

De-Risking and Other Challenges in the Emerging Market Financial Sector

Findings from IFC's Survey on Correspondent Banking

Overview

Recent efforts to strengthen the global financial system will ultimately contribute to greater financial stability and a safer world. However, the resultant de-risking is reportedly having a negative impact on banking in emerging markets. With this 2017 Correspondent Banking in Emerging Markets Survey of over 300 banking clients in 92 countries, IFC brings important new information and data to the de-risking discussion.

Findings

More than a quarter of global survey participants claimed reductions in Correspondent Banking Relationships (CBRs). Globally, 27 percent of survey participants noted CBR reductions in 2016, and several regions reported reductions with significant frequency. Over one-quarter of survey participants in Europe and Central Asia and Latin America and the Caribbean reported decreases, and over one-third in Sub-Saharan Africa. Comparing 2016's reduction frequency with prior-year surveys, this degree of market fluctuation is significant. Furthermore, the reduction of CBRs is a surface indicator; the challenges faced by emerging market banks are more complex.

Seventy-two percent of participant banks report that they are facing multiple external challenges that reduce their ability to serve customers. Compliance Costs and Correspondent Banking-related difficulties were most frequently identified. Banks most often indicated that compliance requirements imposed by national/local regulators or cross-border correspondent banks, as well as related costs, were difficult to absorb. CBR stress, such as the reductions in the number of active CBRs, reductions of line limits and limited alternatives, also decreased their ability to serve customers. These factors were more frequently identified than market competition/pricing, customer credit risk, macroeconomic risk, foreign exchange availability or increased reserve requirements, among others.

Survey findings suggest that the drivers and effects of de-risking are subtle, complex and pervasive. Countries of all sizes and income levels are affected, as are most emerging markets, with over 60 percent of banks in each region noting the impact of external impediments and over 80 percent of banks in Sub-Saharan Africa. The differences rest in the magnitude, complexity and specifics of the challenges.

Despite significant spending on compliance in 2016, 78 percent of banks expect compliance expenditures to increase substantially in 2017. Along with their global peers, most emerging market banks are tackling several compliance issues: expensive implementation of software or system upgrades; limitations in customer information; a lack of harmonization in global, regional and local regulatory requirements; variable data

Date

1 September 2017

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requests from multiple cross-border correspondent banks and a shortage of training or knowledgeable staff, among others. Banks in countries across a broad range of regions, sizes, and income levels expect costs to more than double in 2017.

Globally, demand for international banking services appears to be outpacing capacity to meet that demand. In 2016, more banks reported increased demand for international banking services than increased capacity to meet demand. Over 60 percent of survey participants in both East and South Asia reported increases in demand. And 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.

Implications

The implications of CBR stress may be quite serious: CBR stress threatens to undermine economic stability and growth, financial inclusion and development goals. CBR stress can affect multiple channels of an economy, including trade and remittances. Without CBRs, trade is often not possible, putting at risk the import of critical goods and ultimately economic growth. Without CBRs, remittances could be hindered, blocking income that families depend on.

Adapting to external challenges, banks report that they are reducing benefits to their customers, raising fees and reducing credit limits. This will spill over into their economies. Banks are also cutting customers; importers/exporters and families appear to be the hardest hit. Banks also noted declining geographic coverage, including intra-country and cross-border.

Next Steps and Conclusion

The results of IFC's survey offer perspective on which actions to address de-risking would be most valued by private-sector emerging market financial institutions. Survey participants most often identified three solution components that would be most useful: (i) harmonized regulations across jurisdictions, (ii) a centralized registry for due diligence data and (iii) assistance with understanding and adapting to the new standards. There are a number of potential actions for all stakeholders to consider, assessing their capacity to contribute for each. These actions include:

Regulatory:

- Continuing to work toward achieving greater harmonization of regulatory requirements
- Maintaining appropriate regulatory capital requirements for short-term, low-risk lending supported by correspondent banking and adjusting Basel liquidity standards to take into account the operational nature of correspondent banking
- Enhancing support to emerging market regulators in developing compliance regulations

Financing:

- Providing additional capital and liquidity by investing directly in and with correspondent banks to sustain and/or expand their CBRs
- Encouraging multilateral organizations to innovate their product offerings to further support correspondent banking, particularly trade finance
- Providing additional funding and guidance to assist some emerging market banks in adapting their KYC systems and/or AML/CFT processes

Capacity building:

- Providing more training opportunities to emerging market banks to improve understanding and application of international and local compliance requirements
- Providing training to select emerging market banks' customers

Technological innovation:

- Supporting the development of central registries for respondent customer data and reconsider current liability standards for those who use it
- Supporting the development of national identity registries for KYC due diligence
- Promoting focused adoption of emerging technology-based solutions where relevant and secure

Knowledge sharing:

- Supporting appropriate information-sharing among institutions to enhance AML/CFT/KYC efforts
- Seeking enhanced opportunities for multilateral collaboration

As multiple stakeholders engage to formulate a cohesive response to emerging market de-risking, the need for a consistent emerging market private sector voice is clear.

A carefully organized, focused response is necessary to effectively address de-risking challenges. The international community recognizes the importance of balancing the appropriate steps to prevent illicit actors access to financial services with ensuring continued or expanded access to finance for companies, small businesses, households and individuals.

Multilateral collaboration entails the establishment of a joint vision, clarifying what success in de-risking resolution would look like. It would identify both key milestones to achieve that vision as well as each organization's specific contributions to achieving those milestones. As the private financial sectors in emerging markets are directly affected by the decisions of multiple stakeholders, it is critical to ensure that their views are well represented in upcoming discussions.

Acknowledgements

The authors would like to recognize all those individuals who generously contributed their time, expertise, and guidance as we embarked upon this effort.

Nesrine Abdelmoniem, Semira Abdulkadir, Mehmet Akgunay, Jorge Alejandro Godoy Alaniz, Pervez Ashiq Ali, Greg Alton, Jimena Altube, Jihad Alwazir, Fabiola Amarante, Sara Ugarte Aramendia, Regina Camille Sison Aseron, Salah El Din Mohamed El Assar, Zeynep Attar, Marc Auboin, Armando Ayala, Jonas Tago Ayeri, Batmunkh Batbold, Vittorio Di Bello, Paulo De Bolle, Petya Koeva Brooks, Marcos Brujic, Andrei Budescu, Thuy Thu Bui, Ateeq A. Butt, Marcelo Castellanos, Alexandra Celestin, Dave Chalia, Meriem Chattou, Fiona Chen, Nadia Chiarina, Mauricio Cifuentes, Ledia Cirko, Hamide Burcu Copuroglu, Siobhan T. Cropper, Robert Cull, Loan Mai Thi Cung, Diane Damskey, Alexandre Darze, Bozor Davlatmamadov, Asli Demirguc-Kunt, Marie Dieng, Ante Dodig, John Michael Donnelly, Katrin Dopler, Alexandra Dzeboeva, Matthew Ekberg, Aurelia Fah, Sandra Fallon, Giorgio Felici, Saulo Ferreira, Alicia Ferrer, Ernestine Emefa Nyavor Foli, Allen Forlemu, Kevin Gani, Ramiro Garcia, Saurabh Garg, Alexandra Glatznerova, Monica Gonzalez, Mary Goodman, Olesya Grebeniuk, Sebastien Gregarek, Neil Gregory, Baret Gurden, Maria Irene Gutierrez, Hedi Saadeldin Hassan, Yasser Mohamed Tawfik Hassan, Bill Haworth, Elizabeth Hickman, Olayemi I. Idris-Animashaun, Shazia Iqbal, Tania Khan Jamal, Tor Jansson, Vladimir Jelisavcic, Damata Kaleem, Richard Muamba Kasenga, Susanne Kavelaar, Faeyza Khan, Mahima Khanna, Haruko Koide, Gokhan Kont, Benie Olivier Landry Kouakou, Marta Kozak, Anna Krivosheeva, Joseph Akwasi Kuma, Alok Kumar, Kristina Ladonina, Anne-Lucie Lafourcade, Sophie Lalieva, Hans Peter Lankes, Ceri Wyn Lawley, David William Lawrence, Zaiheng Li, Marcelo Pan Chacon Liberman, Lingshu Liu, Tanya Lloyd, Karla Lopez, Gregory Lorne, Alexei Lunin, Aliou Maiga, Madalitso Ben Makhela, Hama Makino, Ricardo Alvaro Cardona Maldonado, Karina Chan Mane, Nicolas Marquier, Meritxell Martinez, Yira Mascaro, Johan Mathisen, Gerald Matthe, Carlos Mayorga, John Philip McNally, Jasmine Meesarapu, Fernanda Mendoza, Catherine Miriti, Anurag Mishra, Keita Miyaki, Florian Moelders, Ahmed Hanaa Eldin Mohamed, Maria Fernanda Molejon, Maria Fernanda Molejon, Abubakar Sediq Momodu, Mehmet Mumcuoglu, Edwin Mbugua Munene, Alejandra Munoz, Francisco Jose Nandin, Roman Nemaev, Lien Hoai Nguyen, Nga Thanh Thi Nguyen, Aleksey Nikiforovich, Sean Nolan, Margrit Nzuki, Akintunde Ogunmodede, Anna Ostrovskaya, Asli Ceren Ozhan, Annie Parseghian, Alejandra Perez, Dung Kim Pham, Nikolay Potseluev, Gabor Pula, Marcel Rached, Vijaya Ramachandran, Florenca Rashid, Pramada Reddy, Thomas Rehmann, Manuel Reyes Retana, Mark Rozanski, Karin Rubach, Claudia Ruiz Ortega, Agustin Matias Saenz, Marta Sanchez-Sache, Felipe Sanint, Rogerio Ferreira Dos Santos, Arturo Sarabia, Veronica Rita Garcia Seffino, Raquel Segrera, Yakhara Ngally Sembene, Gimhani Talwatte Seneviratne, Shehzad Sharjeel, Nilesh Shrivastava, Fatma Mohamed Aziz Sidky, Daniel Machado De Sousa, Mircea Stoica, Bilal Rabah Al Sugheyer, Xiaoxi Sun, Ethiopis Tafara, Yasam Talu, Wilfried Tamegnon, Ali Adnan Tariq, Helena de le Torre, Giang Phuong Thi Truong, Halil Ucarer, Umedjan Umarov, Emile Van der Does de Willebois, Eugenia Vargas, Danielle Marie Velez, Pierre Ligneul De Villeneuve, Iulia Vlad, Yuting Wang, Inosha P. Wickramasekera, Maureen Williams, Hakan John Wilson, Weichuan Xu, Maxim Yushchenko, Nury Gianina Manrique Zapana, Lingjun Zhu, Houda Zinoun, Virginia Ziulu, Georgy Zvonkov

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Abbreviations Used in This Text

ACAMS	Association of Certified AML Specialists
ADB	Asian Development Bank
AfDB	African Development Bank
AML	Anti-Money Laundering
ANZ	Australia and New Zealand Banking Group Limited
BAFT	Bankers Association for Trade and Finance
BBA	British Bankers' Association
BCG	Boston Consulting Group
BIS	Bank of International Settlements
CARICOM	Caribbean Community
CBR	Correspondent bank relationship
CDB	Caribbean Development Bank
CDD	Customer due diligence
CFT	Combatting the Financing of Terrorism
CGD	Center for Global Development
CPMI	Committee on Payments and Market Infrastructures
DFI	Development finance institution
DLT	Distributed ledger technology
EAP	East Asia and the Pacific region
EBRD	European Bank for Reconstruction and Development
ECA	Europe and Central Asia region
ECB	European Central Bank
EU	European Union
FATF	Financial Action Task Force on Money Laundering
FCS	Fragile and conflict-affected situations
FSB	Financial Stability Board
G-SIB	Global Systemically Important Banks
GTFP	Global Trade Finance Program (IFC)
ICC	International Chamber of Commerce
IDA	International Development Association
IDB	Inter-American Development Bank
IFC	International Finance Corporation
IIF	Institute of International Finance
ILO	International Labor Organization
IMF	International Monetary Fund
ISO	International Organization for Standardization

KYC	Know Your Client
KYCC	Know Your Client's Client
LAC	Latin America and the Caribbean region
LC	Letter of credit
LEI	Legal entity identifier
LIC	Low-income country
MENA	Middle East and North Africa region
MTO	Money transfer organization
NPO	Non-profit organization
PEP	Politically exposed persons
PMPG	Payments Market Practice Group
SA	South Asia region
SDG	Sustainable Development Goals
SME	Small and medium enterprise
SSA	Sub-Saharan Africa region
SWIFT	Society for Worldwide Interbank Financial Telecommunication
TFP	Trade Facilitation Program (EBRD)
UBO	Ultimate beneficial owner
WTO	World Trade Organization

PREFACE. WHY BANKS ARE ESSENTIAL TO A COUNTRY'S DEVELOPMENT

Of all components of a financial system, banks are the driving force—they enable virtually every part of a market to function. The exchange of money for products and services is at the core of an economy's function. Communities are teeming with activity that is facilitated by the transmission of money every day. Millions of daily transactions touch every part of the market, enabling households, firms and governments to buy essential goods, pay employees and suppliers, grow and invest capital, purchase homes, pay debts, seed farms, build savings, start and expand companies, finance infrastructure, provide hospitals and schools, store and distribute energy, produce construction equipment, manufacture goods, and provide services to communities. Financial transactions are the mechanism by which people, companies and countries survive, grow, develop and, ultimately, excel. As financial intermediaries, banks enable the mechanisms that transmit money. They are essential to basic economic function, stability and growth.^{1,2,3,4,5}

Banks make transactions easier and more secure. Banks hold almost half of the global financial system's total assets, which approximated \$450 trillion in 2010.^{6,7} Other components of financial systems, such as capital markets, clear all non-cash asset transfers through banks and other financial intermediaries. All global financial transaction volume—including \$14 trillion daily in U.S. dollar-denominated transactions—passes through financial intermediaries, either directly (when banks are involved in the investments), or indirectly, as assets held in banks are transferred, cleared, settled and stored.⁸ By enabling non-cash flows, banks eliminate the uncertainty and potential for loss associated in cash or barter-based markets, making transactions quicker and cheaper.⁹ The financial system also makes transactions safer because they happen in a structured, formal and regulated manner. Banks improve resource allocation through the continuous aggregation of investment opportunities, as well as the development and application of systems for assessing those with the potential for financial success.^{10,11} They deploy customer capital toward productive uses, stimulating firm growth to support the broader economy.

Banks bring more people into the financial system. Relying on economies of scale unavailable to individuals, banks can take on more risk and manage that risk effectively.¹² In many cases, a single individual or company may not be willing to take on credit risk because of lack of resources to assess creditworthiness, a high probability of loss, or lack of tools to protect against loss. Thanks to their size and expertise, banks can collect and process vast amounts of information on their customers and potential customers. Banks leverage this wealth of knowledge to make credit allocation decisions. Pooling, diversifying and mitigating risk enables financial intermediaries to lend—and lend more—to customers that pose certain risks that a single entity would not likely cover. Extending credit to customers that did not previously have access grants more people the ability to buy homes, pay for an education, invest in new businesses and purchase goods that improve their productivity. Thus, banks make a material contribution to the expansion of financial inclusion.

Banks create a cushion against shocks and contribute to stability. Banks offer a secure place for customers to save money, as well as tools for risk management. Building savings not only enables future investment; it also helps create a “cushion” in case of income fluctuations or sudden unforeseen expenses.¹³ For families, this might be due to job loss or health emergency; for businesses, this could be caused by a market downturn or the loss of a major customer. Other financial products, such as loans, may provide tenors or grace periods that create a temporary window to adapt to exogenous circumstances or even internal mistakes. Banks' own balance sheet capital can act as a source of absorption for shocks experienced by their customers. At the macroeconomic level, banks slow the effects of acute economic events impacting entire sectors by absorbing payment challenges that may create temporary liquidity shortages.¹⁴ Banks can also be channels for monetary

policy that supports stability or, in the aftermath of crises, economic recovery. Together, these benefits support wealth accumulation, protect people from falling into poverty, prevent businesses from succumbing to short-term funding challenges, and sustain credit during economic downturns.

