdrawal of correspondent banking services, and its impact on legitimate customers, at the request of the G20 and FSB. Other organisations, including the International Monetary Fund (IMF) and the Basel Committee on Banking Supervision, also work in this space in various capacities.

With many Commonwealth countries directly affected by de-risking, the Secretariat has been working with member countries, international banks, money service businesses (MSBs) and other key stakeholders to develop solutions to address the drivers and consequences of de-risking. At the Commonwealth Central Bank Governors Meeting in October 2014, governors from across the Commonwealth expressed their growing concern about the adverse impacts of AML/CFT regulations. These concerns were subsequently taken forward and shared with the G20 through the Annual Commonwealth–Francophonie–G20 dialogue in April 2015. A two-day expert forum on de-risking was then convened in July 2015, the results of which were presented and discussed at the 2015 Commonwealth Central Bank Governors Meeting, before the Commonwealth surveyed its membership on the unintended consequences of AML/CFT regulations and potential solutions to these issues in late 2015.

This report draws on the Commonwealth's work on de-risking to date, including the outcomes of its recent survey, the July 2015 expert forum on de-risking and the Secretariat's ongoing dialogue with member countries and the international community. The report summarises the key areas of concern for members in relation to AML/CFT regulations, before considering each of these areas in turn and, where relevant, drawing out recent trends to determine the impact and implications of these issues for developing countries.

While it is hoped that this analysis will contribute to a better understanding of the drivers and impacts of de-risking, the main focus of this report is to identify practical solutions to de-risking. The report therefore discusses a number of potential policy solutions and actions for both developing and developed countries, and the international community more broadly.

Although this analysis relates specifically to the experiences of Commonwealth member countries, the size and breadth of the Commonwealth's membership¹ suggest that the findings and solutions discussed herein can be applied more broadly across the developing world.

1 The Commonwealth membership includes 47 developing countries and 31 small states over 6 continents.

2. The Impact of De-risking Across the Commonwealth

This section provides an overview of the impacts of de-risking across the Commonwealth. It summarises the outcomes of the Commonwealth survey on de-risking (Commonwealth Secretariat, 2015a), highlighting the areas of greatest concern to member governments, before discussing the implications of these risks.

2.1 Key concerns of Commonwealth members

The Commonwealth survey on de-risking (Commonwealth Secretariat, 2015a) was distributed to all member countries, with 31 responses received, including 29 from developing countries. The respondents were representative of the breadth of the Commonwealth – both regionally (Africa (10), the Caribbean (11), the Pacific (5) and South Asia (3)) and in terms of development (responses were received from high-, middle- and low-income countries, as well as small island developing states). In most cases it was the country's central bank that provided, or coordinated, the national response.

The Commonwealth survey asked members to identify the main risks posed by AML/CFT regulations. The overall results for respondents

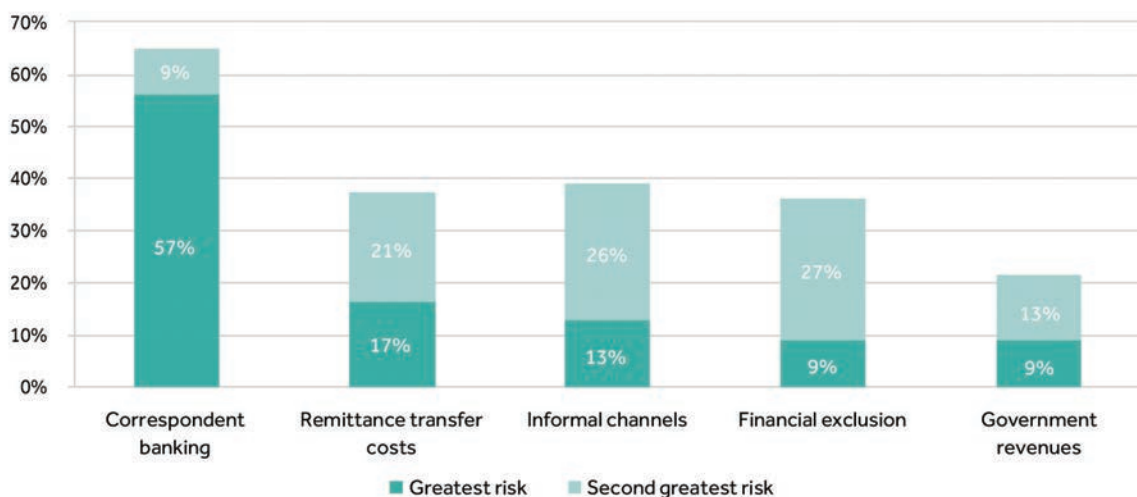
can be seen in Figure 1, with the decline in CBRs by far the greatest concern, followed by rising remittance costs.

Table 1 highlights how these results vary between regions of the Commonwealth. While the loss of CBRs was identified by Commonwealth Pacific and Caribbean countries as their primary concern, of greater concern to African and South Asian members were rising remittance costs and the increased use of informal flows, respectively. These differences tally with the economic contexts and vulnerabilities of these regions, which are explored further in the remainder of this section.

2.2 Correspondent banking relationships

CBRs are an essential component of the global payment system. They provide banks with access to financial services in jurisdictions where they have no branch presence or bank licence, and provide cross-border payment services to individuals and businesses in otherwise disconnected jurisdictions. These relationships are therefore vital for many developing countries, whose small banking sectors are heavily reliant on CBRs to access wider financial markets.

Figure 1. Commonwealth country concerns



Source: Commonwealth Secretariat (2015a)

Table 1. Commonwealth country concerns associated with AML/CFT regulations

Region	Greatest risk	Second greatest risk
Africa	Remittance costs	CBRs
Caribbean	CBRs	Financial exclusion
Pacific	CBRs	Remittance costs
South Asia	Informal channels	Financial exclusion

Source: Commonwealth Secretariat (2015a)

A number of international banking associations have reported correspondent account closures since 2012 (HM Treasury, 2015), with data collated by the World Bank also indicating rising CBR closures (World Bank, 2015a). Between 2012 and mid-2015, 75 per cent of large global banks reported a decline in their Vostro accounts, while 32 of the 91 banking authorities surveyed by the World Bank reported 'significant declines' in CBRs, with a further 17 indicating 'some decline' (World Bank, 2015a).

Many Commonwealth developing countries have been severely affected by CBR closures, with 17 of the 23 Commonwealth developing countries for which data was received² reporting CBR losses since 2012, with 70 per cent of these closures experienced since 2015, as shown in Figure 2.³

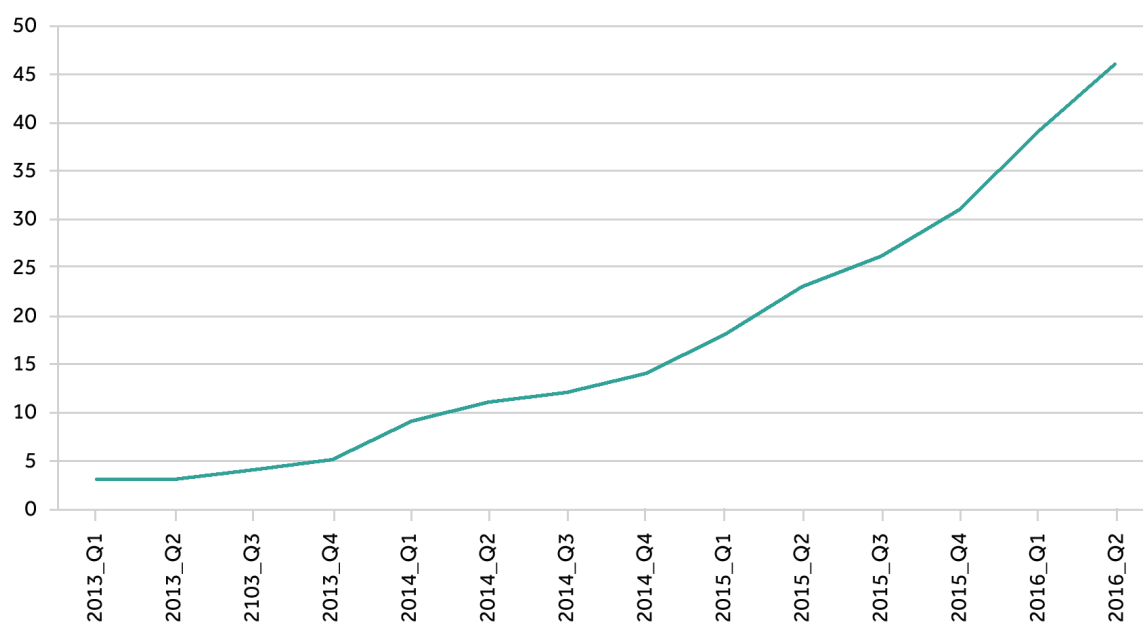
CBR restrictions and closures have been greatest in the Caribbean, with almost all Commonwealth Caribbean countries reporting CBR losses since

2012, and the majority reporting multiple closures. Many Commonwealth Pacific banks have also faced CBR losses, which given these countries' small banking sectors, has potentially disastrous consequences for their economic and financial stability. While some closures were reported in Commonwealth African and South Asian countries, poor country data means that conclusions cannot be drawn over the extent and impact of CBR closures in these regions. However, given the level of concern expressed about CBR closures by Commonwealth African countries (see Table 1), these losses are likely to be substantial.

While many of these closures have affected

2 Four African, 12 Caribbean, 5 Pacific and 2 South Asian Commonwealth countries provided information on CBR closures.

3 Five closures were reported in 2013, 9 in 2014 and 17 in 2015. At the time of writing (April 2016) 15 closures had been reported so far in 2016.

Figure 2. Correspondent bank account closures in Commonwealth developing countries (cumulative)

Note: Data presented for 17 countries

commercial banking relationships, perhaps a more concerning development is the increasing number of government bank accounts closures in recent years. At least three Commonwealth governments and/or central banks have lost their accounts with correspondent banks since 2015, in some cases with banks they had held accounts with for decades. These losses have affected both governments' overseas investments (a significant source of government revenue) and their foreign exchange management, with implications for external debt obligations in at least one Commonwealth country (Commonwealth Secretariat, 2015a; Moody's Investors Service, 2016).

Increased de-risking by international banks poses a major threat to the provision of correspondent banking services, and understanding the reasons for the loss of these relationships is crucial to designing effective policy solutions. As mentioned above, there is increasing recognition that the implementation and interpretation of AML/CFT regulations is driving de-risking (World Bank, 2015a; G24, 2016). These findings were echoed by the majority of Commonwealth members, several of whom provided information on banks' justifications for CBR closures. These included concerns over regulatory factors, such as 'inadequate ML/FT risk management' and

'reputational risks'; and economic factors, such as changes in 'business strategy' and 'overall risk appetite' (Commonwealth Secretariat, 2015a). However, for the majority of surveyed members, closures were a consequence of profitability concerns rather than perceived risks, as growing AML/CFT monitoring and compliance costs significantly reduce the profitability of correspondent banking services. These views are supported by the Commonwealth's Trade Finance Facility, which found that the majority of international banks had 'limited or no interest' in offering trade financing services to small states in the Commonwealth, largely because of the low volume and low returns from these countries.

While reasons for account closures may vary, it is clear that these closures can have significant consequences, as highlighted by the Belize case study described in Box 1. CBR losses can have significant implications for remittance flows, international trade, financial inclusion and financial stability, which not only affect the provision of CBR services to de-banked countries, but can also cause a 'significant concentration of relationships in a relatively small number of service-providing institutions', increasing systemic risks (FSB, 2015). Given the significance of CBRs for Commonwealth developing countries and the potentially negative impact of CBR losses, it is concerning that 50 per

Box 1. De-risking in Belize: the impact on CBRs

According to the Central Bank of Belize, almost all banks operating in the country have been affected by CBR closures or restrictions since Q4 2014, significantly impairing the ability of Belizean individuals and businesses to transact and trade internationally.

In 2016, two Belize banks lost their credit card settlement accounts in the USA. At the time of writing, these banks were unable to settle their credit card balances with payment systems operators, such as Visa, which insist on their customers using US bank accounts. These closures have had significant implications for the tourism industry in Belize as well as other international businesses operating from the country.

According to a recent Moody's Investors Service report (2016), '80% of Belize's banking system is likely to lose correspondent and credit card settlement services by mid-year 2016', with the loss of these services potentially disastrous for the country – compounding existing economic and fiscal frailties, such as depleted oil reserves, impending fiscal imbalances and the planned abolition of EU sugar quotas. Furthermore, if this trend continues, it could place significant pressure on central bank reserves, leading to potential credit default (Moody's Investors Service, 2016).

De-risking poses a serious threat not only to the banking and financial systems of Belize, but also to the operations of its monetary authority. The Central Bank of Belize lost one of its overseas accounts with a major international bank in 2016, impairing the country's ability to manage its official foreign exchange reserves, which are essential for ensuring foreign currency liquidity and absorbing external shocks in times of crisis.

cent of Commonwealth countries that experienced CBR losses received no forewarning from banks over their intentions to suspend or restrict account services, significantly impairing their ability to find alternative means of service provision (Commonwealth Secretariat, 2015a). Given this and the existing challenges small states face in accessing the global financial system, it is not surprising that many of the Commonwealth's developing country members identified the loss of CBRs as the greatest risk to their countries from AML/CFT regulations (Commonwealth Secretariat, 2015a).

2.3 Remittances

Remittances are an important and stable source of capital for many developing countries. They also provide a much-needed lifeline for many of the world's poor, funding day-to-day survival consumption as well as basic investment expenditure in areas such as health and education. These flows thus provide an important safety net to some of the poorest parts of the world.

As illustrated in Figure 3, remittances have become an increasingly important source of capital for Commonwealth developing countries, often exceeding official development assistance (ODA), private capital flows and foreign direct investment (FDI) to these countries. In particular, formal remittance flows to Commonwealth Africa have

increased dramatically in recent years – rising fivefold between 2004 and 2014 – while remittance flows to Tonga and Samoa account for more than 20 per cent of their GDP, putting them among the ten most remittance-dependent countries in the world (see Figures A.1 and A.2).

Due to the size and significance of remittance flows to many developing countries, the international community has committed to reducing remittance transfer costs through a number of international initiatives. In 2011, the G20 committed to reducing the cost of remittance transfers from 10 per cent to 5 per cent by 2014 (G20, 2011),⁴ while the 2015 Addis Ababa Action Agenda pledged to reduce the average cost of remittance transfers to below 3 per cent and to ensure that no remittance corridor exceeds 5 per cent by 2030.

Despite these commitments, the average cost of remittance transfers to Commonwealth developing countries rose to 10.6 per cent in Q1 2016, a level 3 per cent above the global average. By comparing country average costs (illustrated in Figure A.3) with the G20's 5 per cent target, the UN's Sustainable Development Goals target of 3 per cent and the World Bank's proposed target of 1 per cent,⁵ Figure 4 illustrates the potential gains to Commonwealth

⁴ This builds on commitments originally made by the G8 to reduce the cost of remittance transfers from 10 per cent to 5 per cent between 2009 and 2014.