Beyond their home country's borders, banks provide an integral link into the global economy. Banks transmit opportunities that rise from connections to the global economy, working across borders to provide businesses and citizens with access to foreign exchange and foreign markets. Well-functioning financial systems ease external financing constraints and facilitate inflows of foreign capital (including foreign direct investment, portfolio investment and bonds, and remittances) into markets.¹⁵ In many cases, banks also provide access to goods produced abroad, connecting households and real-sector firms into global supply chains. In terms of trade access, companies use banks to finance exports that increase national income through expanded ability to access foreign markets. They can also finance imports that provide the foundations of innovation and productivity growth (ideas, knowhow, technology, infrastructure and capital equipment); deliver the raw materials needed to participate in global supply chains with value-added manufacturing; and ensure the supply of critical commodities necessary for daily economic function, livelihoods and, in some cases, lives.¹⁶ Through capital inflows and exchange of goods, banks enable trade and investment that drives firm and industry growth.¹⁷

Countries with better-functioning financial systems and banks grow faster, and growth spurs poverty reduction.^{18,19,20,21} Economic growth is the most powerful instrument for reducing poverty and improving the quality of life in developing countries. Growth creates stronger demand for labor and generates job opportunities, which in turn creates a virtuous upward cycle for further growth and poverty reduction—the cornerstone of the global development agenda.²² Banks are in the best position to effectively transfer private-sector savings to productive investments. Workers with access to financial products can more easily save to educate themselves, increasing their chances of finding employment. Entrepreneurs are more likely to start businesses in areas with greater financial development. Industries grow faster in countries with better financial systems.²³ A World Bank study found that doubling the amount of credit for the private sector is associated with a 2 percentage point increase in the GDP growth rate.²⁴ A 4 percentage point increase in an economy's consumer credit, or a 10 percentage point increase in corporate credit, raises real GDP growth by 0.3 percentage points.²⁵ As companies launch and grow, more jobs are available and employment rates improve.²⁶ Globally, every 1 percentage point of additional GDP growth has been found to increase employment by 0.3 percentage points.²⁷ Cross-country studies performed over the past half-century have found that a 10 percent increase in a country's average income level will reduce the poverty rate by between 20 and 30 percent.²⁸

Challenges faced by banks, particularly de-risking, may impede the function of financial systems' capacity to optimize growth, stability and poverty reduction. Over the last decade, many banks have become increasingly vocal about the challenges they are facing in certain markets and asset classes as market dynamics continue to change. However, in the past few years, anecdotal evidence has highlighted the specific threat of de-risking stemming from, most notably: (i) increasing capital and liquidity requirements; (ii) rising costs associated with regulatory guidance; and (iii) requirements and related sanctions rising from AML, CFT, and Know Your Client (KYC)-related costs. Responding to these issues, multiple institutions, including IFC and at least 15 other multilateral bodies, have engaged to collect evidence and support the clarification and consideration of broad guidance on compliance, application of said guidance by individual regulators, and the implications on participants in the formal financial system. These efforts are part of a broad effort supported by the G-20 to mitigate the potentially detrimental consequences of de-risking on economic stability and the global development agenda.

SECTION 1. DE-RISKING CONTEXT AND DRIVERS

Since the financial crisis, banks in most countries have faced a combination of challenges that have changed their decision-making calculus.^{29,30,31,32,33} Low interest rates, more volatile portfolio flows, slower growth, rapid technological developments and the entry of technology-focused competitors are among the changes that have dramatically altered the dynamics of the global financial system.^{34,35} In addition, 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. Global, regional and local regulators have addressed these changed dynamics through new requirements for financial sector participants with an eye toward bolstering global economic stability and improving the resilience of financial systems to protect them from future shocks. For many banks, these changes in the macroeconomic, geopolitical, regulatory and commercial landscapes have shifted income opportunities, increased costs and changed the way they think about risk and return and other issues that are critical to their viability.

In general, banks have had to adapt to a surge of regulatory activity in a compressed time period, and de-risking is an increasing concern. While many of these regulations have increased financial system resilience and helped identify suspicious customer behavior, they have also imposed increases in both reserve capital requirements and compliance costs. As a result, some banks find it more difficult to do business with certain markets and customers. According to the Financial Action Task Force on Money Laundering (FATF) and the Wolfsberg Group et al, so-called “de-risking” refers to financial institutions terminating or restricting their relationships with customers or categories of customers in order to avoid risk.^{36,37} Participants in the de-risking discussions understand that the drivers of these decisions are more complex than the formal definition suggests. De-risking is of acute concern when it means that banks are severing ties with each other, particularly across borders, because the flow of money between people, businesses and markets is necessary for security, stability and growth. As many banks are beginning to curtail these connections, it reduces emerging market banks' capacity to help their customers and thus countries thrive.

Changes in capital reserve requirements have contributed to financial system resiliency, but have limited the amount of capital some banks have to invest in their customers. Following the 2007–2008 financial and 2010–2011 Eurozone crises, multiple regulatory reforms by governments and international bodies have sought to quantify systemic risk and promote greater transparency, recognizing that improved capacity to accurately measure risk ultimately strengthens the financial sector and further stabilizes the economy. Of particular note, the Basel III accord strengthened financial sector regulation, supervision and risk management to increase bank resiliency through additional disclosure requirements and guidelines pertaining to leverage ratios, capital requirements and liquidity. One result has been higher reserve capital and liquidity requirements. In addition, the Dodd-Frank Act requests that systemically important U.S. financial institutions maintain an additional capital cushion to absorb loan losses in future downturns and hold a larger portion of assets in cash or securities that can be easily liquidated in the event of a run on banks.³⁸ With more capital in reserve, banks generally have relatively less to lend and so are allocating increasingly scarce capital to more profitable products, markets and customers. Relationships that generate lower returns or more challenging risk are more likely to be re-evaluated and terminated. In October 2016, the Institute of International Finance (IIF), along with Ernst & Young released its 7th annual Global Bank Risk Management Survey with responses from 67 banks from 29 countries, including 23 of 30 global systemically important banks (G-SIB).³⁹ These banks expressed concerns about regulatory proposals to increase capital further and reduce risk sensitivity, which could have the effect of making areas of core lending activity unprofitable and thus infeasible. Sixty-three percent of participants identified changes to internal ratings-based models (which may come with the

finalization of the Basel III reforms) as a major concern and highlighted that the models could change the economics of some areas of business.

At the same time, there have been greater efforts to combat money laundering and terrorism financing. The FATF has proposed global standards for AML and CFT that follow a risk-based approach,⁴⁰ which was designed to provide banks with greater flexibility in determining the most effective measures to identify and address money laundering/terrorist financing risks.⁴¹ The adaptation of this approach also shifted the responsibilities of banks from completing pre-determined compliance activities (box ticking) to ensuring that their policies, controls and procedures are effective at managing and mitigating their risk.⁴² In addition to indicating that identification and response measures for money laundering should be effective, FATF has indicated that financial institutions should be required to take steps to identify and assess threat risk for customers, countries, products, transactions, delivery channels, among others.⁴³ These international standards are then implemented at the national and sometimes subnational level, with each country interpreting and adapting them to local conditions. In the case of AML/CFT, this has created ambiguity as well as variance and inconsistencies (for instance, with what constitutes sufficient effectiveness) between jurisdictions, often leaving banks to absorb, manage and apply regulations that deliver a significant set of complexities. Some banks have noted cases where, to be in compliance with some regulatory rulings, they are out of compliance with contradictory rulings from other regulatory bodies; other regulations limit actions that would ultimately contribute to shared international efforts to limit money laundering and terrorist finance.⁴⁴ A primary example of this constraint relates to cross-border and intra-institutional information sharing as noted by the G7.⁴⁵ KPMG's 2014 survey found that over half of survey respondents were unable to share information across jurisdictions, even across their own businesses.⁴⁶ Responding to IFC's 2017 survey, one Sub-Saharan African bank wrote that it faces "conflicting" requirements and "sometimes unpredictable outcomes" from multiple regulatory agencies across the countries where it operates.⁴⁷ Another bank in Latin America and the Caribbean acknowledged regulatory "inefficiencies" generated by a lack of standardization of requirements and "the need for constant attention to new regulatory requirements ... [to] keep up to date with the new typologies of AML/CFT/KYC."⁴⁸

While banks have more flexibility to develop their own risk assessment and response processes and procedures, they are also subject to unspecified and potentially large fines. While both the risk-based approach and follow-on clarification efforts have the potential to improve global capacity to restrict money laundering and terrorist financing, the shift in regulatory approach has both increased expectations of the financial sector and reduced clarity of regulatory expectations. In some cases, regulators have prosecuted certain institutions and handed down significant fines, some in the billions.⁴⁹ While details for some large fines suggest liability on the part of the relevant bank⁵⁰ (regulators note that only a small portion of infractions are fined),⁵¹ the magnitude of the penalties creates the potential for significant downside—not only for non-compliant banks, but for any banks that are assessing compliance-related risk for activities in certain markets or with certain customer groups. This is true even when those involved are performing legal activities; while fine probability may be low, the existence of the potential, as well as the material amounts of recent fines, change the risk-reward formula for many banks. A March 2017 report by Boston Consulting Group (BCG) said banks globally have paid \$321 billion in fines since 2008 relating to failures to identify and address money laundering, market manipulation and terrorist financing, among others.⁵² The total value of AML-related fines charged by regulators in the U.S. rose significantly between 2010 and 2015, reaching \$15 billion in 2014.⁵³ U.S. officials note that there is a graduated spectrum and process between the identification of deficiency and, after several steps, a potential fine.

In its report, BCG predicted that the number of fines paid globally is set to increase in the coming years as European and Asian regulators are expected to apply sanctions more vigorously. Thus, what was once a fairly intangible reputational risk has become both a significant and unpredictable financial risk for each customer, counterparty bank and market with which a correspondent bank is engaged.

Financial institutions have reported that the risk of AML- and CFT-related sanctions is a growing concern. In a 2014 survey of 317 financial services providers representing 48 countries, KPMG found that nine out of 10 participants acknowledged that AML/CFT sanctions are a priority area for banks—the highest ratio in the 10-year history of the survey.⁵⁴ Regulatory approach was ranked as the top AML concern, with 84 percent of participants stating that the pace and impact of regulatory changes pose significant challenges to their operations. KPMG noted that despite deep investments in AML/CFT programs, regulatory investigators continue to identify gaps in the KYC information maintained, and regulators' expectations regarding the identification of banking clients' ownership structure and rationale remain a challenge, given the complexity of ownership of some clients, even as compliance capacity continues to improve.

The shifts in the AML/CFT compliance landscape may help combat money laundering and terrorism, but they also increase costs for many banks in multiple ways. Improvements in customer due diligence (CDD) are undeniably beneficial to financial system transparency and stability, but an increasing risk of large penalties of violations creates 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.⁵⁵ Second, the additional scrutiny of some banks' customers raises costs, particularly for adding new customer relationships or markets.⁵⁶ Many banks are investing in new processes, procedures and tools that link CDD to transaction monitoring systems that raise flags and investigate suspicious activity in real time.^{57,58} These costs are often incurred before any transactions are executed and may not ultimately be recovered if market and customer returns are relatively low. Third, a lack of harmonization in compliance requirements raises costs for banks as they seek to understand and apply local requirements.⁵⁹ Many banks face a shortage of the skills needed to excel at tracking and managing various compliance requirements, and constant skills development is required.⁶⁰ Fourth, there are situations where regulations are changing on a monthly or even weekly basis.⁶¹ Ongoing changes to and tightening of compliance requirements in any single jurisdiction, along with divergence in levels of enforcement, require additional time, resources and costs to adapt.⁶² An analysis of national AML/CFT regulations found at least nine emerging markets had made one or more significant changes in 2015 alone.⁶³ A 2016 Thompson Reuters survey of over 300 global financial institutions noted that compliance officers continue to experience “regulatory fatigue” from changing and increasing regulation; 69 percent of firms expect an increase in regulatory changes while more than a third of firms report spending at least one day every week tracking and analyzing regulatory updates.⁶⁴

Surveys of banks conducted since 2014 show a clear trend of rising spending on compliance. AML compliance costs have risen 53 percent since 2011, exceeding previous predictions of over 40 percent in 2011, according to the KPMG survey.⁶⁵ That study estimated that expenditures on AML programs will exceed \$10 billion within the next two years. As an example, Goldman Sachs' 11 percent headcount rise since 2012 was primarily explained by heightened compliance efforts, according to its chairman and chief executive officer (although the expectation is that as systems are fully developed, there may be room to reduce some related headcount).⁶⁶ A 2015 survey of financial services compliance professionals worldwide by Dow Jones and the Association of Certified AML Specialists (ACAMS) found that most participants had increased their AML investment by up to 24 percent since 2013.⁶⁷ Most participants said they anticipated additional increases of up to another 24 percent over the coming three years. The same survey in 2016 found that increased regulatory expectations

represented the greatest compliance challenge (cited by 60 percent of participants). A 2016 IIF and Ernst & Young survey of banks found that increased focus on non-financial risks, including money laundering (72 percent agreed, up from 52 percent in 2015) and sanctions (52 percent agreed, up from 30 percent in 2015), was placing greater financial strain on their businesses.⁶⁸ A 2016 study of compliance officers by Thompson Reuters found that, consistent with prior years, 67 percent of firms expect senior compliance staff to cost more as demand for experienced capacity rises.⁶⁹ A 2017 compliance risk study by Accenture of 150 leading compliance officers in financial institutions across the globe found that 89 percent of institutions project investment in compliance-related capabilities to rise over the next two years, noting increasing complexity in the compliance risk ecosystem which will require further investment in skills.⁷⁰ The study was highlighted in an April, 2017 article in Forbes Magazine, which notes that compliance costs are rising for financial institutions as new risks emerge.⁷¹ A review of IMF Article IV discussions suggest that many countries expressed concern about increases in the cost, processing time or scrutiny of their CBRs.⁷²

Cross border banking activities are important components of a cohesive global financial system and important to linking emerging markets to that system. Many of these activities are underpinned by CBRs, through which banks provide payment services for each other, enabling cross-border payments, foreign currency settlements and access to foreign financial systems. A joint fact sheet by the U.S. Department of Treasury and Federal banking agencies states: “The Global Financial System, trade flows and economic development rely on correspondent banking relationships.”⁷³ The Wolfsberg Group defines correspondent banking as “the provision of a current or other liability account, and related services, to another financial institution, including affiliates, used for the execution of third-party payments and trade finance, as well as its own cash clearing, liquidity management and short-term borrowing or investment needs in a particular currency.”⁷⁴ The Committee on Payment and Market Infrastructures (CPMI), a group of central bank representatives housed under the Bank of International Settlements (BIS) tasked with monitoring developments in and improving efficiencies in payment, settlement and clearing systems, refers to correspondent banking as “an arrangement under which one bank (correspondent) holds deposits owned by other banks (respondents) and provides payment and other services to those respondent banks.”⁷⁵ In effect, correspondent banking involves agreements or contractual relationships between banks to provide payment services for each other, a function that is essential to the provision of international banking services to each banks’ customers, including cross-border payments, foreign currency settlements and access to foreign financial systems.^{76,77} CBRs enable trillions of dollars in daily cross-border transactions to facilitate economic activity, such as trade finance, international remittances and financial services for global charities and non-profit organizations (NPOs).^{78,79} As simultaneous reserve capital and compliance requirements increase, cross-border banking activities become vulnerable, particularly those underpinned by CBRs.

With the regulatory changes highlighted above, the typically-lower-margin correspondent banking business line is more vulnerable to supply pressure. The IMF has indicated that regulatory changes, coupled with the general post-crisis environment and macroeconomic conditions have made several large correspondent banks structurally more risk-averse.⁸⁰ In a July 2016 report, the IMF wrote: “A lack of clarity on the scope of customer due diligence requirements, including whether there is a need to conduct due diligence on a customer’s customer, can lead to a decision to terminate CBRs ... [as can] conflicting regulatory or legal requirements, notably between customer due diligence and data protection and privacy.”⁸¹ As discussed further in Section 6, the IMF’s 2017 board paper highlights actions taken by FATF and BCBS to address the need for greater clarity, also noting that some global banks still find regulatory expectations “unclear, inconsistently communicated, unevenly implemented by individual examiners,” and as such, regulatory uncertainty remains.⁸² The same IMF

2017 report indicates that there have been few, if any, cases where confirmed losses in CBRs have led to systemic economic risk, but it does indicate that IMF staff remains watchful.

In 2014, IFC noted signs of potential de-risking in correspondent banking activity, pointing to a new wave of challenges with respect to availability of financing for emerging market banks.⁸³ In 2014, IFC assessed the sentiments of global and regional banks via a survey of 333 members (both correspondent and respondent banks) of its Global Trade Finance Program (GTFP) across 107 countries (both emerging markets and OECD countries). The GTFP is an initiative launched in 2005 to facilitate trade in emerging markets by providing risk mitigation to global banks to extend their capacity to provide credit in emerging markets. Sixty percent of GTFP-confirming banks said they had not increased their overall lines for emerging market banks over the last six months. In cases of CBR reductions, rising compliance costs and country or counterparty bank risk factors are the most commonly cited reasons. Seventy percent of confirming banks said they had seen a rise in compliance costs in the last three years, and 66 percent expected compliance costs to continue to rise in the next six months. A follow-up IFC survey of emerging market respondent banks in 2016 supported prior findings and showed increasing pessimism about the availability of correspondent lines and the negative impacts of de-risking.⁸⁴ Compared to findings in the IFC's survey of the same respondent group in the prior year, the percentage of bank survey participants anticipating near-term decreases in their CBRs increased from 3 percent in 2015 to 22 percent in 2016.⁸⁵

Beyond IFC, data from multiple sources suggests that some correspondent banks are de-risking from certain markets and customers. It appears that many correspondents have opted to conclude relationships that are considered higher risk, less profitable or unproductively complex, or those which constitute an unsustainable combination of the three. Instead of managing the risks associated with maintaining ongoing customer or counterparty bank relationships, correspondents may decide to exit these relationships entirely if revenue potential no longer warrants the cost and risk required to generate that revenue. Systematic, recurring and consistent global data that objectively verifies the number of CBRs is not readily available; in their absence, many stakeholders are engaged in learning what they can, particularly if their position provides unique access to useful information. Numerous surveys have provided insight into how these new requirements were affecting business decision making:

- A 2014 report—among the earliest to assess the challenge of de-risking—conducted by the Basel Institute on Governance, Bankers Association for Finance and Trade (BAFT), the British Bankers' Association (BBA), the International Chamber of Commerce (ICC), IIF and the Wolfsberg Group noted that “AML/CFT and other financial crime risks are causing banks to withdraw from or reduce their exposure to certain countries, customer sectors, products, business lines and markets.”⁸⁶
- A 2014 survey of 17 international clearing banks led by BBA found that since 2011, many thousands of relationships have been closed with an average per-bank decline of approximately 7.5 percent.⁸⁷
- The European Central Bank's (ECB) 2015 survey of 22 correspondent banks across eight euro-area countries found participants' relationships with respondent banks had decreased steadily over the previous 13 years.⁸⁸
- A 2015 World Bank survey found that globally, CBRs have been on the decline, and that certain financial products are clearly effected.⁸⁹ The survey included 110 banking authorities, 20 large banks and 170 smaller local and regional banks across 91 jurisdictions. In roughly half of jurisdictions (49 of 91), the banking authorities and slightly more local and regional banks indicated a decline in CBRs. Three-quarters of large correspondent banks surveyed said they had reduced their CBRs. Issues

related to compliance with CDD requirements are most commonly cited as the cause of the decline in CBRs.

- In a 2016 IIF and Ernst & Young survey, participant banks said capital, liquidity and leverage changes under Basel III are causing them to rethink their business models.⁹⁰ Over 48 percent said they have exited or are planning to exit business lines, and 27 percent said they are leaving specific countries.
- In a 2016 survey conducted jointly by ACAMS and LexisNexis, 30 percent of participants said their institution had implemented more stringent standards for accepting customers.⁹¹ Forty percent said their bank was leaving specific geographic areas, with the top two reasons being that the segment was no longer within the firm's risk appetite (56 percent) or that the cost of compliance made the segment unprofitable (51 percent).
- According to the ICC's 2016 global trade and finance survey, which covers 357 respondent banks in 109 countries, 35 percent of participants reported experiencing termination of CBRs.⁹²
- On behalf of the United Kingdom's Financial Conduct Authority, U.K.-based law firm John Howell & Co. surveyed 64 global correspondent banks and did deep dives into four banks' (one global and three U.K.-based) account turnover patterns for 2011–2014.⁹³ John Howell & Co. found that over the last three years, CBRs have been exited at an accelerated rate.
- Recently published research from Accuity indicates that CBRs fell globally by 25 percent between 2009 and 2016.⁹⁴
- Also recently published research from the McKinsey Global Institute noted declining correspondent banking relationships since 2011, accompanied by other forms of cross border banking and foreign exchange trading.⁹⁵

SWIFT data shows some decrease in CBRs and CBR volume between 2011–2015, as well as a decrease in active correspondents between 2011 and 2016, with all regions experiencing a continuous decline since 2013; country data highlights the effect on emerging markets. The Society for Worldwide Interbank Financial Telecommunication (SWIFT) is a platform through which a significant portion of global cross-border financial transactions are conducted. CPMI performed analysis on monthly SWIFT messaging data relevant to correspondent banking between 2011 and 2015, incorporating the number of SWIFT messages sent and received, as well as the nominal dollar value of each and count of active counterparty relationships.⁹⁶ The analysis confirmed at least some decrease in the number of active correspondents in over 120 of 204 jurisdictions, with the decline exceeding 10 percent for over 40 of them.⁹⁷ It shows an uptick in the number of transactions between early 2011 and mid-2012, with then a moderate increase through 2015, as well as a reduction in the nominal dollar value of total transactions. Notwithstanding accompanying data limitations,¹ both the number of CBRs and dollar value of transactions are important indicators since most banks manage their correspondent banking businesses through relationship counts and the dollar value of respondent line limits; operational strategy in the correspondent banking space focuses less on the number of transactions that pass through those relationships/line limits. An IFC staff review of CPMI's data summary by country⁹⁸ indicates that over half of emerging markets and islands² experienced a reduction in the number of CBRs and

¹ Note this nominal, dollar-based value data is subject to various limitations, such as exchange rate fluctuations.

² Countries include: Afghanistan, Albania, Angola, Argentina, Armenia, Aruba, Azerbaijan, Bahamas, Bahrain, Bangladesh, Barbados, Belarus, Belize, Benin, Bermuda, Bhutan, Bolivia, Bonaire, Bosnia and Herzegovina, Botswana, Brazil, Bulgaria, Burkina Faso, Burundi, Cambodia, Cameroon, Cape Verde, Central African Republic, Chad, Chile, China, Colombia, Comoros, Congo, Democratic Republic of

total dollar value transmitted between 2011 and 2015. The Financial Stability Board recently concluded analysis of SWIFT data, finding that between 2011 and 2016, the number of active correspondents, as measured by SWIFT message traffic, follows a downward trend with all regions except South Asia and has experienced a continuous decline since 2013.⁹⁹

Further interpreting CPMI's findings, the IMF indicates that globally, total dollar values of correspondent payment flows between 2010 and 2015 have remained fairly stable and economic activity has been "largely" unaffected¹⁰⁰; 2016 data was not available for IMF's analysis. There remains reason for concern, given the complexity of CBRs and the potentially less-visible cumulative effects of individual CBR closures throughout emerging markets. Both CPMI and the IMF raise concerns regarding the concentration of correspondent relationships,^{101,102} which could present challenges in emerging markets with transaction costs, stability/alternative sources of correspondent support, managing multiple currency settlements and providing support for the total dollar volume of transactions. A review of IMF Article IV discussions suggest that many countries expressed concern about increases in the cost, processing time or scrutiny of their CBRs.¹⁰³ In addition, there remains a concern that concentration of CBRs presents and potentially exacerbates financial system vulnerability. Finally, the extent to which reductions in CBRs may be a lead indicator of future challenges with correspondent banking is undetermined, as is the realization of the potential that multiple macro-financial channels could be adversely affected by withdrawal of CBRs and/or other CBR stress. **In many cases, where CBRs remain, respondents face new limitations.** If not cancelled entirely, correspondents are setting new minimum activity thresholds, passing on higher costs to respondents or pressuring respondents to limit their exposure to certain high-risk customers. Below certain activity thresholds, correspondents may be unable to recover the costs of account maintenance and management (plus a margin) and, in these cases, some correspondents are deciding to close accounts. In some cases, some correspondents have taken the step of pressuring respondent banks to limit their exposure to certain categories of customers in order to maintain a CBR. The World Bank's 2015 survey found that several smaller banks reported severing ties with money- or value-transfer services to maintain CBRs.¹⁰⁴

Some emerging market respondent banks do not receive clear explanations for being de-risked, and many find recent regulatory complexity challenging. The ICC's 2016 survey found that in many cases of CBR termination, local banks did not receive explanations for terminated CBRs, hindering their ability to respond or adjust.¹⁰⁵ The ICC found that compliance measures are disrupting banking relationships, with 35 percent of local banks reporting having experienced termination of CBRs due to compliance measures. The percentage of participants citing AML/CFT compliance as a significant impediment has increased over the years (reaching 90 percent this year), and the vast majority (83 percent) said they expect compliance requirements to continue to increase. As

Congo, Costa Rica, Cote d'Ivoire, Croatia, Curacao, Cyprus, Czech Republic, Djibouti, Dominica, Dominican Republic, Ecuador, Egypt, El Salvador, Equatorial Guinea, Eritrea, Ethiopia, Fiji, French Polynesia, Gabon, Georgia, Ghana, Greece, Grenada, Guatemala, Guinea, Guinea-Bissau, Guyana, Haiti, Honduras, Hungary, India, Indonesia, Iraq, Jamaica, Jordan, Kazakhstan, Kenya, Kiribati, Kyrgyz Republic, Laos, Lebanon, Lesotho, Liberia, Libya, Macedonia, Madagascar, Malawi, Malaysia, Maldives, Mali, Mauritania, Mauritius, Mexico, Moldova, Mongolia, Morocco, Mozambique, Myanmar, Namibia, Nepal, New Caledonia, Nicaragua, Niger, Nigeria, Oman, Pakistan, Papua New Guinea, Paraguay, Peru, Philippines, Poland, Romania, Russia, Rwanda, Samoa, Sao Tome, Senegal, Serbia, Seychelles, Sierra Leone, Slovakia, Slovenia, Solomon Islands, South Africa, South Sudan, Sri Lanka, St. Lucia, St. Vincent, Sudan, Suriname, Swaziland, Syria, Tajikistan, Tanzania, Thailand, Timor Lest, Togo, Tonga, Trinidad and Tobago, Tunisia, Turkey, Turkmenistan, Turks and Caicos, Tuvalu, Uganda, Ukraine, Uruguay, Uzbekistan, Vanuatu, Venezuela, Vietnam, Yemen, Zambia, Zimbabwe.

their cross-border counterparty banks face the financing challenges outlined above, many local emerging market banks are finding it difficult to absorb regulatory compliance requirements as well.¹⁰⁶

Concerned about the decline in CBRs and its effects on financial inclusion, the G-20 and the Financial Stability Board (FSB) requested that the World Bank study the reduction of CBRs, which was ultimately translated into an FSB action plan. The IMF, the CPML, the Payments Market Practice Group (PMPG), FATF, the Wolfsberg Group, the IIF, the Basel Institute on Governance, BAFT, BBA and ICC have also been involved to support the clarification of existing guidance on how regulators ought to monitor financial institutions in their jurisdictions. Building on the analyses led by the World Bank, the G-20 has approved a four-point FSB action plan to assess and address the decline in CBRs. The FSB is coordinating efforts to further examine the dimensions and implications of the issue, including improving data collection on the scale of withdrawal, its causes and effects, and clarifying regulatory expectations, including through guidance by the FATF and the Basel Committee.¹⁰⁷ Guidance by FATF on correspondent banking issued in October 2016¹⁰⁸ and Basel in November 2016¹⁰⁹ sought to clarify earlier recommendations; however, industry associations such as the IIF and BAFT expressed concern regarding the generalization of risk, particularly the classification of “high risk” associated with all forms of cross-border correspondent banking.¹¹⁰

The multilateral efforts noted above are part of a broad effort supported by the G-20 to mitigate the potentially detrimental consequences of de-risking on financial inclusion among the world’s poor. New forms of financial exclusion are occurring as an unintended consequence of managing financial crime-related risks, with an existing and increasing impact on correspondent banking and trade finance, and many new corporate and small and medium enterprise (SME) entrants into international markets experiencing difficulties.¹¹¹ “A decline in the number of correspondent banking relationships is a source of concern for the international community because it may affect the ability to send and receive international payments, or drive some payment flows underground, with potential consequences on growth, financial inclusion, as well as the stability and integrity of the financial system,” the FSB has written.¹¹²

Changes under consideration by European regulators, as well as some proposed in the United States, have the potential to improve collaboration and bring about convergence in compliance requirements. In February 2017, through a revision of the European Union’s (EU) 2015/849 Directive on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, EU lawmakers voted in February for tougher AML rules that would cover virtual currencies, trusts and prepaid cards, maintenance of records of relevant entity ownership (beneficial ownership) as part of CFT efforts and a broader clampdown on tax avoidance (the so-called Revision of the European Parliament and Council of the EU’s 2015 Anti-Money Laundering Directive).^{113,114} The rules, which are before national governments for approval, would give tax authorities access to national AML information and require EU member states to create centralized registers of information about bank and payment-account holders. EU citizens could readily access said registers without having to demonstrate a legitimate interest or probable cause for doing so, promoting transparency and accessibility of information. During the same month, the Clearing House, a trade association representing some of the largest U.S. banks, put forth a proposal for significant changes to regulations regarding how financial institutions investigate and report potential criminal activity.¹¹⁵ Their recommendations include raising the minimum thresholds for filing suspicious activity reports, centralizing the supervision and examination of AML/CFT compliance, and collecting raw but anonymized data in bulk. The Clearing House contends that these changes would facilitate the screening and detection of suspicious activity on a real-time basis across institutions, including international transactions.

Several drivers of de-risking seem likely to continue and may hamper efforts to expand financial inclusion. With the majority of AML and KYC regulation written before the digital age, additional changes are expected as regulators adapt to the 21st-century economy. Ongoing changes to and tightening of compliance requirements in any single jurisdiction, along with divergence in level of enforcement, requires additional time, resources and costs to adapt, including time spent engaging directly with regulators. In a 2015 webinar, Steve Pulley, managing director of client onboarding and KYC solutions at Thomson Reuters, hinted at continued changes to compliance needs. “The industry is fundamentally resourced for yesterday’s KYC challenge, not tomorrow’s,” Pulley said.¹¹⁶ Continuous increases in costs for managing compliance risk may push more banks to further disengage from certain customers and customer segments—leaving them outside the financial system and unable to contribute to the economic development of their countries. In addition, compliance-related complexity may continue to increase as, among other reasons, institutions incorporate new forms of risk, such as cyber risk.¹¹⁷

SECTION 2. EMPIRICAL SURVEY STRATEGY AND DATA DESCRIPTION

This paper examines the relationship between increasing compliance costs and correspondent bank de-risking, among other challenges, and the ability of private-sector banks in emerging markets to continue providing international banking services to their customers. 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.

The IFC Financial Institutions Group, which provides investment and advisory services to banks, microfinance institutions, mortgage and insurance companies, and other financial services providers in emerging markets, has built a global network of hundreds of clients in more than 100 countries who rely on cross-border banking to serve the needs of their customers and, through their customers, their countries. The cumulative effect of cross-border transactions, services and customers, while subtle, is a powerful tool for economic stability, growth and development. Our work with these banks has:

- Helped strengthen financial institutions and systems
- Enhanced the role of our clients in building economic growth and stability in their respective countries
- Introduced environmental and social standards in their business activities, sometimes for the first time
- Reinforced the concept of responsible finance
- Deepened client support for strategic customer segments important to the development agenda, including women-owned businesses, trade finance, climate change, agri-finance, and underserved regions, including fragile and conflict-affected ones.