Figure 3. Capital inflows to Commonwealth developing countries

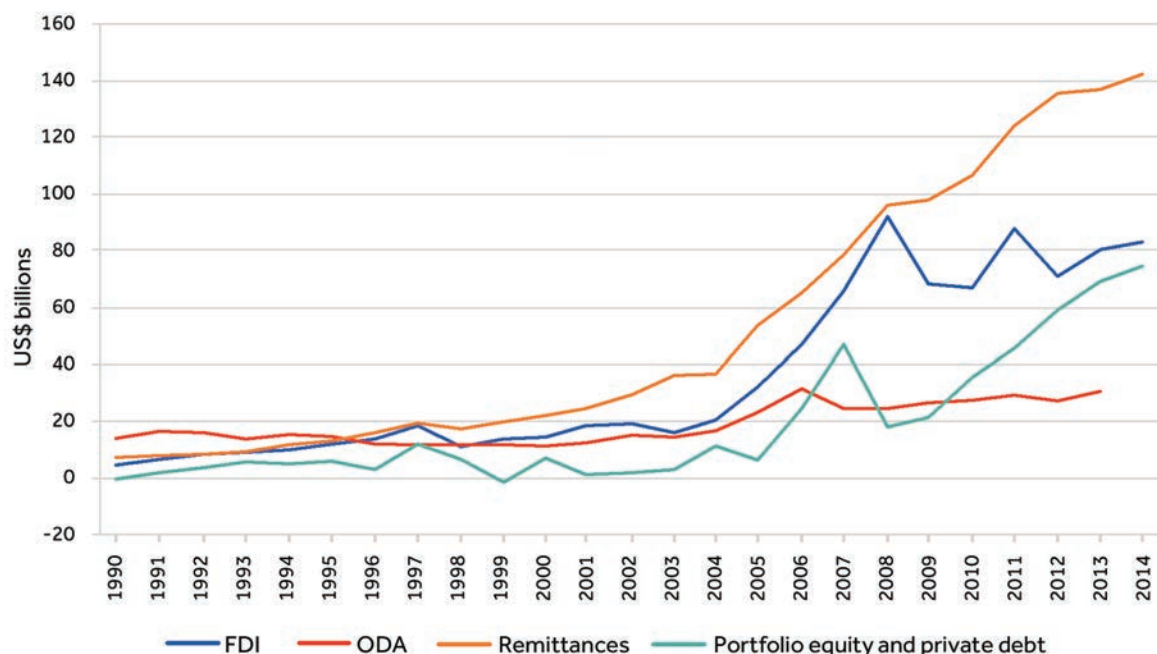
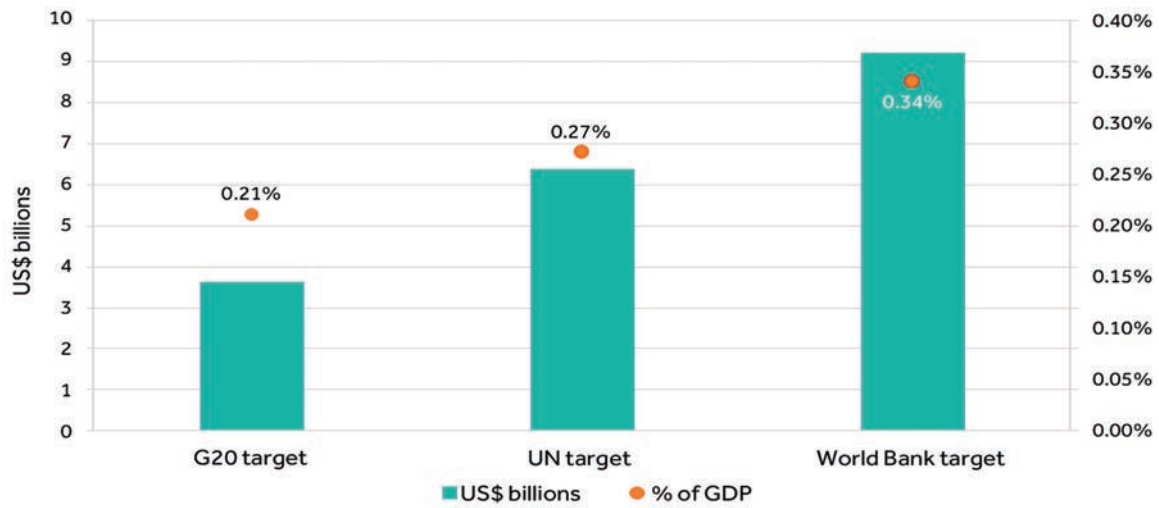
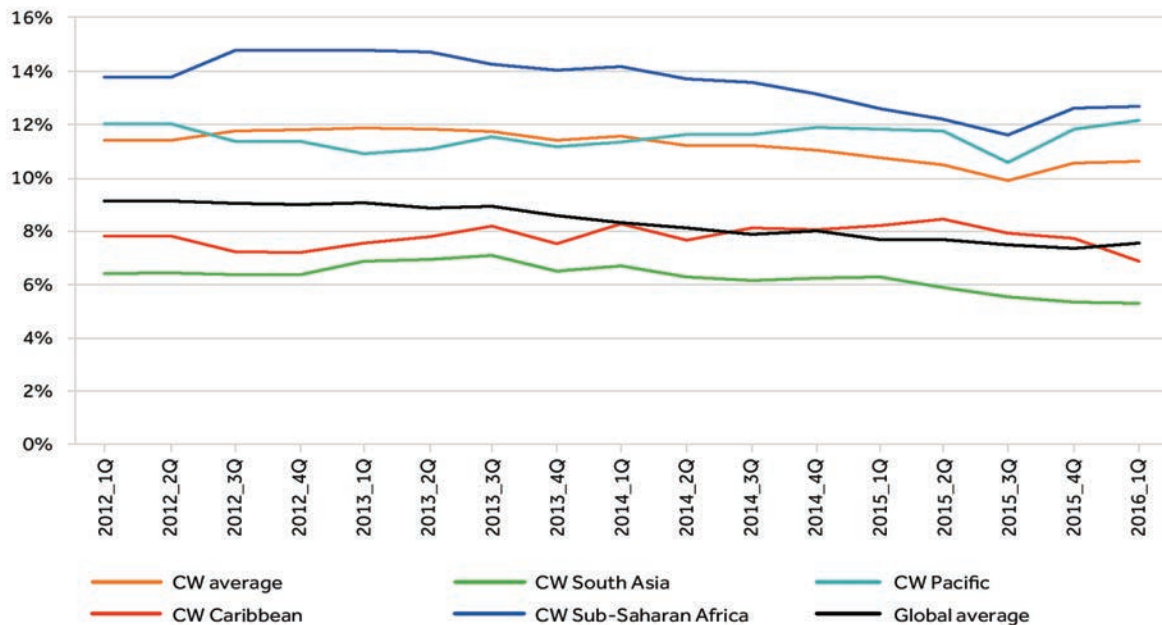


Figure 4. Impact of remittance transfer costs on Commonwealth developing countries (2014)



Note: Data from the World Bank (2015b, 2015c, 2016) Source: Commonwealth Secretariat

Figure 5. Average remittance transfer costs



Note: Data from the World Bank (2015c, 2016); costs calculated assuming US\$200 sent Source: Commonwealth Secretariat

countries from these commitments being met.⁶ Most notably, if the World Bank’s proposed target were reached, over US\$9 billion (or 0.34 per cent of GDP) could be added to the GDP of Commonwealth developing countries (based on 2014 data).

High remittance transfer costs are a concern for many Commonwealth developing countries, but perhaps of greater concern is the recent increase in average remittance transfer costs that has taken place across the Commonwealth since Q3 2015

5 While reducing remittance transaction costs to 1 per cent is not an explicit international commitment, the World Bank did propose the more aggressive target in negotiations surrounding the Addis Ababa Action Agenda. As such, a 1 per cent target is a feasible long-term goal for the international community and has been incorporated into this analysis for illustrative purposes.

6 The calculations in Figure 4 are not corridor specific. For this reason, the volume and costs of specific corridors are not used to calculate the cost of remittance transfers. Rather, this analysis looks at total remittance inflows to each country and compares this with the average cost of remittance transfer to this country. As a result, these figures are purely indicative.

(as shown in Figure 5), most notably in sub-Saharan Africa and the Pacific. These increases have also been experienced globally, with the global average cost of sending US\$200 increasing from 7.37 per cent in Q4 2015 to 7.53 per cent in Q1 2016, the first recorded increase in over a year (World Bank, 2016). While a variety of factors influence remittance transfer costs, recent trends in de-banking are likely to have contributed to rising costs, as MSB account closures reduce competition in the remittance sector, which can in turn increase the price of remittance transfers, particularly in corridors served by a small number of MSBs (CGD, 2015).

As shown in Figure 1, rising remittance transfer costs as a result of AML/CFT regulations are a major concern for many Commonwealth countries, with over 85 per cent of Commonwealth countries believing that AML/CFT regulations have adversely affected the flow of remittances to and/or from their country, or will do so in the future (Commonwealth Secretariat, 2015a; World Bank, 2015d).

In addition to increasing the cost of remittance transfers, the de-banking of MSBs reduces the number of formal channels available for remittance transfers, forcing migrants to use potentially higher-cost, informal providers. Many MSBs have already reported needing to utilise other channels, such as personal accounts or intermediary companies, to

continue functioning, while others have had to cease operations altogether. If the de-risking of the MSB sector continues unabated, then the implications for remittance prices and fragile corridors could be significant, with some countries concerned over potential 'corridor collapses' (Commonwealth, 2015a; World Bank, 2015h).

2.4 Financial inclusion and informal flows

'Financial inclusion' refers to the provision of formal financial services and products at an affordable cost (IMF, 2015). High levels of financial inclusion can have significant macro- and micro-economic benefits for developing countries, through increasing savings and investment and enhancing financial depth and stability. Yet many of these benefits are bypassing Commonwealth developing countries, whose financial inclusion rates average below 50 per cent.

Despite recent improvements, financial inclusion rates in developing countries remain low, with over 2 billion adults financially excluded globally in 2014 (World Bank, 2015e). This situation is particularly acute in Commonwealth developing countries, which on average experience lower inclusion rates than the rest of the developing world, bar the low income category. However, if the Commonwealth's

Box 2. De-risking in Samoa: the impact on Samoan MSBs

Remittances play a fundamental role in the Samoan economy, contributing just under 20 per cent to the country's GDP. However, for non-resident Samoans the costs of sending money home are some of the highest in the world, averaging just below 12 per cent as of Q1 2016.

In 2014, the country's high remittance transfer costs equated to approximately 2 per cent of Samoa's GDP, a figure far greater than the 1.2 per cent growth the economy experienced in the same year (Commonwealth Secretariat, 2015a; World Bank, 2016). While reducing the cost of remittance transfers to Samoa would likely yield significant economic benefits, rising MSB account closures mean these gains are hard to realise. Between 2013 and 2015, 9 of Samoa's 15 licensed MSBs faced account closures in Australia and New Zealand. One Samoan MSB was forced to cease operating in New Zealand as a result, while many other MSBs have reported having to utilise personal or nested accounts to maintain their international presence (Commonwealth Secretariat, 2015a).

In response to these closures, the Samoan government has sought to engage with the governments, regulators and international banks of its major remittance-sending countries, but with little success to date. As a result, the country has been forced to pursue what it deems to be 'last resort measures', such as those discussed in Box 4.

With MSBs handling approximately 80 per cent of Samoa's remittance flows, and with remittance transfer costs to Samoa on average two and a half times greater when sent through banks than MSBs, the impact of further MSB account closures could see non-resident Samoans having to revert to more costly bank or informal channels to transfer funds, with strong implications for both economic growth and security (Commonwealth Secretariat, 2015a; World Bank, 2015d).

Table 2. Financial inclusion rates, 2014 (access to bank or mobile account [% of those aged 15+])

Income classification	Worldwide	Commonwealth
Average	62	48
High income	91	76
Upper middle income	70	66
Middle income	58	52
Lower middle income	43	39
Low income	28	32

Source: World Bank (2015f)

East African member states, where the rapid expansion of mobile money markets saw financial inclusion rates double between 2011 and 2014, are excluded from these calculations, then the financial inclusion rate of the Commonwealth's low-income countries average just 17 per cent, significantly lower than the global 'low-income' average (World Bank, 2015f, 2015g). A summary of overall financial inclusion rates in Commonwealth developing countries is provided in Figure A.4.

Reduced access to formal financial services naturally gives rise to the proliferation of alternative and less regulated financial channels. Such informal practices are particularly prevalent in South Asia and sub-Saharan Africa, where low financial inclusion rates mean that large proportions of these populations rely on informal channels for financial intermediation.

Many Commonwealth members reported that AML/CFT regulations had led to the de-banking of legitimate, low-profit respondent banks and MSBs in their countries, in some instances contributing to an increase in informal financial channels. Businesses are similarly affected by de-risking, as CBR closures constrain their ability to trade internationally and limit their access to financial services and credit from abroad. The International Finance Corporation (IFC) estimates that, based on existing levels of financial exclusion, over 200 million micro-, small and medium-sized enterprises (MSMEs) operating in the developing world are underserved or unserved by the formal financial system, contributing to an MSME financing gap of US\$2.1–2.6 trillion (Stein et al., 2013). This financing gap is only likely to be aggravated by further de-risking. The increased use of informal financial channels also threatens to undermine the underlying goal of AML/CFT regulations - to ensure that international financial flows are sufficiently

regulated and monitored in order to prevent their use for criminal activity.

As noted above, the impact of AML/CFT regulations on informal flows⁷ and financial inclusion is a concern for many of the Commonwealth's member states, with countries from all continents of the Commonwealth reporting increases in informal flows and financial exclusion as a result of AML/CFT regulations (Commonwealth Secretariat, 2015a). This is a particular concern for Commonwealth South Asian countries,⁸ all of which ranked the increased use of informal channels resulting from AML/CFT regulations as the greatest risk to their countries (Commonwealth Secretariat, 2015a).

7 Financial flows that are transferred outside the regulated financial system.

8 The countries that responded to the questionnaire were Bangladesh, India and Pakistan.

3. Policy Solutions

With the unintended consequences of AML/CFT regulations differing between countries, a range of policy solutions aimed at tackling the varying consequences of de-risking were presented to member states through the Commonwealth survey on de-risking (Commonwealth Secretariat, 2015a). Countries were asked to rank seven solutions (see Box 3) according to their perceived effectiveness in countering the adverse consequences of AML/CFT regulations. These ideas were initially raised by attendees to the Commonwealth's Expert Meeting on AML/CFT in July 2015, before being honed through further correspondence with key contributors.

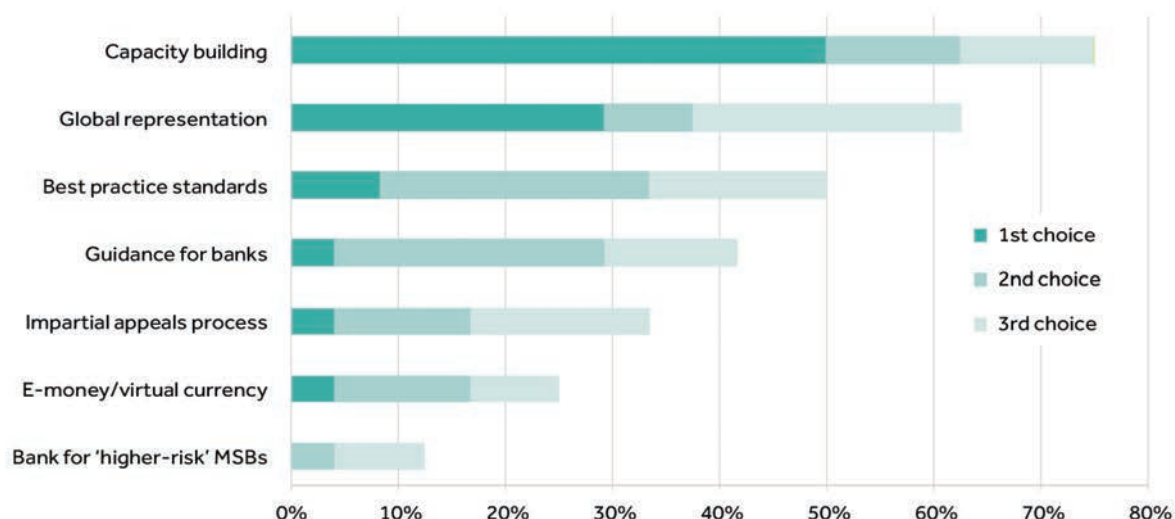
A graph of Commonwealth countries' most favoured policy solutions – listing the percentage of respondents that ranked each option as either their first, second or third most preferred solution – is shown in Figure 6. These solutions are discussed in greater depth in the following section, which – based on consultations with Commonwealth members – lists a number of recommendations the Secretariat believes should be pursued to tackle de-risking.

In summary, the Commonwealth's survey on de-risking revealed that:

1. *Capacity-building initiatives* are the favoured policy solution for members, with 75 per cent of respondents ranking improved capacity building in their top three solutions for tackling the adverse consequences of AML/CFT regulations in their country.
2. 63 per cent of respondents ranked a *global forum for regulators* as one of their top three policy solutions for tackling de-risking, emphasising the need for improved dialogue and concerted action by developed and developing countries, international organisations and banks.
3. 50 per cent of respondents ranked establishing *best practice standards*, and a further 42 per cent *enhanced guidance for banks*, in their top 3 policy options, indicating the need for more prescriptive guidance.