Working with our clients transforms them into partners for development. Since 1956, IFC has provided \$245 billion in financing to businesses in emerging markets.¹¹⁸ In 2015 alone, our banking clients provided 7.6 million loans to small businesses totaling \$243 billion, and 51 million microloans to individuals totaling \$59 billion.¹¹⁹ Our expertise and advice help our clients address systemic issues such as risk management, corporate governance, the introduction of environmental and social standards, and increasingly, compliance systems and processes. We continue to interact with our customers to better understand the implications of regulatory changes and cross-border de-risking.

This paper seeks to enlighten the public discourse on de-risking by sharing insights gleaned from the perspectives of IFC's network of global emerging market financial institution clients. With a focus on emerging markets and the experiences of private-sector banks in those markets, our analysis examines the effects of de-risking from the perspective of the institutions that may be directly experiencing terminations in CBRs. The analysis examines how IFC's client emerging-market banks are responding to de-risking, among other external challenges, and how experiences and responses may differ across regions, countries and institutions.

In this discussion, we present the results of the 2017 Correspondent Banking in Emerging Markets survey, undertaken by IFC to capture both data and information from IFC client banks in 92 emerging markets. This survey was conducted from January to February 2017 and surveys were submitted by 306 private-sector emerging market banks (a 92 percent submission rate) holding a combined \$5 trillion in assets.¹²⁰ IFC staff

estimates using data from Moody's, IMF's Financial Soundness Indicators and various central bank reports suggest that the survey participants represent approximately ten percent of emerging market banking assets, and approximately 30 percent of banking assets in Sub-Saharan Africa. The 17 questions included in the survey covered the following topics:

- Changes in correspondent banking networks
- External challenges and how those challenges affect emerging market banks' ability to serve their customers
- Impacts of AML/CFT compliance
- Barriers to business growth
- Solutions that could help these banks navigate current challenges and grow

Appendix A provides the full text of the survey questionnaire, which covered IFC bank clients (i) that use CBRs to provide international banking services to their customers; and (ii) in which IFC had active investments at the start of the current fiscal year. Appendix B details the country of survey participants by region and lists the countries represented. Appendix C offers a comprehensive overview of survey data.

Survey analysis focused primarily on the frequency of responses, as well as qualitative information obtained.

Its objectives were to:

- Separate and assess drivers of external challenges, including CBR stress and compliance regulation affecting banks in emerging markets
- Develop an understanding of how specifically that has, in turn, affected the clients (and thus, countries) that they serve
- Understand the change in customers and customer demand for international banking services as well as clients' capacity to meet that demand
- Assess changes in the correspondent banking networks
- Collect client voice regarding the solutions that would be the most helpful to them

The survey appears to be among the first to systematically separate external drivers from an emerging market banking perspective, as well as to source CBR change information directly from emerging market banks from so many countries. We are among the first to assess a global set of emerging market banks to learn what is needed from their perspective, and the first to assess, at least preliminarily, the ways in which economies have been affected (through stress on provision of services and customers).

As with any survey-based, information-gathering efforts, there are inherent limitations—responses come directly from banking client participants and are not audited or verified by third parties. As external country-level data on correspondent banking activity is limited, the team could not verify cumulative effects at a macro level. In addition, the number of survey submissions per country ranged from 1 to twelve. Also, given that IFC's corporate governance standards, investment criteria and due diligence are particularly rigorous, survey participant responses may collectively represent the scenario experienced by banks with relatively stronger systems, controls and financial health vs. a completely representative sample of emerging market banks. While this survey is among the first to distinguish frequency of both external challenges and business adaptations, a link between the two is inferred and supported by some participants' qualitative responses. It is not explicitly proven. There is some room for causality noise, although the links are supported by survey participant comments.

SECTION 3. ANALYSIS AND FINDINGS

In IFC's survey, emerging market banks provided feedback on their experiences and outlooks related to de-risking drivers and effects around six broad groups. Each of these contributes to a better understanding of the challenges that emerging market banks are facing. In addition, their answers illustrate specific de-risking experiences—and responses—of emerging market banks, thereby contributing to a global effort to clarify this multi-faceted problem. These groups are:

- a) **Access to correspondent networks:** identifies trends in CBRs in emerging markets in various regions. This provides valuable insights to a metric that has grown in importance in recent years, as concerns about correspondent banking emerged.
- b) **External challenges:** measures the impact of specific externally-driven challenges on banks' capacity to serve customers, particularly compliance and changes in CBRs. This separates the extent to which banks are affected by these two challenges versus other drivers, such as macroeconomic risk, customer credit risk and increased capital reserve requirements. This also helps to distinguish the nuances between the related compliance-related challenges and CBR stress.
- c) **Adaptions to business models in response to external challenges:** shows how the response of banks to these challenges impacts their customers, from which we can infer the effects of de-risking and new compliance complexity.
- d) **Demand for international banking services:** compares demand for international banking services with banks' capacity to supply them. Since such services are the ultimate purpose of CBRs, there could be unrealized potential for economic growth even in regions that are not facing a significant CBR reduction.
- e) **Compliance challenges:** details patterns in bank responses regarding compliance challenges specifics, which can contribute to a deeper understanding and, thus, a more focused response.
- f) **General barriers to growth:** reviews additional barriers to growth which are generally outside of the de-risking sphere.

Our analysis focuses on identifying common themes and differences in the experiences of de-risking across various groupings of emerging markets and banks. The research team divided participants by multiple segments based on country and institutional characteristics. At the country level, these segments included region, income per capita, size of economy (GDP), country risk, International Development Association (IDA) eligible and Fragile and conflict-affected situations (FCS) classifications, oil-exporting countries, total imports (in United States dollars) and import-dependent countries. At the bank level, these segments were focused on institutional risk and size, with institution size measured by total assets, total equity and number of international banking customers.³ Many of these segments intersect; they each represent a set that has potential to be affected by de-risking. The objective was to determine how each segment fared relative to the

³ Country income levels use World Bank classifications for low-income, lower-middle-income, upper-middle-income and high-income countries based on the most recently available GNI per capita data. Size of economy (GDP), import-dependent countries (imports as a percentage of GDP) and institution size (by total assets, total equity and number of international banking customers) were analyzed in quartiles. Country risk was assessed as a dummy variable for investment grade versus non-investment grade according to Standard & Poor's ratings as of March 2017. Oil-exporting countries was similarly assessed as a dummy for oil exporter versus non-oil exporter.

global sample and each other, as well as how the dynamics of de-risking played out within each set; how each may have been uniquely affected. Likewise, there is variance in the number of responses to each question in each country/bank segment; this means that a percent frequency of response is the best comparison metric, but comparable results are particularly sensitive to the value of the ratio's denominator. Appendix C presents response frequency by segments for each survey question.

Survey findings suggest that drivers and effects of de-risking are subtle, complex and pervasive. While each segment sheds light on similarities to and variance from the global results, responses indicate that banks in every segment is facing challenges that affect their capacity to serve customers and thus help their countries grow (Figure 3.1). Correspondent banking and compliance challenges, as well as increasing compliance costs, affect every country and bank type. This limits the speed with which those countries can reach their unique “next level” of development, and the depth with which they can achieve their true development potential. Survey data conveys that the differences rest in the magnitude and complexity of challenges, the ways these challenges are realized and, in some cases, the most effective solutions. There are also common themes that can be lifted from IFC's global network of emerging market banking clients. A copy of the survey in Appendix A provides specific questions as they were asked to survey participants.

Figure 3.1. Every Segment is Affected: Compliance Effects by Country/Institutional Segments

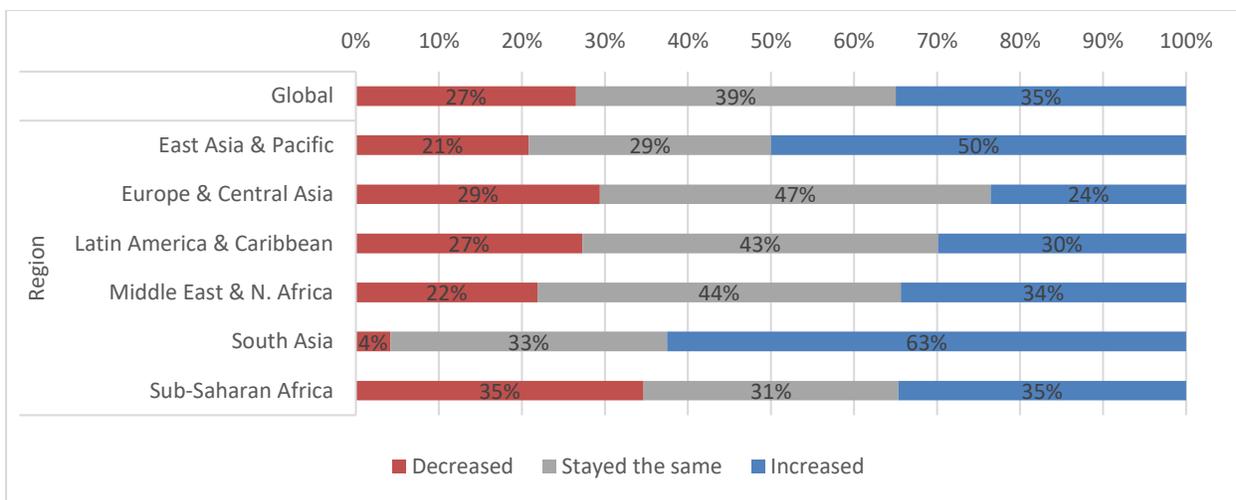
Country/Institution Segment		During 2016, did you have decreased ability to serve your customers because of compliance and/or CBRs?	During 2016, did you have decreased ability to serve your customers for any reasons?	During 2016, did your bank adapt its business in a way that negatively affected customers?	Has your customers' demand for international banking services increased since 2015?	Has your capacity to meet your customers' requests for international banking services decreased since 2015?	Have your bank's active correspondent banking relationships decreased since 2015?	Do you expect your bank's active correspondent banking relationships to decrease in 2017?	Do you expect your bank's compliance-related expenditures to increase in 2017?	Are there any challenging aspects of your bank's AML/CFR/KYC compliance efforts?	Are regulatory challenges and/or costs one of the biggest barriers to growth for your bank?
Global		Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
Region	East Asia & Pacific	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
	Europe & Central Asia	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
	Latin America & Caribbean	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
	Middle East & N. Africa	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
	South Asia	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
	Sub-Saharan Africa	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
IDA Country	IDA	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
	Non-IDA	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
FCS Country	FCS	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
	Non-FCS	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
World Bank Country Income Classification	High-income	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
	Upper-middle-income	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
	Lower-middle-income	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
	Low-income	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
Oil Exporting Country	Non-oil-exporting	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
	Oil-exporting	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
Country Investment Grade (S&P)	Non-investment-grade	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
	Investment-grade	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
	No rating available	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
Country GDP Quartiles	1 (lowest)	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
	2	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
	3	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
	4 (highest)	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
Country Total Imports Quartiles	1 (lowest)	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
	2	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
	3	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
	4 (highest)	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
Country Imports % GDP Quartiles	1 (lowest)	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
	2	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
	3	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
	4 (highest)	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
Institutional Asset Quartiles	1 (lowest)	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
	2	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
	3	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
	4 (highest)	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
Institutional Customer Count Quartiles	1 (lowest)	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
	2	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
	3	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
	4 (highest)	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
Institutional Equity Quartiles	1 (lowest)	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
	2	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
	3	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
	4 (highest)	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
Institutional Risk Rating (IFC)	Lower risk	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
	Higher risk	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y

Y = at least one bank in this segment indicated yes to the question in the top row.

A. Access to correspondent Networks

Globally, just over one-quarter of survey participants indicated that the size of their active network decreased, a notable drop (Figure 3.2). Survey participants were asked whether their number of active CBRs increased, decreased or stayed the same from end-2015 to end-2016. Nearly three-quarters of survey participants noted that the number of their active CBRs in 2016 was either maintained or grew. The largest share of all participants, 39 percent, indicated that they had the same number of correspondents, and 35 percent reported that the number of CBRs available to them increased. The frequency of reported declines marks a notable decrease from surveys that measured CBR-related changes in prior years.

Figure 3.2. Bank Reported Changes in Number of CBRs in 2016



Several regions and certain country types reported notable reductions in the number of CBRs during 2016.

Across regions, Sub-Saharan Africa, Latin America and the Caribbean, and Europe and Central Asia reported declining correspondent banking networks with the greatest frequency. With 35 percent of banks in the region experiencing a decline in CBRs, Sub-Saharan Africa was particularly affected. Over one-quarter of banks in Europe and Central Asia, as well as in Latin America and the Caribbean, also reported decreases in the number of correspondent relationships during 2016. A survey participant in the Middle East and North Africa region noted: “Stricter AML/CFT policies globally [are] resulting in the exit of banking relationships.” Another reported: “The sanctions applied to certain international banks make the operational costs more expensive and, above all, oblige these banks to exit certain markets and cut relationships.” South Asia was relatively unaffected, with few banks reporting declines (4 percent) and 63 percent, the largest share of any region, reporting increases in correspondent network counterparties. However, banks in South Asia indicated a throughput problem within their existing networks. One noted: “[SWIFT Relationship Management Applications] weren’t accepted by [our correspondent] banks, citing lack of potential business. However, [our] clients here were eager to route business to them.” East Asia and the Pacific, South Asia and banks from larger economies (in terms of GDP) more frequently reported CBR increases. It is interesting to note that across many regions, an equal or greater

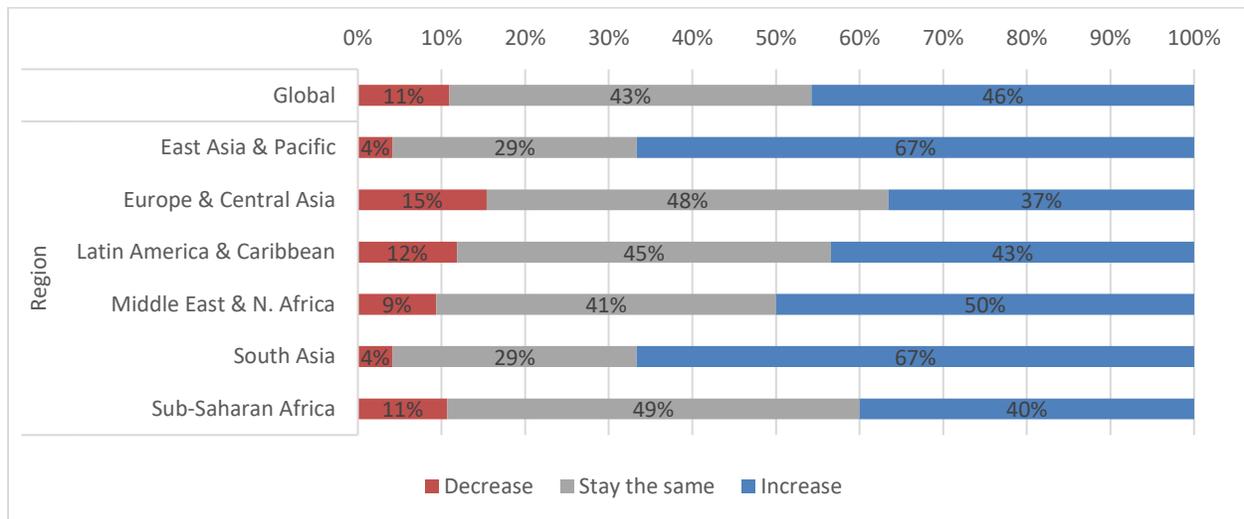
number of banks reported increases than decrease. At the most basic level, this allays some concern as we can infer that some banks are gaining capacity, helping to fill potential market gaps. However, the data does not quantitatively assess the change in lines or line limits, and, based on prior year surveys,¹²¹ this degree of market fluctuation is significant and remarkable.

Notable differences arose in other country/institutional segments as well. Survey participants in high-income countries, non-oil-exporting countries, import-dependent countries, countries with lower total imports, countries with smaller GDP, unrated countries, smaller banks by total assets and equity, and higher-risk banks reported that CBRs decreased more frequently than the global average. Banks in FCS, oil-exporting countries, larger economies, non-import-dependent countries, and banks with a larger asset base reported decreases less often. Intra-segment comparisons also provide interesting information. Non-FCS countries were more likely to report lost CBRs, in addition to high-income countries, non-oil-exporting countries, smaller economies, and more import-dependent countries. Smaller banks by assets or equity and higher-risk banks also experienced CBR declines at a higher rate than the global average.

In addition, challenges with maintenance of CBRs were independently identified as a barrier to growth for institutions across multiple countries. The survey collected qualitative responses from participants in response to the question, “What are the biggest barriers to growth?” Thirty survey participants across 25 countries, including 10 in Sub-Saharan Africa and eight in Latin America and the Caribbean, specifically mentioned challenges in maintaining CBRs in their discussions of more general business growth barriers. These challenges included the termination of CBRs; stricter limits on credit lines; high or increasing costs to maintain these lines; and an inability to obtain new lines. Banks in low- and middle-income countries noted one or more of these challenges at a higher rate than counterparts in high-income markets. In seven countries, including Kenya, Lebanon, Nicaragua, Pakistan, Paraguay, and Vietnam, banks indicated that CBR-related challenges were their sole obstacle to growth. A survey participant from a smaller economy in the East Asia and the Pacific wrote that international banks have no interest in starting relationships with any financial institutions in their country, leaving that market’s banks unable to grow. One bank shared this anecdote: “Establishing new lines with correspondent banks has been a challenging task ... This has hindered some of our clients’ international business activities, especially for extended-tenor transactions beyond one year.”

A large majority of survey participants expect their correspondent networks to grow or remain the same in 2017 (Figure 3.3). Eighty-nine percent of survey participants indicated that they expect the number of correspondent connections to increase or stay the same in 2017. The largest share, over 46 percent, said they expect their correspondent networks to grow and a slightly smaller share, 43 percent, said they anticipate maintaining their relationship count at the same level. Just 11 percent of survey participants reported that their number of active CBRs is likely to fall.

Figure 3.3. Bank Outlook for Changes in Number of CBRs in 2017



Globally, survey participants tended to be more optimistic about their access to CBRs than their experience indicated. Globally, 75 percent of banks which experienced CBR declines in 2016 said they actually expect growth (22 percent) or maintenance (53 percent) of their relationships going forward. Only 25 percent of banks that experienced reductions said they expected to continue experiencing cuts. A further 11 banks had not experienced decreases in 2016 but expected to see reductions in 2017.

Survey participant expectations also contrast with indications from many cross-border correspondent banks, as detailed in Section 1, which report that correspondents are making significant reductions in the number of cross-border correspondent relationships. A smaller share of participants said they experienced declines than the share that indicated the same in a 2016 ICC survey.¹²² The ICC's assessment found that 35 percent of emerging market respondents in their sample surveyed had experienced decreases in CBRs.

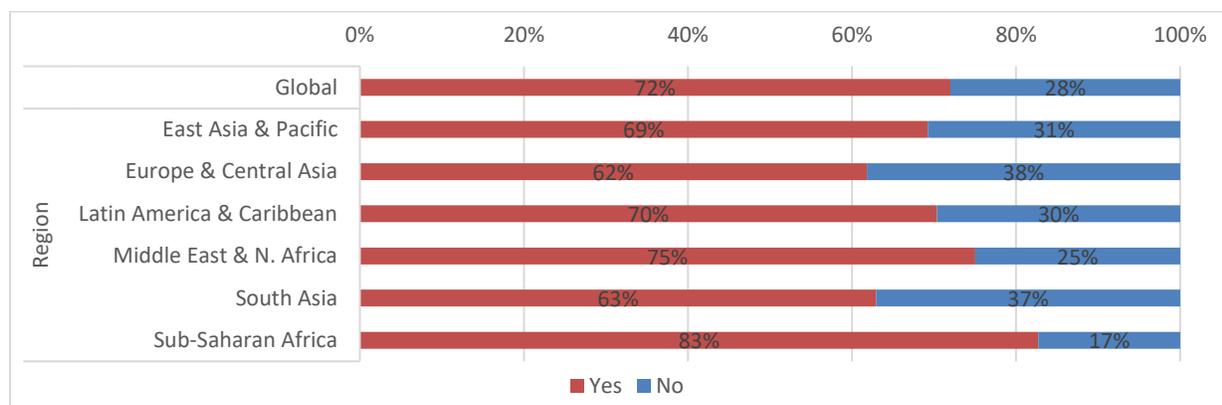
Among all regions and country types, no group had more than 15 percent expecting declines in relationships in 2017. Europe and Central Asia had the least optimistic outlook, with 15 percent anticipating declines and 48 percent expecting to hold flat. Expectations of reductions were also slightly above the global average in Latin America and the Caribbean at 12 percent. The correspondent network outlook among survey participants in both East Asia and the Pacific and South Asia was significantly positive, with 67 percent of survey participants in both regions expecting increases, and 4 percent of survey participants predicting decreases. In all segments considered, there were no remarkable deviations from the global outlook. Banks in investment-grade countries and banks in countries with larger total imports were more likely to forecast further drops than their intra-segment peers.

B. External Challenges

Seventy-two percent of survey participants indicated that they faced specific external challenges which decreased their ability to serve customers in 2016 (Figure 3.4). These banks noted that they experienced at least one obstacle to serving their customers last year. Banks across multiple segments reported rates of

decreased ability that differed notably from the global trend. Across regions, banks in Sub-Saharan Africa and the Middle East and North Africa more frequently reported decreased capacity to serve customers, while banks in Europe and Central Asia and South Asia less frequently reported obstacles. A bank in East Asia and the Pacific identified the following challenges: “Country risk rating and a general risk aversion (ignorance) approach by most international banks.”

Figure 3.4. Bank Reported that External Challenges Hindered Ability to Serve Customers



Compared to global results, survey participants in both low- and high-income countries⁴ indicated challenges with notably higher frequencies, as did smaller banks by assets and customers, and higher-risk banks. In addition, within segments, banks in IDA countries more frequently indicated external challenges. Banks in countries with more total imports, as well as larger and lower-risk banks, reported external challenges less often. In terms of specific country credit ratings, banks in countries just below investment grade (S&P BB+) more often reported a reduced ability to serve customers than those banks in countries just above the investment-grade threshold (S&P BBB-).

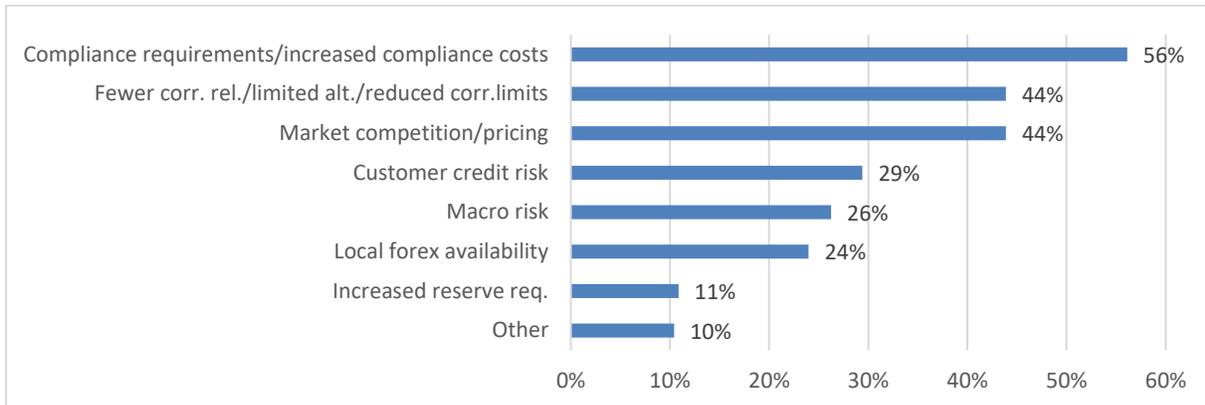
Survey participants who reported a stable or increased ability to serve customers offered insight on drivers of success. In the face of obstacles identified above, 28 percent of banks were still able to maintain or grow their customer service capacity. Among these survey participants, strong capital, innovative products and services, and increased staff and/or branches were the most common contributors to their performance. A few members of this group cautioned that, as increased compliance requirements have not yet affected their business results, they expect future growth could be constrained.

The most frequently cited driver for a reduction in banks' ability to serve their customers was compliance requirements and correspondent network issues. (Figure 3.5). Of survey participants that indicated a reduction in ability to serve their customers in 2016, 72 percent globally indicated decreased ability and attributed this reduction in whole or part to compliance requirements (56 percent) or changes in CBRs (44 percent). With respect to compliance requirements, banks indicated that AML/CFT and/or KYC requirements imposed by

⁴ Given available data for this question, the sample size for high-income countries was 12 banks.

national regulators, local regulators or cross-border correspondents, and/or increased costs related to these compliance requirements were responsible for their declining ability to serve customers. Among the specific challenges with CBRs noted by participants were reductions in the number of active CBRs, reductions in line limits available from active CBRs, and limited alternatives to existing CBRs. A number of survey participants also selected market competition and pricing, customer credit risk, macroeconomic risk, and availability of foreign exchange in the local market.

Figure 3.5. Bank Reported These Reasons for Reduced Ability to Serve Customers



Survey participants in four out of six regions identified at least one compliance challenge most frequently, and at least one CBR challenge was among the top three in five out of six regions (Figure 3.6). Banks in four out of six regions most often noted at least one (often several) compliance requirement as a challenge, with Middle East and North Africa and East Asia and the Pacific exceeding a frequency of 75 percent. In five of the six regions, banks identified at least one CBR challenge as the second most frequent response. Market competition and/or pricing was the most often cited obstacle in Latin America and the Caribbean. Sub-Saharan Africa most often noted foreign exchange availability as a challenge. Increased customer risk was among the top three most frequent response in East Asia and the Pacific, Latin America and the Caribbean and South Asia.

Figure 3.6. Three Reasons Most Frequently Reported for Reduced Ability to Serve Customers, by Region

Sub Saharan Africa	Middle East-North Africa	Europe and Central Asia	East Asia and the Pacific	South Asia	Latin America and the Caribbean
Foreign exchange availability (61%)	Compliance requirements (78%)	Compliance requirements (53%)	Compliance requirements (83%)	Compliance requirements (59%)	Market competition /pricing (47%)
CBR stress (61%)	CBR stress (56%)	CBR stress (50%)	CBR stress (39%)	Market competition/pricing (59%)	Compliance requirements (46%)
Compliance requirements (51%)	Market competition/pricing (26%)	Market competition/pricing (47%)	Market competition/pricing (22%)	CBR stress (29%)	Increased customer credit risk (31%)

Taking a different view of the data, banks often identified more than one challenge, and often more than one specific compliance or CBR challenge, including multiple challenge selections by banks in the compliance and CBR space. Specific challenges ranged from specific sources of updated compliance requirements (national vs. cross-border correspondent banks) to increased costs, reduced number of relationships, line limits or alternatives for CBRs. Compliance and CBR challenges accounted for 53% of all challenges identified globally and ranked in the top three most frequently selected across all regions.

There were also a handful of notable variations with respect to compliance and CBR-related obstacles across a number of country and institutional segments. Compared to global averages, low-income country (LIC) banks, smaller banks (by total equity) and higher-risk banks mentioned compliance requirements less often, but considered CBR challenges and increased customer credit risk more often. Larger banks and countries with higher imports or higher risk mentioned compliance challenges more often, but foreign exchange availability less frequently (as did larger economies). Foreign exchange availability was selected more frequently by smaller and higher-risk banks, as well as countries with a smaller imports and unrated countries. LIC and higher-risk banks more frequently noted geopolitical or macroeconomic issues, while smaller banks in terms of assets mentioned market competition and pricing. For intra-segment comparisons, compared to those in non-IDA countries, banks in IDA countries less often mentioned compliance requirements and more often mentioned CBR challenges, as well as market competition and/or pricing, as reasons for their decreased ability to serve their banking customers. When considering bank size by total assets, smaller banks most frequently noted market competition/pricing as an obstacle compared to all other bank sizes.

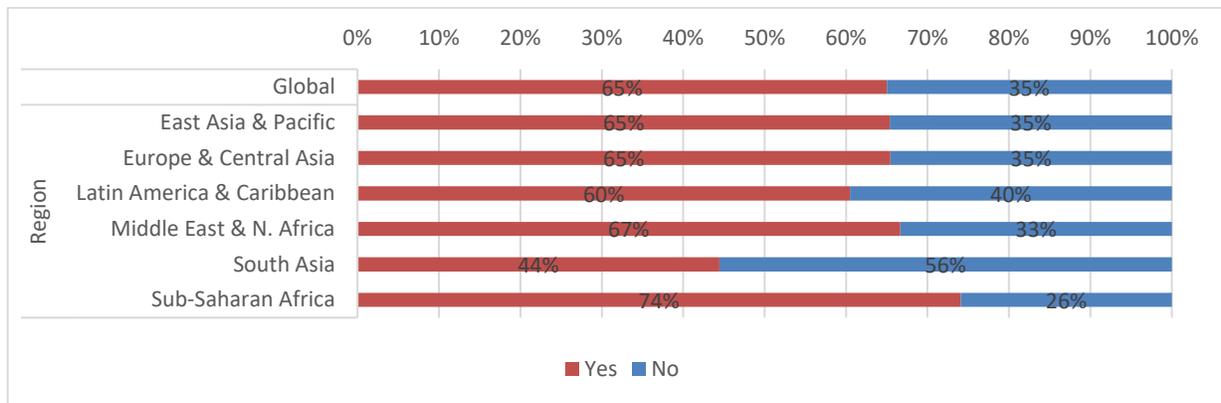
Beyond compliance and CBR, investment-grade and non-investment-grade countries displayed frequency variance in other areas. Compared to the global average, non-investment-grade countries less often cited geopolitical or macroeconomic risk and limited foreign exchange as a reason which decreased their bank's ability to serve their customers. The same pattern arises for increased capital requirements: relatively more investment-grade banks cited these reasons, while non-investment-grade banks mentioned increased capital requirements less often than the global average of 8 percent. Among other segments, banks in LIC, FCS countries, IDA countries and countries with higher import dependence, as well as larger banks, reported reduced ability to respond to customer needs at a higher rate than the global average.

There are differences in the complexity of the challenges that banks in various segments are facing, where complexity is measured by the number of obstacles to serving customers that were selected. Sixty-one percent of banks globally selected between zero and two specific challenges, while 25 percent faced more than three challenges and 12 percent faced five or more. Among country groups that had notable variations from the global average, 53 percent of LIC and 56 percent of banks in Sub-Saharan Africa (46 banks in 22 countries) mentioned three or more reasons. Banks in Latin America and the Caribbean indicated the least complexity, with only 23 percent of participants indicating more than three challenges. A bank in Europe and Central Asia articulated an example of the complexity of challenges many banks face, citing “the general global geopolitical situation; sanctions that prevent an active use of funds from international partners; [currency] volatility; credit risk growth; and a growth trend in NPLs.”

C. Adaptations to Business Models in Response to External Challenges

Sixty-five percent of survey participants indicated that they adapted their business in a way that reduced benefits to customer offerings in 2016 (Figure 3.7) in response to external challenges. These banks reported either that they reduced the number of customers served or that they executed one or more business adaptations that would ultimately reduce the benefits provided to their customers (for example, reduced product offerings). Note that the connection between external challenges identified and business adaptations is inferred and supported by survey participant comments; however, the link has not been statistically or explicitly proven, and thus there is some room for causality noise. Compared to the global trend, banks in Sub-Saharan Africa and the Middle East and North Africa more frequently reported some form of retrenchment.