Box 3. Proposed policy solutions

1. **Capacity building** for regulators, financial institutions and commercial entities so that countries are better able to implement FATF standards, and banks are better able to distinguish between high-risk and low-risk customers.
2. **Enhancing the role of global forums** to give greater voice to developing country needs, to facilitate the sharing of information (such as identified risks) and best practice, and to harmonise approaches to regulation.
3. **Best practice standards** that identify a list of 'reputable' MSBs, where inclusion to this list requires adhering to agreed high-standards of risk management. These standards would be compiled in collaboration with the banking industry to determine the measures necessary for MSBs to satisfy banks' internal risk standards.
4. **Guidance for banks** to ease banks' concerns over their liability for AML/CFT breaches and to provide greater guidance on how to bank 'higher-risk' customers.
5. **An impartial appeals process** that requires commercial banks to obtain regulatory consent before they can close accounts and allows MSBs to appeal account closures.
6. **The use of virtual currencies** to facilitate international money transfers and avoid formal banking networks.
7. **A bank for 'higher-risk' MSBs** to provide temporary bank services to 'higher-risk' MSBs that have had their accounts closed. The bank would engage with local regulators and the FATF to identify compliance issues, and work directly with de-banked MSBs to help improve standards and re-open their closed commercial accounts.

Figure 6. Percentage of countries that ranked each policy option as a priority solution

Source: Commonwealth Secretariat (2015a)

In addition to those solutions presented above, many Commonwealth developing countries have undertaken a range of initiatives aimed at tackling the inadvertent consequences of AML/CFT regulations.

Some of these solutions are listed in Box 4, with the intention of providing an indication of the local and regional efforts being undertaken by developing countries to combat de-risking.

Box 4. Commonwealth country solutions

Government clearing houses

In 2016, the Central Bank of Samoa opened a number of bank accounts with commercial banks operating in major remittance-sending countries. The intention was for these accounts to act as clearing facilities – balancing payments between MSB agents in different countries, thereby avoiding the transfer of funds between jurisdictions and their associated costs.

Under this solution, money sent from MSBs operating abroad is paid into the Central Bank's account, but is not converted into local currency. Rather, the Central Bank uses its public finances to transfer the equivalent in Samoan currency to MSBs operating in Samoa, retaining the original remittance transfer in its foreign exchange reserves. The intention of these accounts is to decrease the costs and instability involved in sending remittances internationally, and to increase the government's access to foreign reserve holdings overseas.

Although central bank accounts were established in some foreign commercial banks, many MSB agents have had their accounts terminated, severely affecting the functioning of this solution.

CBR pooling

The pooling of correspondent banking services by local and regional Caribbean banks was suggested at the Caribbean Heads of Government Meeting in February 2016 as a potential solution to CBR closures. Members proposed that pooling their banking services could increase the profitability and appeal of these services to potential correspondent banks, as the volume of transactions would be much larger. However, with banks operating in differing jurisdictions, the pooling of services is complex and, even if achieved, the larger number of transactions may not be sufficient to secure CBRs when weighed against the challenges associated with servicing pooled banks.

Insurance against AML/CFT breaches

At the 2016 Caribbean Heads of Government Meeting, Prime Minister Barrow of Belize proposed that member countries investigate the use of insurance mechanisms that decrease the liability of

correspondent banks for AML/CFT breaches by making respondent banks and governments liable for AML/CFT breaches. Such insurance mechanisms could alleviate correspondent banks' concerns over ML/TF abuse without encouraging negligence among regulators and respondent banks (CARICOM, 2016). At present, such insurance products do not exist and, owing to the potential risks and large fines associated with breaches, their premiums are likely to be prohibitively expensive.

Categorisation of MSB licences

Several Commonwealth countries are considering categorising the licences they offer MSBs to help inform and improve banks' understanding of their local remittance markets. The categorisation of licences by type of MSB (for instance by inflows and/or outflows) can help inform banks about the nature of their clients' business, and reduce their due diligence and monitoring requirements.

By contributing to a broader understanding of each customer's risk profile, the categorisation of MSB licences can strengthen the remittance market in country. However, this categorisation must be incorporated into a broader assessment of geographic, customer, product and other risks, and should not be used to facilitate the identification and subsequent de-banking of categories of customer. As a result, the categorisation of licences should be pursued only where it is felt it can mitigate risk and increase the provision of services by improving banks' understanding of the local remittance market.

For many commercial banks, the costs and perceived risks of providing services to supposed 'higher-risk' clients are seemingly too great. Yet investments in risk controls and advanced analytics could make the identification of genuine AML/CFT risks far easier.

Recognising that one of the key drivers of de-risking is the decreased profitability of correspondent banking services, a number of potential technological solutions intended to reduce the compliance costs and concerns of correspondent banks are discussed in Box 5.

Box 5. Technical solutions to reduce the costs of compliance

Improved CBR analytics and information sharing

The difficulty of monitoring CBR activities naturally deters banks from providing correspondent banking services. However, through the use of data analytics, one can make the monitoring of these services far easier and safer. Various analytical tools can help banks assess client risk and reduce the uncertainty and costs associated with providing Vostro accounts. Automated entity consolidation software uses name-matching and contextual analysis to extract and consolidate information about those involved in transactions, including their behaviour and activities. This process facilitates the collection of a richer set of data that can be analysed and assessed to more easily identify risks. If information on jurisdiction, type of business, transaction volume and services used is accumulated, holistic client profiles can be built that can help identify illegal or suspicious activity. When these processes are combined with analyses of historical alert data, patterns of illicit or suspicious activity can emerge and, as more data arises, the efficiency and outcomes of these models will naturally improve (PwC, 2015).

While such automated processes should not replace manual investigations, they can improve the efficiency and accuracy of investigations as well as reduce compliance costs, thus making the provision of correspondent banking services more attractive. For these processes to be sufficiently adopted, however, their use must be promoted at the international level as part of best practice.

Beyond technology, there is also a need for greater information sharing and co-ordination between and within jurisdictions to reduce due diligence costs, and for a more consistent and standardised approach to requesting and sharing information. The CPMI (2015) recommends a number of technical measures to improve the exchange of information between banks. These include the use of 'know your customer' facilities to help banks avoid duplication, the use of unique legal entity identifiers in correspondent banking to accumulate standardised information, and the adoption of various information-sharing agreements so that further data on identified 'high-risk' transactions can be more easily obtained.

4. Commonwealth Recommendations

Based on the solutions discussed in Section 2, a set of Commonwealth recommendations are outlined below and summarised in Box 6. These recommendations build on the outcomes of the Commonwealth's expert forum in July 2015, the findings of the Commonwealth's survey on de-risking, and discussions with various member countries and international organisations to identify a set of Commonwealth recommendations to combat de-risking. While these recommendations are based on consultations with our membership, they do not necessarily reflect the perspectives of all Commonwealth members.

The country-specific solutions discussed in Box 4 have not been included in the Commonwealth's recommendations due to their limitations, as discussed previously, and their untested nature. However, as these and other options are proposed and tested, it will be important for country and/or regional experiences with these solutions to be captured and shared more broadly to determine their implications and effectiveness at combating de-risking.

4.1 Global forum for regulators

Increasing the FATF's and FSB's membership to include more developing countries and regional organisations, as well as further empowering FATF Regional Style Bodies, could help ensure that developing countries contribute more to the formulation of international standards and

encourage a more proportionate application of these regulations by developed countries.

The lack of effective representation of developing countries in international forums presents significant challenges for developing states. Several Commonwealth countries reported low levels of engagement in the setting of FATF standards as well as low or no consultation in determining AML/CFT regulations in major remittance-sending countries.⁹ Many Commonwealth countries reported that their attempts to engage with developed country governments, regulators and international banks had gone unanswered. This suggests not only a lack of voice for many developing countries in the formulation and implementation of these regulations, but also an inability among some developed countries and international banks to engage with developing countries to discuss these issues.

Strengthening the role of FATF Style Regional Bodies and increasing the FATF's and FSB's membership to include more developing countries and regional development organisations could increase developing country participation in the formulation of AML/CFT standards and regulations, as well as encourage a more proportional application of these standards and regulations by implementing countries and international banks.

⁹ All of the Commonwealth's Pacific and South Asian countries and 80 per cent of the Commonwealth's Caribbean membership ranked a global forum for regulators in their top three solutions to de-risking.