Figure 3.7. Bank Reported Business Model Adaptations that Reduced Benefits to Customers

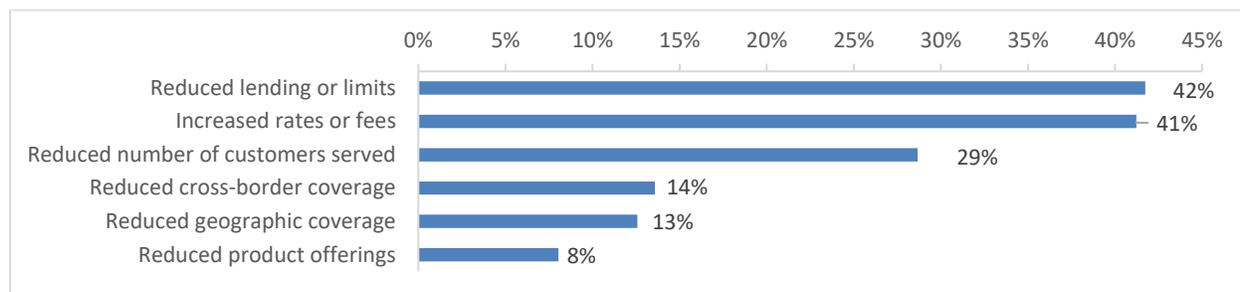


Thirty-five percent of survey participants indicated that adaptations did not negatively affect customers, and many of these banks grew. In general, banks that indicated growth said that this trend was driven by efforts to capture increased market share by increasing staffing, expanding their branch network, reducing rates, or increasing product offerings through innovation and quality improvements.

Meanwhile, among the majority of banks that retrenched, the most frequently taken actions were to reduce lending, increase pricing or reduce the number of customers (Figure 3.8). Survey participants noted a multitude of adaptations made in 2016 to adjust their business model in response to a changing environment.

The two most common responses—reducing overall customer lending and/or limits, and increasing rates or fees charged to customers—were reported by over 40 percent of banks. Other adaptations included reductions in the number of customers served (reported by nearly 30 percent), as well as cross-border coverage, geographic coverage or offerings of specific products and services.

Figure 3.8. Business Adaptations Executed by Banks



The distribution of adaptations differed significantly region to region, with reduced lending/limits, reduced customers served and increased rates/fees among the top three in all regions (Figure 3.9). Sub-Saharan Africa reported several adaptations with higher frequencies than the global averages. Banks in Europe and Central Asia noted reductions in geographic coverage more frequently (22 percent) than their global peers. Banks in the Middle East and North Africa also reported reduced cross-border coverage with 29 percent frequency, more than double the global average.

Figure 3.9. Top 3 Business Adaptations, by Region

Sub Saharan Africa	South Asia	Middle East and North Africa	East Asia and the Pacific	Europe and Central Asia	Latin America and the Caribbean
Reduced lending or limits (48%)	Increased rates or fees (58%)	Increased rates or fees (37%)	Reduced lending or limits (41%)	Reduced lending or limits (44%)	Increased rates or fees (53%)
Increased rates or fees (40%)	Reduced lending or limits (50%)	Reduced lending or limits (33%)	Increased rates or fees (35%)	Reduced number of customers served (31%)	Reduced lending or limits (35%)
Reduced number of customers served (30%)	Reduced number of customers served (17%)	Reduced number of customers served (29%)	Reduced number of customers served (12%)	Increased rates or fees (28%)	Reduced number of customers served (35%)

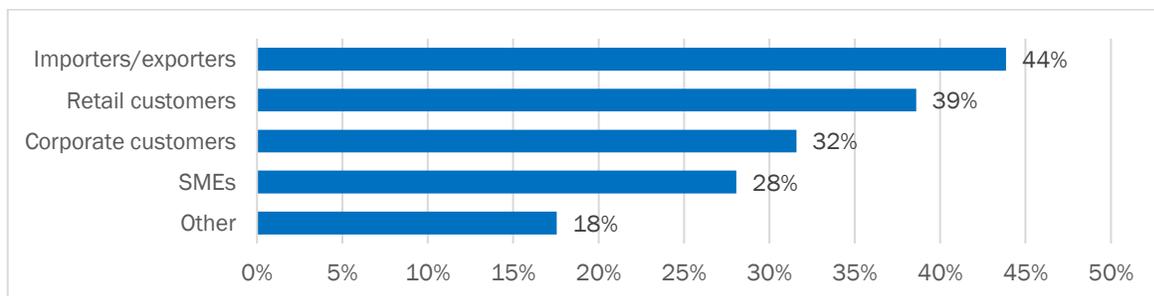
Also notable is the complexity of the retrenchment region to region. Over one quarter of banks in Europe and Central Asia, Middle East and North Africa, and Sub-Saharan Africa selected four or more adaptations.

Differences in adaptations emerged across a number of segments. In comparison to global averages, LIC banks more frequently reduced line limits, increased charges or reduced their customer base. Meanwhile, banks in high-income countries more frequently reduced the number of customers, cross-border coverage or geographic coverage. Large banks were more likely to reduce cross-border coverage and less likely to reduce their number of customers or line limits or increase charges; smaller banks more frequently reduced their customer base or geographic coverage. FCS country banks increased charges more often, but banks in non-FCS countries were more likely to reduce their customer base. Banks in oil-exporting countries were more likely to adapt by reducing line limits than non-oil exporting country banks.

Many banks dismissed customers in 2016, and importers and exporters were most frequently affected.

Globally, 19 percent of survey participants indicated that they reduced the number of customers in 2016. Except for the two Asian regions, 20 percent or more of banks in all other regions reported customer reductions. Of participants that said they reduced the number of customers served, firms engaged in import and/or export activities were most commonly affected—by 44 percent of banks in this segment (Figure 3.10). Retail customers were impacted at a similar rate (39 percent) and at a higher rate than their corporate counterparts, both larger firms and SMEs. Other customers that were noted as dismissed include financial institutions and NPOs. Furthermore, banks that detailed specific product offerings most frequently reported reducing letter of credits (LC) and issuance of foreign currency bank drafts, both of which are commonly used in the financing of cross-border trade transactions. One real-sector agricultural processing firm has faced this challenge, noting to IFC: “When you are in Africa, no one wants to work with you without a confirmed letter of credit.”

Figure 3.10. Among Banks that Reduced Client Coverage, These Segments Saw Customer Reductions

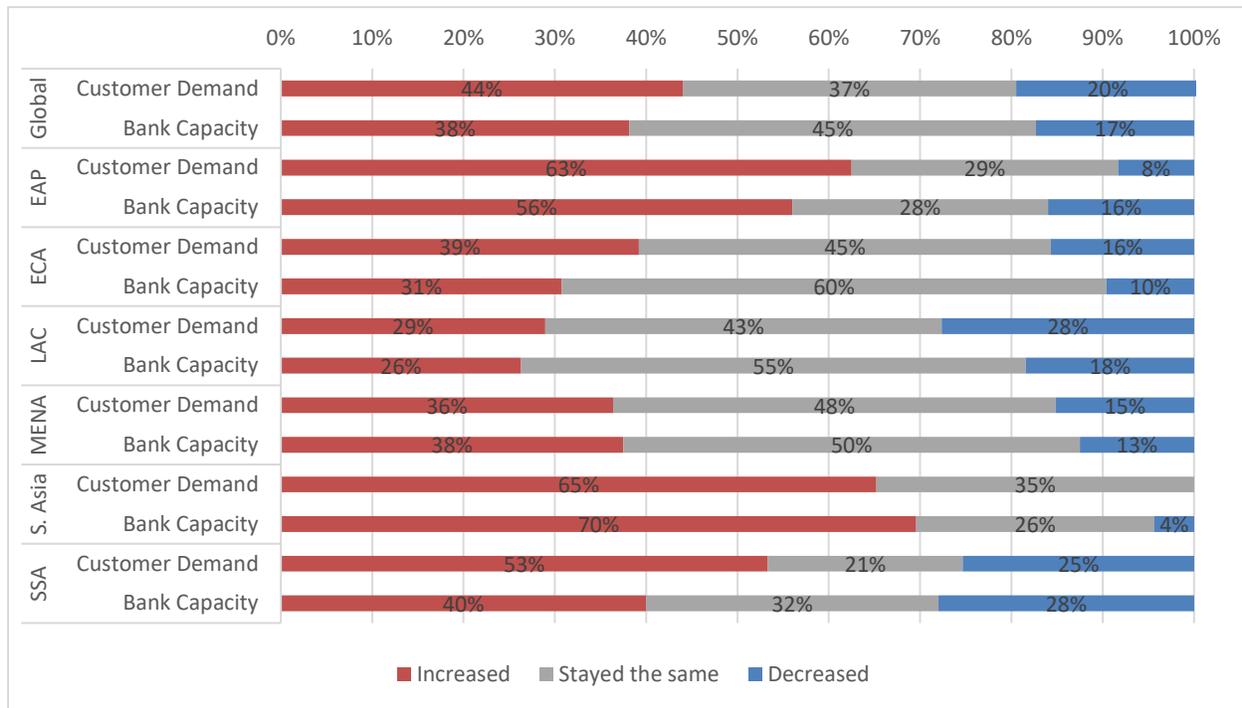


D. Demand for International Banking Services

Globally, demand appears to be outpacing capacity to meet that demand: in 2016, more banks reported increased demand for international banking services than increased capacity to meet demand. Survey participants reported providing international banking services to approximately four million customers, including over half a million SMEs.⁵ Globally, 44 percent of banks reported increased demand for international banking services in 2016, and 37 percent indicated that demand stayed the same (Figure 3.11). Simultaneously, 38 percent of banks indicated that capacity to meet demand has increased, while 45 percent said that their capacity remained the same and 17 percent reported a decrease.

There was regional, country and institutional segment variance in frequency of demand changes. Regionally, banks in South Asia (65 percent), East Asia and the Pacific (63 percent) and Sub-Saharan Africa (53 percent) most frequently reported increases in customer demand, while among banks in the Middle East and North Africa (48 percent), Europe and Central Asia (45 percent) and Latin America and the Caribbean (43 percent), demand was expected to stay the same.

⁵ 224 survey participants provided data for the number of customers that they have provided international banking services to in 2016. It is likely that a higher question response rate would significantly increase the total number of customers reported.

Figure 3.11. Customer Demand for International Banking Service vs. Bank Capacity to Meet Customer Demand

Certain segments more frequently reported increased demand. Compared to the global average, demand increased more frequently in IDA and FCS countries. Demand also increased more frequently in countries with lower income per capita, lower GDP or lower total imports, as well as in unrated countries, and among banks with a larger number of international banking customers. Intra-segment, the most notable variance was between country income levels, investment-grade and non-investment-grade or unrated countries, GDP and number of international banking customers. Demand decreased more frequently in countries with less import dependency or lower-income and among smaller, riskier banks. Demand decreased less frequently in lower-middle-income countries, as well as among banks with a greater number of international banking customers. Notably, no banks in South Asia indicated that demand had decreased.

There were also differences in capacity across regions and country and institutional segments. Compared to the global averages, banks in Sub-Saharan Africa (28 percent) and Latin America and the Caribbean (18 percent) more frequently indicated that their capacity was decreasing. Comparing segments to global response rates, low-income and unrated countries indicated their capacity had decreased more frequently, as did smaller economies, countries with less total imports, higher-risk banks, and banks with fewer international banking customers. Within segments, LIC, unrated countries, smaller markets, and higher-risk or smaller (by assets) banks more frequently reported decreased capacity than their intra-sub-group peers. Banks in lower-risk countries and smaller or higher-risk banks, among others, reported capacity increases less frequently.

In many cases, as demand is rising, capacity to meet that demand is not increasing. Globally, among those banks facing increased demand, 30 percent reported that their capacity to meet demand for their services would stay the same (20 percent) or decrease (10 percent). Specifically, banks in Sub-Saharan Africa, Latin America and the Caribbean, Europe and Central Asia, and East Asia and the Pacific saw demand rising more frequently than their capacity to fulfill that demand. Over half of banks in the Middle East North Africa (50 percent), Latin America and the Caribbean (55 percent), and Europe and Central Asia (60 percent) maintained capacity at the same level as prior years.

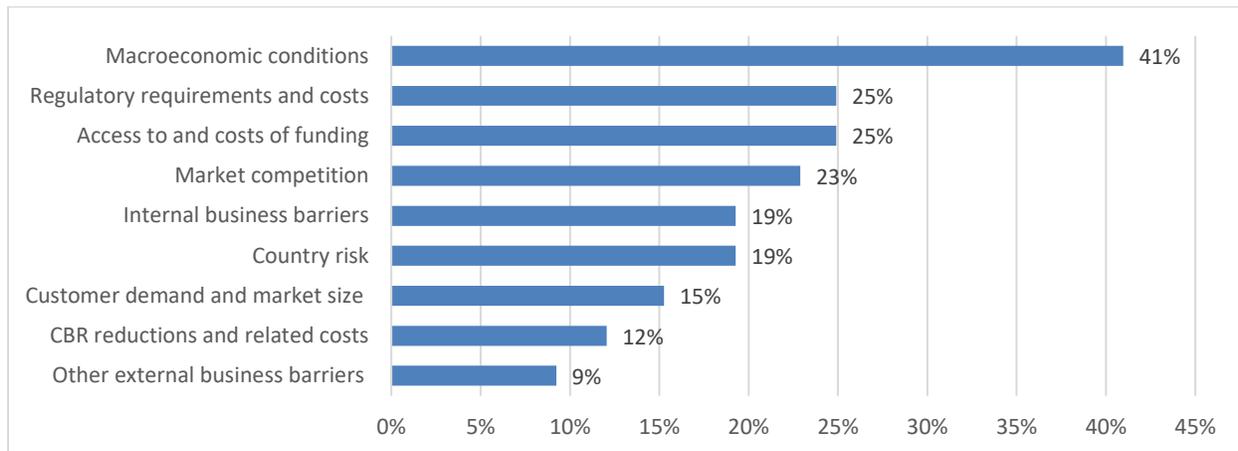
Some banks identified specific reasons for changes in customers' demand or their own ability to meet that demand. Among banks that reported increased demand, many attributed the growth to increased trade in their country or an increased customer base. Banks from Bangladesh, Dominican Republic, India, Kenya, Lebanon, Malawi, Nepal, Pakistan, Panama, Paraguay, Vietnam and Zambia indicated increased demand driven by increases in trade volumes. For those banks whose capacity decreased, they attributed the decreases to stricter regulations, increasing compliance requirements or higher capital requirements. For those banks whose capacity increased, they attributed this trend to increased capital, stronger relationships with correspondent banks, more correspondent banks, increased credit limits from correspondent banks, investment in compliance or robust trade activities.

E. Compliance Challenges

The survey also collected banks' independently written responses for a broader perspective on their barriers to business growth in the current global environment, beyond obstacles related specifically to compliance.

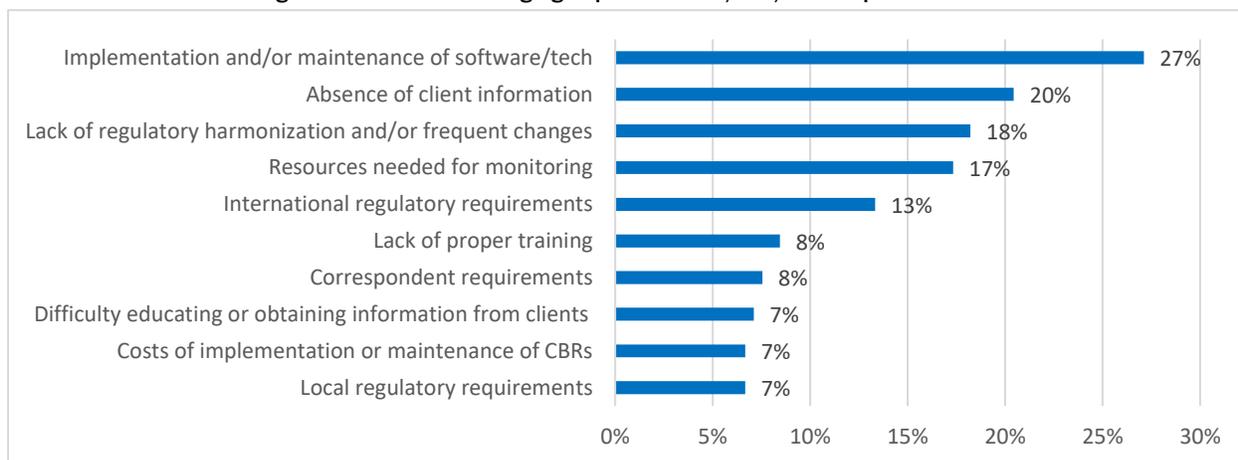
Emerging market banks commonly noted AML/CFT regulations and/or KYC requirements as a barrier to growth. The IFC survey asked survey participants, broadly, "What are the biggest barriers to growth for your bank?" In response, one-quarter of all banks indicated that the implementation and/or costs of international or domestic regulations regarding compliance or capital reserve requirements represented a significant barrier to business growth (Figure 3.12). This was the second most common challenge globally, after macroeconomic conditions, which was named by 41 percent of participants.¹²³ Banks in East Asia and the Pacific and South Asia were less likely to name regulations as a barrier than their counterparts in other regions. Institutions in low- and lower-middle-income countries were more likely to face growth challenges from regulations than those in upper-middle- and high-income countries. However, no bank mentioned regulatory requirements as its only growth barrier. It was most commonly discussed alongside macroeconomic conditions, internal business barriers and market competition.

Figure 3.12. Most Commonly Cited Barriers to Growth



Specifically regarding compliance-related efforts, systems and technology implementation were a primary concern. IFC asked its emerging market bank partners about the most challenging aspects of their AML/CFT/KYC compliance efforts. The 10 most common responses among all participants are noted in Figure 3.13, and 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 (27 percent). Banks in Latin America and the Caribbean and Middle East and North Africa expressed the greatest concern about systems management. Several banks indicated they were in the process of implementing formal AML/CFT reporting and/or KYC systems and noted that, in the absence of these systems, they were required to manually verify customer identities against sanctions, politically exposed persons (PEP) and other blacklists.

Figure 3.13. Most Challenging Aspects of AML/CFT/KYC Implementation



Reports for regulators and correspondents also had to be produced manually. Challenges continued post-implementation as well, as AML/CFT reporting and/or KYC systems had to be linked to core banking systems, upgraded in response to new or changing requirements, and updated to reflect changes to customer data and status. One survey participant in Latin America and the Caribbean described the challenges created by the implementation of new systems and processes. These challenges included “reinforcing our KYC process to ensure the acceptance of new customers as a result of the new investigations of the federal police; developing new processes to capture aliens and report them to other jurisdictions; conducting face-to-face training for AML/CFT matters; improving monitoring of AML/CFT rules; and investing in training and courses for the AML team,” the bank wrote.

Incomplete or inadequate customer information was also a problem. The limited availability of certain information about customers was the second most commonly cited aspect across all participants (20 percent). 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. These hurdles make it more difficult and time-consuming to identify the ownership structures and ultimate beneficial owners (UBOs) of firms— decreasing the chance that correspondents will be willing to take on the risk of doing business with them. In Sub-Saharan Africa, the customer information deficit was most often mentioned as a compliance challenge. In six countries, including Cameroon, Guinea, Liberia and Tanzania, poor or non-existent national identification requirements exacerbated difficulties in properly identifying transaction parties.¹²⁴ In three countries, a lack of adequate and sequential numbering of residences and businesses added to the identification challenge. Some banks mentioned that verifying identities and addresses was a particular problem for customers in rural areas.

As a result, banks faced challenges in getting customers to respond to requests and saw their business reduced. Seventeen percent of banks cited that the resources needed to monitor AML/CFT risks and/or customers (via KYC systems) were significant, and banks in East Asia and the Pacific most often noted resource requirements as a pressing issue. Globally, 8 percent of banks said that they faced difficulties in obtaining information directly from customers. In some cases, customers did not fill out KYC surveys completely or simply did not respond to information requests. These non-responses added to the challenge of building customer profiles and providing staff with high-quality and reliable customer data that can be used to detect suspicious behavior or transactions. In other instances, customers stopped doing business entirely. Because the CDD needs of correspondents may differ from transaction to transaction, information requests to emerging market banks' customers were often disaggregated, sporadic and unpredictable. The complexity of these requests often had the effect of increasing transaction processing time, which deterred customers, or limited respondents' ability to process entire classes of transactions. One South Asian bank wrote that it faced a “huge number” of AML/KYC-related queries from its cross-border correspondent banks that required “significant time” to address with its customers. Some of the queries were related to transactions that had been settled more than five years ago. As a result of the “stringent KYC of correspondent banks,” the bank said it has been “struggling to route individual remittances, especially for students who are studying abroad.” A Sub-Saharan African bank echoed that sentiment: “The ever-changing regulatory compliance landscape means we have to constantly educate our clients on these stringent requirements, and some are usually not happy with the delays occasioned.”

Lack of harmonization across global, regional and local regulations is creating additional challenges. Eighteen percent of survey participants globally said lack of regulatory harmonization between banks and countries represented a significant compliance hurdle. Frequent changes to requirements by regulatory bodies or

correspondents also generated considerable concern. Regulatory differences across jurisdictions have resulted in cases where requirements in one country are in direct conflict with those in another. One Sub-Saharan African bank operating in multiple countries wrote that it faced “inconsistent” and “conflicting” policies “with sometimes unpredictable outcomes across geographies.” In addition, early movers in adapting to pending regulatory changes face a form of “regulatory arbitrage” as customers leave banks for competitors rather than bear more stringent reporting requirements and, thus, higher service costs. “Customer KYC is not applied at the same level of compliance among banks in [East Asia and the Pacific],” wrote one survey participant. “Therefore, there's the fact that [the] customer will choose services offered by banks with lower compliance levels of KYC and refuse banks applying [a] higher level of compliance.” Thirteen percent of global participants indicated that international compliance requirements created a challenge. This was the most commonly noted challenge in Europe and Central Asia, due in large part to their customers’ frequent business with entities in the EU, which necessitates compliance with strict EU standards. Several banks in that region noted new difficulties and costs that stemmed from the recent implementation of Fourth EU AML Directive, and a recent Joint Opinion published by the European Banking Authority, European Securities and Market Authority, Joint Committee of the European Supervisory Authorities and the European Insurance and Occupational Pensions Authority confirms problems with regulatory harmonization.¹²⁵ One bank in Europe and Central Asia described its specific reporting challenges. “Due to the very high penalties, banks have to dedicate huge resources to mandatory reporting,” the bank wrote, further indicating that there were consequently fewer resources available to continued upgrade of its suspicious transaction monitoring.

Banks reported that they had a number of other compliance-specific concerns. Other frequently highlighted challenges included limitations on formal training for staff; the lack of appropriately skilled workers in the market; the increasing complexity of and documentary requirements for transactions; the increasing cost of maintaining CBRs; and the increasing risk of cybercrime. Some banks said that their capacity and budget for employee training on the use new compliance systems and updates on frequent changes to requirements across jurisdictions is too limited. Others indicated that efforts to grow their compliance function by hiring new employees were hampered by a lack of workers with the requisite AML/CFT skills in their markets.

Despite efforts to date, 78 percent of banks expect compliance costs to increase in 2017 (Figure 3.14), and almost 10 percent of those expect it to at least double (Figure 3.15). Survey participants reported spending over \$62 million in 2016 on compliance-related efforts including, among other items, software, IT systems upgrades, staff, and staff training. Only two percent of participants expected their compliance expenditures to fall.

Figure 3.14. Bank Outlook for Change in Compliance-Related Expenditures in 2017

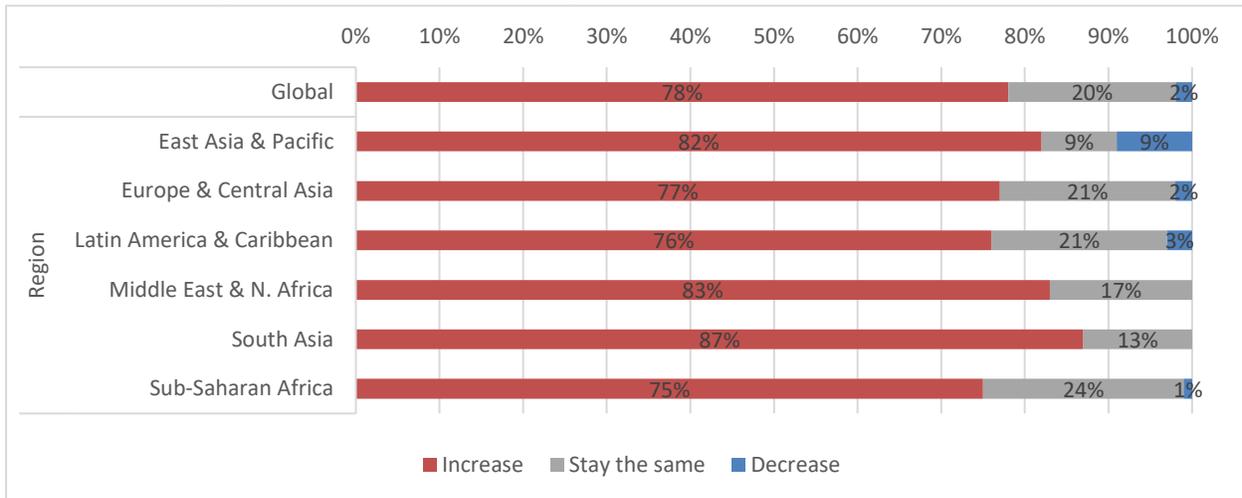
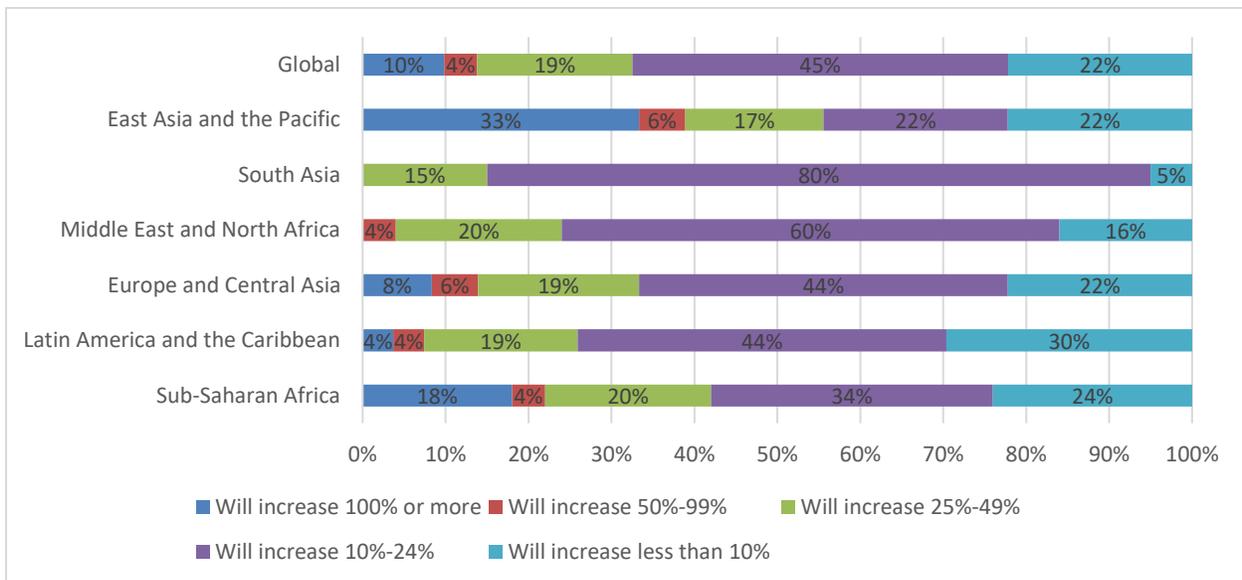


Figure 3.15. Percent Increases Expected Among Banks Expecting Increased Compliance-Related Expenditures



Compliance costs are expected to increase in all regions. No banks in South Asia or the Middle East and North Africa reported that they anticipate a decline in their compliance expenditures. South Asia had the largest share of survey participants expecting a cost increase. More than one-quarter of banks in East Asia and the Pacific and Sub-Saharan Africa expected compliance cost growth of 25 percent or more. More than 10 percent of banks in these same two regions expected the increase will exceed 100 percent. Globally, at least one bank

in 15 countries⁶ said it expects costs to double, including banks from seven Sub-Saharan African countries and three countries in East Asia and the Pacific. Another seven countries⁷ have banks that expect costs to increase by more than 50 percent. East Asia and the Pacific had the largest share of banks with costs expected to fall (8 percent).

Specific segments displayed expected increases more frequently. In general, banks in high-income countries and lower-middle-income countries, banks in investment-grade countries, and larger banks based on asset size more frequently expect increases in compliance-related expenditures. Conversely, upper-middle-income countries, banks in non-investment-grade and unrated countries, and smaller banks, were more likely to expect decreased or stable compliance costs, compared to the global average. Certain segments indicated that they expected increases greater than 50 percent with notably higher frequency than the global average; they include banks in East Asia and the Pacific, Sub-Saharan Africa, lower-middle income countries, oil exporting countries and smaller banks.

F. General Barriers to Growth

As depicted in Figure 3.12 above, when banks were asked to identify barriers to growth in the broadest sense, several other relevant challenges came to light.

Access to funding was another significant challenge, particularly in LICs. Globally, one-quarter of survey participants raised concerns about their ability to grow their lending portfolio; they attributed their difficulty to lack of access to funding or insufficient investments to bolster their capital base. Among the specific types of funding mentioned were foreign exchange, trade finance, medium and long-term finance, and foreign aid and Development finance institution (DFI) financing. “In the face of constant demand, we face difficulty in accessing foreign currency given existing restrictions,” reported one Sub-Saharan African bank. Another bank in Europe and Central Asia wrote, “Dollarization of [our country’s] banking sector is a constraint for growth, as it limits potential of efficient capital allocation.” A handful of banks also discussed the need for certain derivatives, such as currency hedging tools, to manage the risk in their portfolio. Financing difficulties, as well as their respective costs, were a growth barrier for 32 percent of participants in LICs – a higher proportion than in middle- and high-income countries. In fact, in LICs, access to funds, combined with macroeconomic conditions, was the most commonly cited challenge to business growth.

Competition, country risk, and customer demand and market size were also mentioned as hurdles to business growth. Many said they face significant competitive challenges from various types of market participants. A number of banks described how investments in innovative technologies to manage AML/CFT reporting and/or KYC were making them less competitive on price and they had to pass on some of those higher costs to customers, denting their market share. Wrote one South Asian bank:

“[Our bank has] massively invested in [digital] innovation of technical solutions and service for customers. Undoubtedly, [the] cost of such a solution has to be embedded in pricing of products and

⁶ Includes Albania, Congo, Ghana, Guatemala, Honduras, Indonesia, Kenya, Moldova, Namibia, Rwanda, Sao Tome and Principe, Tanzania, Turkey, Vanuatu and Vietnam.

⁷ Includes Angola, Nicaragua, Peru, Philippines, Romania, Saudi Arabia and Turkey.

services. [This affects our market access.] Sometimes, it seems to be a deterrent for growth opportunities of the bank.”

Survey participants noted other specific external business barriers. Country risk was also frequently discussed, covering poor sovereign ratings in Mongolia, Papua New Guinea, Ukraine, Vietnam and Zambia; FATF gray listing in Lao PDR; and specific political circumstances (namely in Brazil, Bulgaria and Ukraine) and legal system challenges (in Armenia, Central African Republic, Guinea, Sierra Leone, Togo and Uganda). Still another segment of participants noted limitations in demand, due most often to shortfalls in financial inclusion, financial literacy and household purchasing capacity. Additional external barriers ran the gamut of development challenges: missing financial infrastructure, poor hard infrastructure, energy supply instability, large informal sectors, protectionist policies, absence of common trade tariffs, limited economic diversification, and limited connectivity with global markets.

The complexity of growth hurdles for some banks was notable. A survey participant in Europe and Central Asia explained: “Market competition is the strongest barrier. Other factors ... [include] constant market level (limited economic growth of companies); limited governmental measures to support development of the economic environment; ... and [our bank’s] lack of rating. Hence [we face] downsized limits from international banks and higher transaction costs when deals accepted.”

G. Summary

Survey findings suggest that drivers and effects of de-risking are subtle, complex and pervasive. While each segment sheds light on similarities to and variance from the global results, correspondent banking and compliance challenges and increasing compliance costs affect every country type.