Box 6. Key recommendations

1. **Global forums** – increasing the FATF's and FSB's membership to include more developing countries and regional organisations would help ensure that developing countries contribute more to the formulation of international standards, and could encourage a more proportional application of compliance requirements by implementing countries.
2. **Guidance for banks** – the international community should push developed country governments to introduce guidance that clearly demonstrates the responsibilities and liabilities of banks regarding AML/CFT when providing services to 'high-risk' clients.
3. **Best practice standards for MSBs** – introducing a set of standards for the formal certification of MSBs could help increase the legitimacy and reputation of the MSB sector, reducing de-banking.
4. **Capacity building** – the capacity-building needs of many developing countries are not being met. A platform for identifying the specific capacity constraints of developing countries is required so that these can be brought to key international forums and shared with donors.

In line with recommendations by the G24 and the Alliance for Financial Inclusion (G24, 2016), a forum of affected countries could be established to discuss shortcomings in the current AML/CFT agenda with the FATF, FSB and G20, and identify key areas of work these organisations should undertake to combat de-risking. This forum could also be used as a platform to facilitate discussion between affected countries and international banks to identify how banks can meet their due diligence obligations in 'high-risk' scenarios and reduce de-risking.

In addition, a more consistent interpretation by countries of the FATF's recommendations would likely reduce the costs of providing financial services to MSBs and local and regional developing country banks. If AML/CFT regulations are to be applied more consistently across jurisdictions, greater co-ordination between countries is needed.

4.2 Guidance for banks

The international community should push developed country governments to introduce better guidance and risk-tolerance standards for banks that balance ML/FT concerns with financial inclusion goals, as well as outline how banks can deal with 'higher-risk' customers such as correspondent banks and MSBs.

Many Commonwealth countries expressed the need for enhanced regulatory guidance so that banks have a clearer understanding of each jurisdiction's regulatory expectations (Commonwealth Secretariat, 2015a, 2015b). This includes a greater understanding of required levels of due diligence for 'higher risk' clients; the provision of guidance on the use of constraints, such as credit limits, in lieu of account terminations; and assurances that punitive actions for ML/FT breaches will be proportionate.

The World Bank's survey of international banks (World Bank, 2015h) revealed that a key reason for MSB account closures was 'a lack of confidence in MTO procedures', with banks indicating that they would re-engage with several de-banked parties if:

- a) national supervision improved so that banks could better rely on government oversight; and
- b) regulators published guidance identifying requirements for banks on the provision of accounts and banking services to higher-risk customers.

Such guidance should enable banks to differentiate between higher- and lower-risk providers and corridors, particularly as less than half of the countries surveyed by the World Bank (2015h) had

issued guidance on the provision of accounts and services to MSBs.

Similarly, many banks also raised concerns around the provision of financial services through CBRs owing to the opaque nature of these relationships, which leave banks more susceptible to AML/CFT breaches (World Bank, 2015a).¹⁰ Many correspondent banks indicated that before taking on this risk they would like to receive more guidance from regulators on accepted levels of risk tolerance and assurances that breaches of AML/CFT guidelines would not necessarily imply negligence on their behalf. Such assurances and guidance could encourage the banking of legitimate MSBs, respondent banks and other customers, and help ensure that money laundering and terrorist financing are better targeted by AML/CFT regulations. The World Bank has also called for more clarity on risk differentiation (World Bank, 2015a).

In addition, 50 per cent of Commonwealth countries reported that banks had failed to warn the regulatory authorities of their intentions to close MSB accounts, suspend CBRs or terminate Vostro accounts, limiting opportunities to identify alternative banking relationships. The provision of guidance material by regulators that encourages greater forewarning, as well as the use of trial periods, credit and other constraints over outright account terminations, would not only benefit many individuals and businesses in these countries, but also improve financial inclusion and stability.

In working with the banking sector to develop this guidance, governments should also emphasise to banks the value of adopting technical solutions, such as those outlined in Box 4, which have the potential to both reduce the cost of compliance and make it easier for banks to identify illegal or suspicious activity.

4.3 Best practice standards for money service businesses

Introducing a set of best practice standards for MSBs could help increase the legitimacy and reputation of the sector, but could also lead to the stratification of MSBs and the de-risking of small, resource-constrained remittance service providers.

Since MSBs and banks operate internationally, some form of global best practice standard for

¹⁰ The correspondent seldom has direct relations with the final customer of the respondent bank, increasing associated risk.

MSBs that satisfies banks' and regulators' concerns could create a more stable market for MSBs. However, with MSB sectors varying widely between jurisdictions, achieving international consensus will prove difficult, if not impossible. Nevertheless, there could be significant benefits in introducing regional standards among country groupings, especially where only a small number of sender countries dominate regional markets.

If best practice standards are produced in conjunction with banks, regulators and MSBs, these standards could ease banks' concerns over providing services to 'credible' MSBs, helping to establish trusted remittance service providers and stable remittance corridors. While such standards could stabilise remittance markets in countries close to corridor collapse, collapses are unlikely and any standardisation of the sector is prone to cause stratification, with those MSBs that cannot afford to step up their compliance forced to exit the market.

Although the Commonwealth considers that best practice standards can be beneficial, there is a trade-off between compliance and competition. While some Commonwealth countries have expressed an interest in operationalising these standards, significant due diligence is required before they are implemented, as their effects will vary depending on country circumstances.

4.4 Capacity building

Many countries expressed that their capacity-building needs are not being met and that a platform for identifying individual countries' specific capacity constraints is required so that they can be brought to the attention of key international forums, such as the G20 and FATF, as well as donor governments.

The majority of Commonwealth developing countries have voiced concerns over their inability to implement AML/CFT regulatory requirements, with regulators, financial institutions and commercial entities lacking the necessary funding, training and resources to meet the onerous supervisory demands and costly compliance requirements of some banks and jurisdictions (Commonwealth Secretariat, 2015a).

As can be seen in Figure 6, capacity-building initiatives received the greatest support from Commonwealth developing countries, with 75 per cent of all countries identifying improved capacity building as one of their top three solutions to tackling the adverse consequences of AML/CFT regulations.

More specifically, 70 per cent of Caribbean and 80 per cent of Pacific countries ranked capacity building in their top three solutions to de-risking, while 70 per cent of African countries reported increased capacity building as their favoured solution.

Although capacity-building initiatives can address deficiencies in AML/CFT compliance, many Commonwealth countries believe that more action is needed at the international level to provide targeted assistance to developing countries that is in line with their specific capacity-building needs. While regional training opportunities and pooled regional resources were suggested as potential means to increase capacity and raise awareness among reporting agencies, the creation of a platform to identify and facilitate the allocation of capacity-building and technical assistance efforts was widely supported by the Commonwealth's membership. Recent developments under the auspices of the G20 with respect to technical assistance for taxation could provide a useful model, as the key international organisations involved in the provision of this assistance have sought to develop a joint platform to identify the needs and capacity constraints of recipient countries.

While capacity-building initiatives can address deficiencies in AML/CFT compliance and help banks differentiate between low- and high-risk customers, there are limitations on the extent to which capacity-building initiatives, and the implementation of AML/CFT standards, can address the larger issue of de-risking. With banks able to restrict or close accounts on commercial grounds alone, banks may refrain from providing banking services for reasons entirely unrelated to regulatory compliance or identified risks. As a result, further capacity-building initiatives may have a limited impact on the provision of services to MSBs and respondent banks if de-risking is based on commercial or other objectives (Commonwealth Secretariat, 2015a). For this reason, greater precedence is given in this report to those policy solutions focused on the setting of standards and the use of guidance to promote a fair AML/CFT regime at the international level.

5. Conclusion

The Commonwealth survey on de-risking identified the implementation and interpretation of AML/CFT regulations as a major driver of de-risking (Commonwealth Secretariat, 2015a). While AML/CFT regulations are essential to protecting the integrity of the global financial system, there are a number of negative – albeit unintended – consequences of these regulations for developing countries, including the de-banking of legitimate individuals, businesses and governments. The de-risking of legitimate MSBs and respondent banks not only affects de-banked institutions and their customers, but can also have adverse effects for the stability and safety of the financial system as a whole – undermining the very objectives of these regulations.

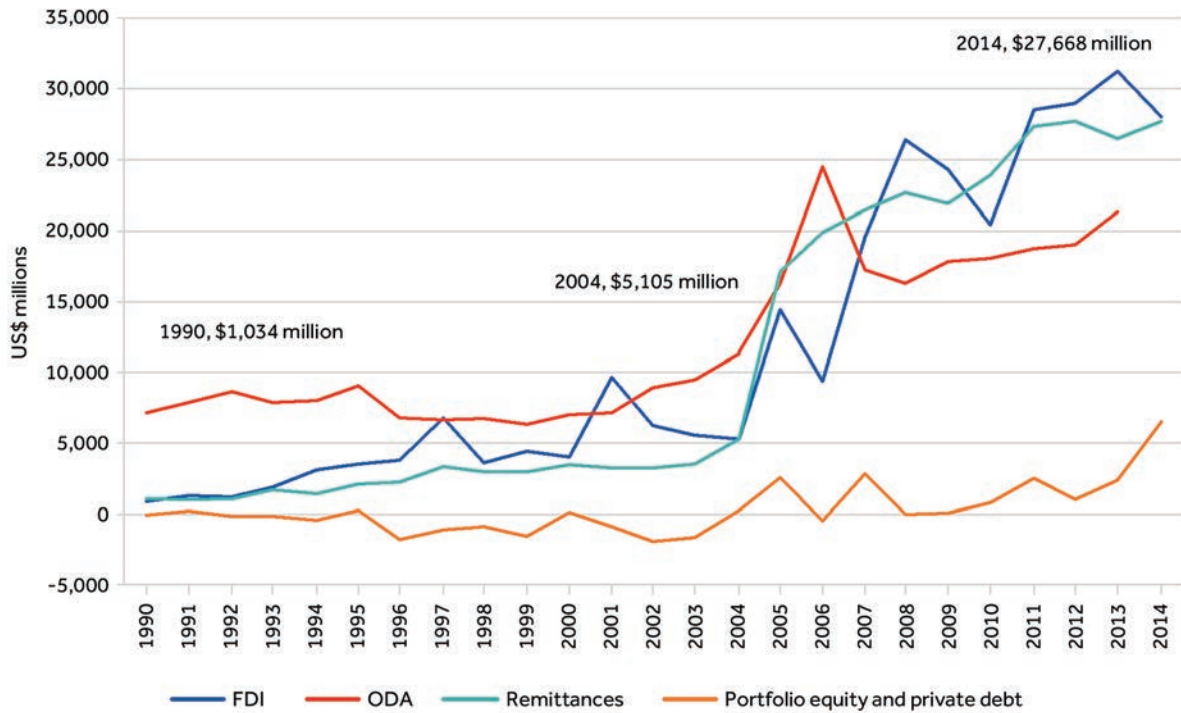
The development and implementation of AML/CFT regulations, led by the world's most developed countries, has inevitably focused on the misuse of the international financial system to facilitate money laundering and terrorist financing. However, with the unintended consequences of AML/CFT regulations for developing countries potentially significant, there is a clear need for greater balance between the public policy goals of financial security and financial inclusion.

While actions pursued by the G20, FSB, FATF and other international organisations and countries have sought to reduce the adverse impacts of AML/CFT regulations on developing countries, the increasing magnitude of this issue suggests that further action is urgently needed. This report seeks to advance international efforts to identify practical and effective responses to the adverse impacts of de-risking for developing countries.

Overall, there is a need for a more comprehensive and coherent approach to the issue of de-risking, one that consolidates international efforts through targeted action and a consistent voice. The G20 is well placed to continue to lead this work and to initiate an international response on the scale the issue demands. In this context, the focus of this year's G20 development agenda on policy coherence should help highlight the need to take account of developing countries' perspectives in designing international policy measures. Indeed, de-risking presents a fitting issue through which to assess the G20's commitment to policy coherence.

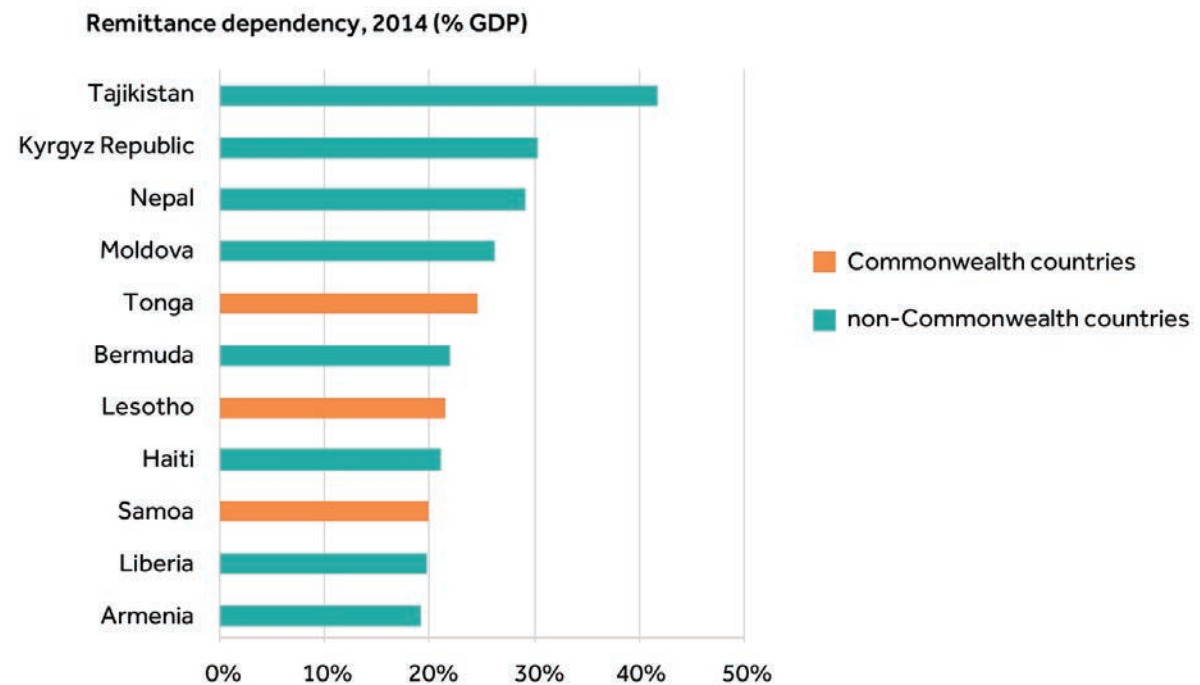
Annex

Figure A.1 Capital inflows to Commonwealth African countries



Note: Call-out boxes reveal remittance flow figures for the years indicated Source: World Bank (2015b)

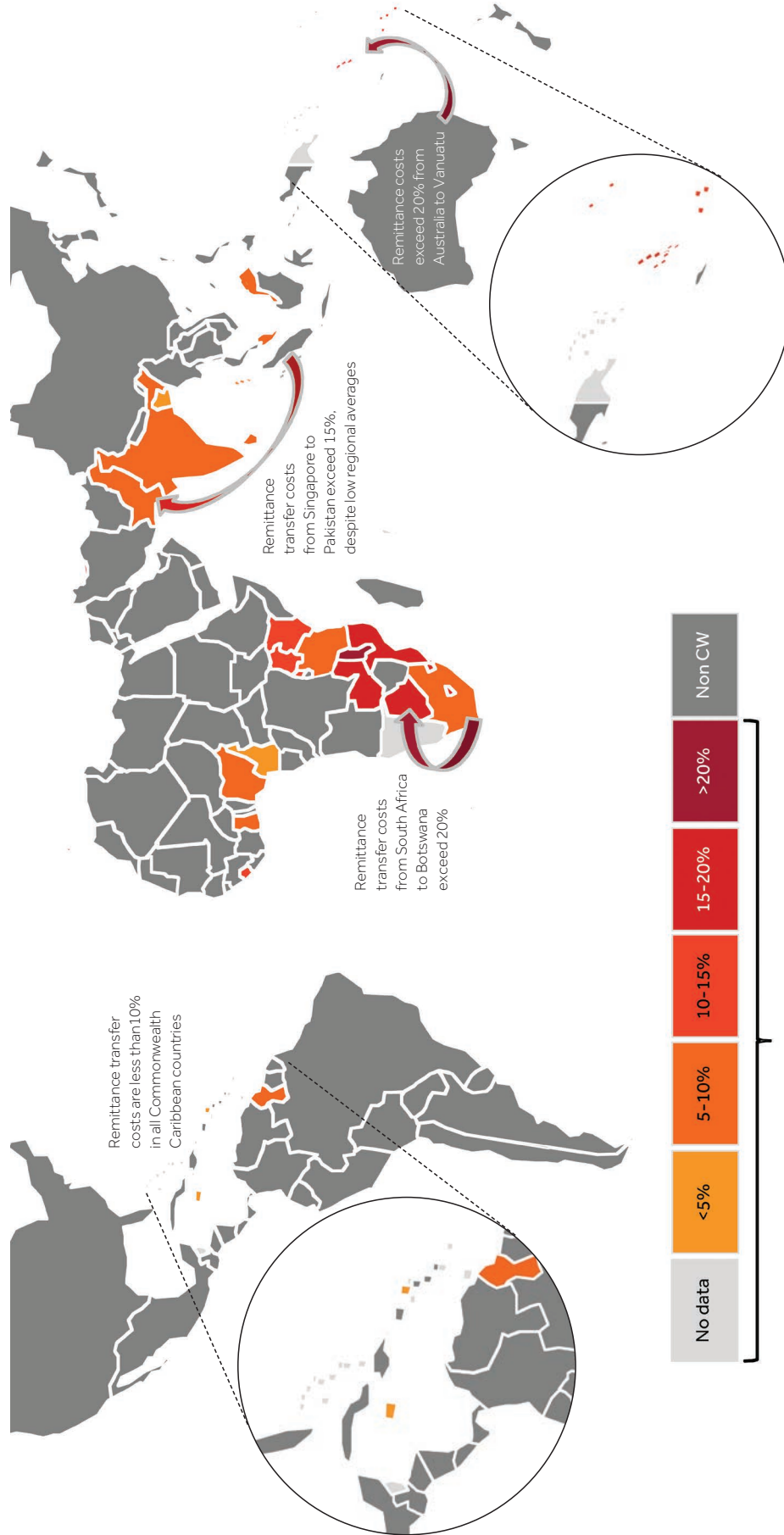
Figure A.2 Major remittance-dependent countries



Source: World Bank (2015b)

Figure A.3 Remittance cost map for the Commonwealth's developing country membership

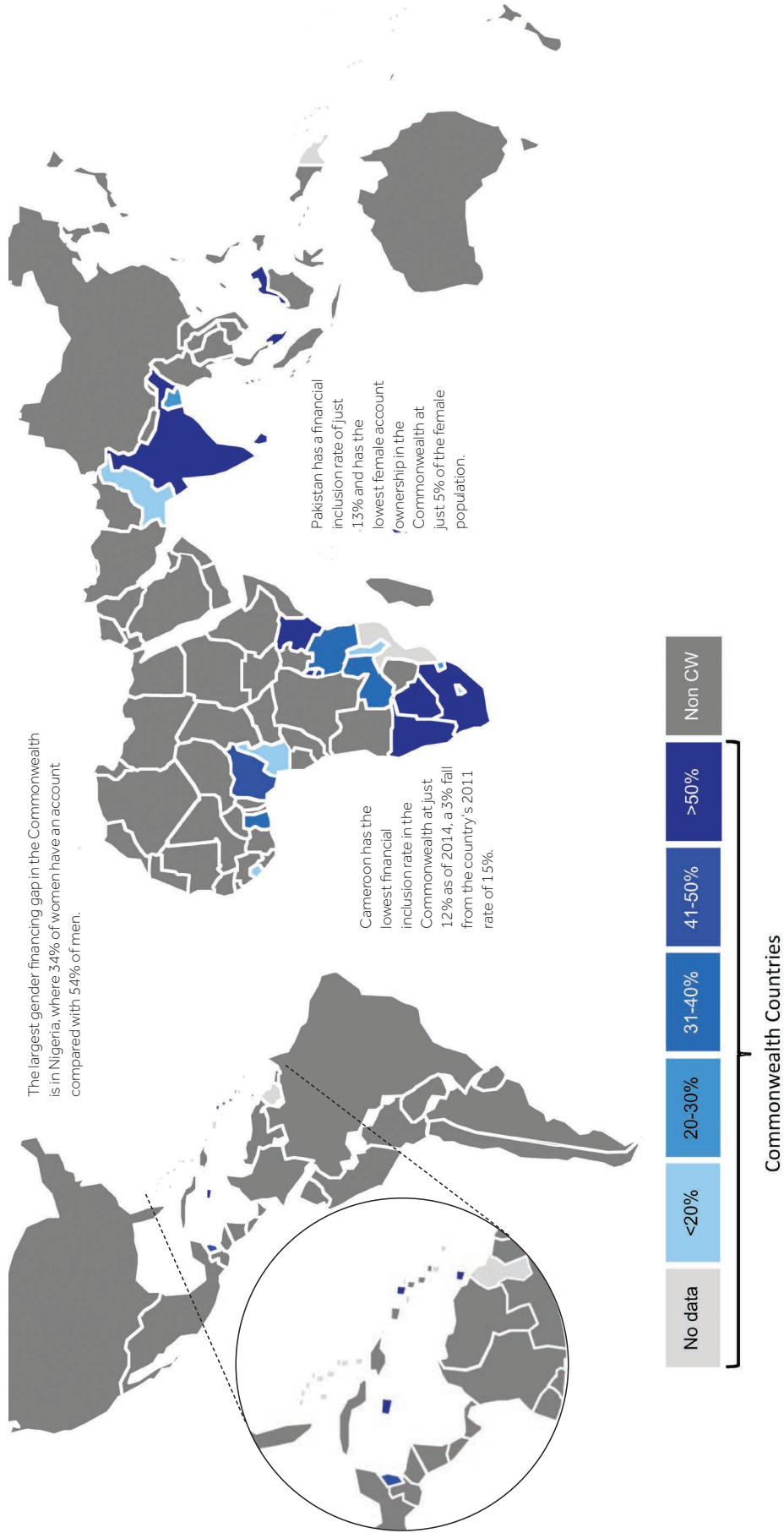
66% of Commonwealth countries face average remittance transfer costs greater than the global average of 7.37%.
 25% of Commonwealth countries' average remittance transfer costs are double the global average.



Source: Commonwealth Secretariat. Data taken from the World Bank's remittance prices worldwide dataset (World Bank, 2016). Data for Q1 2016 unless specified

Figure A.4 Financial inclusion rates in the Commonwealth

52% of adults (aged 15+) in Commonwealth developing countries are financially excluded. Men are 13% more likely than women to have a bank account in Commonwealth developing countries.



Source: Commonwealth Secretariat. Data from the World Bank's Findex database (2015f). Data for 2014 except for Lesotho, Swaziland and Trinidad and Tobago, for which 2011 data was used

Glossary of Key Terms

AML/CFT refers to the standards, practices and regulations aimed at supporting anti-money laundering (AML) and countering the financing of terrorism (CFT). AML/CFT standards have been developed by the Financial Action Task Force (FATF).

Correspondent banks are banks that provide services on behalf of other financial institutions. They often act as a domestic bank's agent abroad, conducting business transactions, accepting deposits and gathering documents on behalf of a respondent bank.

De-banking is a consequence of de-risking and, in this context, refers to the closure of bank accounts in response to growing pressure from national and international regulators to comply with AML/CFT regulations.

De-risking refers to the phenomenon of financial institutions terminating or restricting business relationships with clients or categories of clients to avoid, rather than manage, risk.

FATF is the Financial Action Task Force, the inter-governmental body responsible for developing and promoting policies to combat money laundering and terrorist financing.

ML/FT refers to 'money laundering/financing of terrorism'.

Money service businesses (MSBs) are defined here as non-bank organisations specialised in the provision of remittance services. These include money transfer operators (MTOs), microfinance institutions, credit unions, foreign currency exchanges and other institutions able to provide remittance services.

Respondent banks are banks that receive financial services from other financial institutions acting on their behalf. Effectively, correspondent banks perform financial services on behalf of respondent banks.

Vostro accounts are the accounts that correspondent banks hold on behalf of other foreign banks.

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