At the surface level, most correspondent networks remain intact, but several regions reported notable reductions. Nearly three-quarters of survey participants noted that active CBRs were either maintained or grew in 2016. Almost half of survey participants remain optimistic about the outlook of their correspondent networks, despite input to the contrary by their cross-border correspondent banks. However, concern lies in the still-large portion of banks that indicated CBR declines. Over one-quarter of survey participants in Europe and Central Asia and Latin America and the Caribbean, and over one-third of banks in Sub-Saharan Africa, reported decreases. These findings are important as they demonstrate the potential for differences in result interpretation. There is reason to be optimistic as CBR networks in 73 percent of survey participants appear, at the surface, to be relatively unaffected, and 2017 is expected to be stable. However, with nearly 30 percent of global survey participants claiming reductions, the data indicates stress on what would ordinarily be a fairly stable count.

A deeper look reveals that that banks are facing multiple external challenges. The most frequently identified challenges were compliance requirements and increased compliance costs, followed closely by challenges with correspondent networks. Along with their global peers, emerging market banks are tackling several compliance challenges, for example:

- Expensive implementation of software or system upgrades
- Lack of harmonization in global, regional and local regulatory requirements
- Varied data requests from multiple regulators and cross-border correspondent banks
- Limitations with local information and a shortage of training and/or knowledgeable staff

Despite significant spending in 2016 (as high as \$9 million per bank), 78 percent of banks expect compliance expenditures to increase substantially in 2017, with banks in countries across a large range of regions, sizes and income levels expecting costs to more than double. Survey participants further described adaptations to their business models in response to these challenges ultimately affected their customers negatively. For example, banks frequently reduced lending or limits, increased fees, or cut customers. However, there is notable variance in the adaptations that different banks and countries have employed. Also important is the juxtaposition between banks reporting that demand for international banking services is increasing while their capacity to meet that demand is fixed or in decline. This further hinders the realization of economic development. Seventy-two percent of survey participants indicated that in 2016, external challenges decreased their ability to serve their customers. The complexity rising from the combination of exogenous factors is notable, as most banks are facing challenges on multiple fronts.

Reviewing survey results, we find that all country types area affected and need support; certain areas appear to be particularly 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. Sub-Saharan Africa appears to be facing the greatest challenge, along with the Middle East and North Africa. However, even regions that appear to have fared better, such as East Asia and the Pacific and South Asia, face their own set of obstacles and indicate that their offerings are not keeping pace with increasing demand. 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. Reviewing these results comprehensively, we recognize that all areas are affected and, thus, solutions need to help financial sectors across all emerging markets to shore up their capacity to serve their customers and, thus, countries, as well as their capacity to meet growing demand for international banking. Our findings also suggest that each region and some country groups and institution types are unique in terms of the challenges they are facing and the adaptations they have to deploy. This indicates that while there is a global set of common solutions that would benefit all, the sequence and prioritization of the application of those solutions may differ, and a strategic approach will be needed to assess the most valuable actions to take for each segment.

SECTION 4. SPECIFIC DE-RISKING EFFECTS

Evidence suggests the loss or potential loss of CBRs may limit many banks' provision of services, and reductions in these services could have significant effects on certain customer segments and economic sectors. CBRs are the connective tissue linking various points across the global financial system, offering foreign banks access to U.S. and EU financial markets, and foreign currency.¹²⁶ Complexities of the relationships between CBRs and national economic performance, noise inherent in the assessment of any macro-economic driver and limited availability of CBR-related data all present challenges in quantifying the effect of de-risking on economies. However, the combination of an understanding of the importance of Correspondent Banking to economies and specific segments therein, indications from some banking authorities and a flood of anecdotal and survey evidence indicates the possibility that a reduction of CBRs has had negative effects, and consequences may continue to deepen. While the global financial system has not been affected systemically, correspondent banking de-risking appears to affect certain financial products, countries and customers, sometimes severely. Beyond smaller economies, there are also indications that larger emerging markets and businesses are also affected. A survey participant from a larger country in Latin America and the Caribbean explained that, combined with other factors, de-risking is contributing to significant obstacles for doing business in the local economy. "Country risk perception, access to products (for example, financial guarantees), and the cost of current correspondent lines (much higher than neighboring countries) ... [are] affecting the competitiveness of local companies," the bank reported.¹²⁷

Certain forces may mitigate the worst of the negative effects of reduced CBR. The curtailment of CBRs may remove or limit banks' ability to process transactions handled directly through correspondent relationships: trade finance, remittances and any transactions that require settlement in foreign currency. Banks that can maintain or grow their CBRs are able to process higher dollar-volume amounts of correspondent banking, thus cross-border financial flows may ultimately be less affected. Equilibrium effects may emerge in some markets if some banks are able to take on the CBRs that are lost by others, although this is less likely as many correspondent banks have indicated less willingness to launch new relationships. Country-level information reporting efficiencies may be introduced if CBRs become more concentrated. Furthermore, workarounds are likely to prevent the realization of systemic crises in most countries. However, even if these mitigating factors do come about, there will still be negative effects that are invisible at the macro-level, given the econometric noise in any country. Access to this type of finance is likely to take longer to obtain, be more expensive and be less available to some existing or potential customers. This will ultimately slow the rate at which a country can grow, and reduce the availability of finance within that system. Beneath the macro view, as de-risking affects banks' capacity to serve customers, there are and will be individual families and companies that are acutely effected and thus de-risking could be catastrophic to the livelihoods and lives of some. In this way the "micro view" is also important; the cumulative effect may not be visible at the macro level, but it will likely be present.

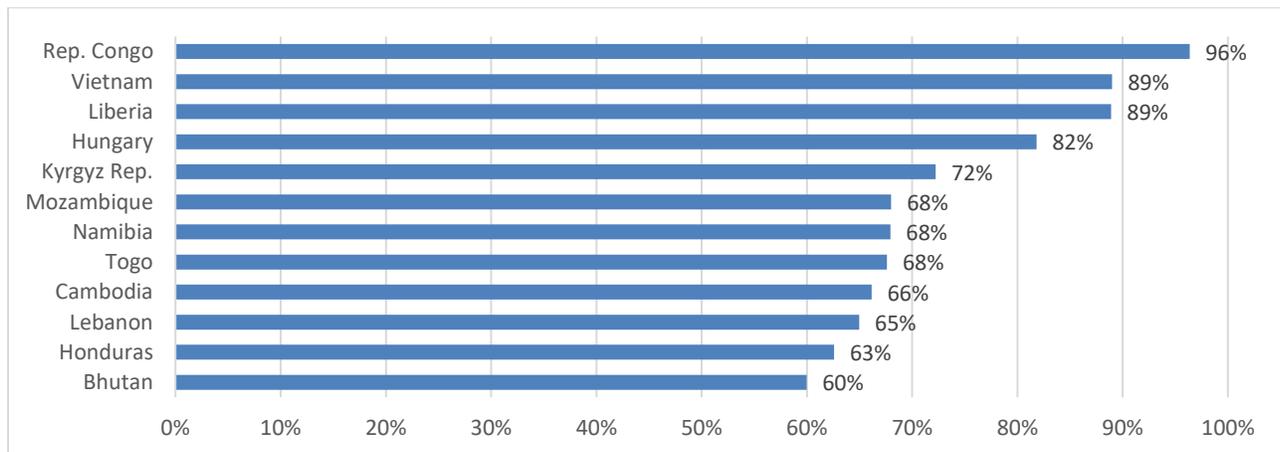
A. Effects on Trade Finance

Trade has long been recognized as a key driver of development, and its importance to a country's overall economic performance is well-documented. While individual trade transactions are short-term, the accumulated development impact of trade is significant and long-term. Developing countries which trade successfully tend to have made the most progress in alleviating poverty and raising living standards.¹²⁸ Openness to the world economy, including trade participation, was one of the key elements of sustained high growth identified by the 2008 report of the Commission on Growth and Development.¹²⁹ Evidence shows that a 1 percentage point increase in a country's trade share raises income per capita by 2 percentage points.¹³⁰

Furthermore, trade supports the availability of goods critical to economic function and life. Some 21 countries in Sub-Saharan Africa rely on imports for more than 90 percent of their energy needs; half of the top 20 rice importers globally are from among the poorest countries in Africa.^{131,132} In addition, domestic producers often require imports of agricultural inputs, such as seeds, fertilizer, agrichemicals, irrigation and equipment, during pre-planting phases and throughout the crop cycle. Figure 4.1 shows a selection of emerging markets across all regions for which imports make a critical contribution to GDP.

In many cases, trade in emerging markets would not occur without trade finance. Bank-intermediated trade finance supported one third of the \$19 trillion in global trade in 2013, according to estimates by BIS.¹³³ Furthermore, data collected between 2005 and 2011 indicate that a one percentage point increase in trade credit extended led to a roughly 0.4 percentage point increase in a country's real imports.¹³⁴ Reductions in the availability of trade finance have been found to affect trade. It is estimated that credit shocks related both to working capital and trade finance accounted for between 15 percent and 20 percent of the decline in trade during the 2007-08 crisis.¹³⁵

Figure 4.1. Imports as Percentage of GDP, Selected Countries



Source: World Bank World Development Indicators.

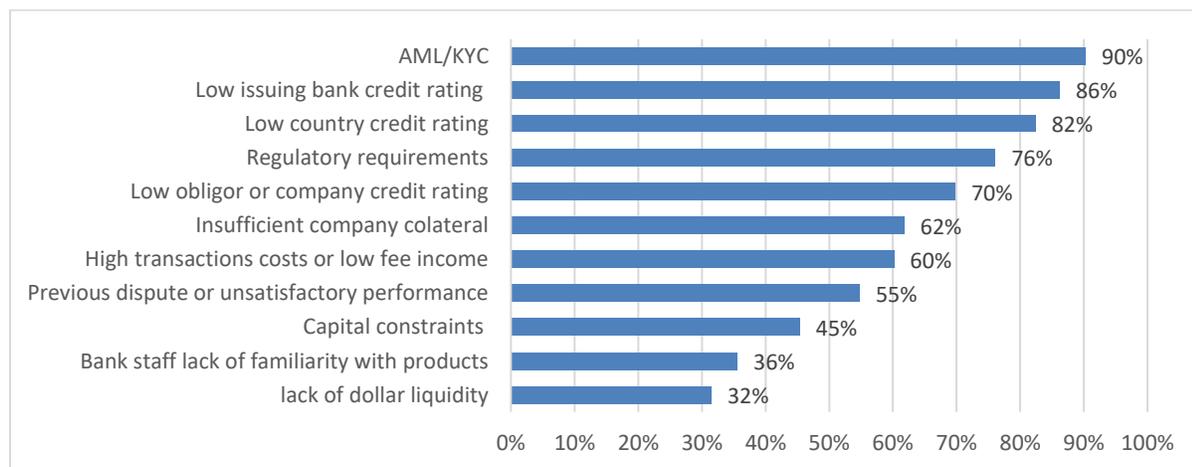
Trade finance products are premised on CBRs. Trade finance instruments, intermediated by commercial banks, are designed to address the risks rising from the lack of familiarity between buyers and sellers, the timing differences of cash needs and cash flows, and other risks—real or perceived—of a country or counterparty. Trade finance instruments are premised on an existing credit relationship between counterparty banks.¹³⁶ International banks, which are often required to “confirm” the payment to the exporter if documents conform to that required by an LC, take on the reimbursement risk related to local emerging market banks. Thus, in order for goods to be shipped, a confirming bank must be willing to take the payment risk of the local bank. In many cases, this is heavily reliant on a correspondent relationship business model; in a few cases, banks have an extensive network of subsidiaries that facilitates trade finance, and others use a hybrid. However, it is not clear that the extended model will always continue, given the current environment, or that those that do continue will address the emerging market trade finance gap. This may not be possible if

exposure constraints exist for the customer or the country, or the potential return on this exposure does not merit the risk taken.

Despite its low-risk nature, trade finance appears to be vulnerable to de-risking. Trade finance, the short-term financial obligations and related documentation taken on by banks transacting cross-border, is typically considered to have lower financial risk due to a near-zero global loss history and relatively short tenors, among other factors.¹³⁷ In today's environment, many international banks with trade finance expertise face increased risk-based capital constraints and other regulatory pressures that have an impact on their emerging market operations (Figure 4.2). While relevant and specific macro-level data regarding the net change in correspondent relationships for trade finance is not available, survey information suggests a potential magnitude of the de-risking challenge. In a 2015 survey conducted by the ICC, roughly two-thirds of banks said that the implementation of Basel III regulations has affected their cost of funds and liquidity for trade finance.¹³⁸ In the same survey for 2016, increased costs for AML/KYC continued to be a challenge: 93 percent of participants said that these factors continue to be a strong impediment to facilitating trade finance, and 62 percent noted they had seen trade finance transactions decline due to AML/KYC considerations.¹³⁹ Seven in ten participants in the 2015 survey said that implementation of AML/KYC regulations was already resulting in their bank's decreased support for trade transactions.

The gap between trade finance demand and supply was sizable pre-crisis, and many are concerned that it will continue to expand, impeding trade. Studies by the World Trade Organization (WTO), the Asian Development Bank (ADB) and the African Development Bank (AfDB) have shown a large, unmet demand for trade finance. The WTO estimated a global trade finance gap of \$1.4 trillion, with significant shortfalls in emerging regions like developing Asia, where trade finance demand exceeds supply by up to \$425 billion.^{140,141} In Africa, the value of unmet demand for trade finance has been estimated to be \$120 billion, fully one-third of the

Figure 4.2. Trade Finance Impediments Identified by Banks



Source: ICC Global Survey on Trade Finance, 2016.

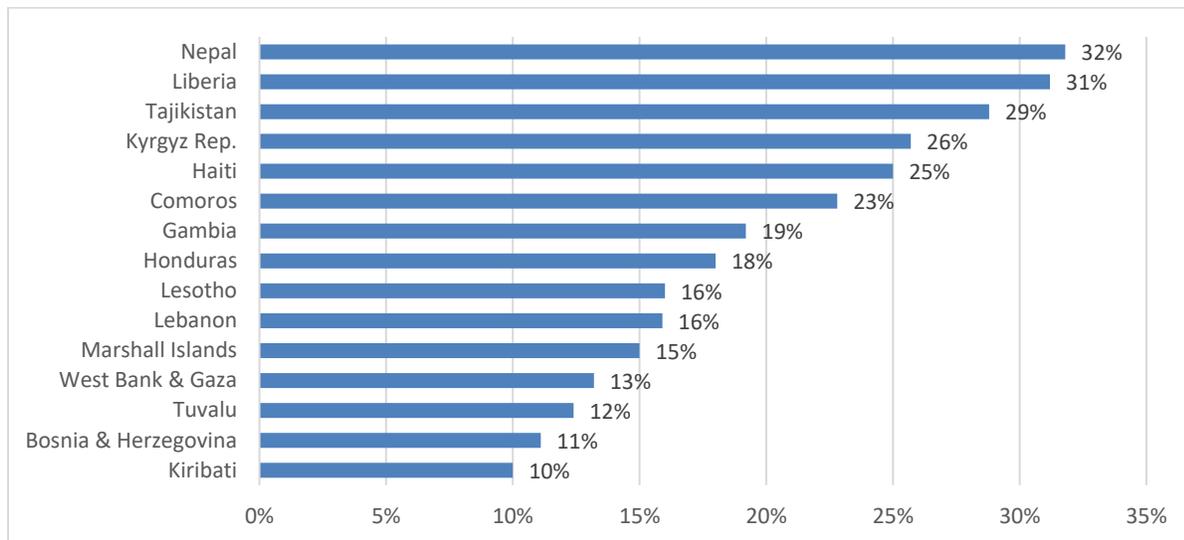
continent's trade finance market, according to the AfDB.¹⁴² Because bank-to-bank relationships represent a key element in cross-border transactions, declines in CBRs put trade finance at risk.¹⁴³ This has the potential

to hurt trade in both rich and poor countries. If heavily regulated higher-income countries are unable to issue LCs due to KYC concerns or lack of correspondent connections, exports from these countries will suffer. Conversely, if banks in these countries are unable to confirm LCs issued by banks in importing countries for the same reasons, exports from lower-income, higher-risk countries will also be affected. The ICC noted that due to AML and KYC issues, 62 percent of survey participants have declined trade finance transactions, and three-quarters of banks said that SMEs were the most adversely affected customer group.¹⁴⁴ In a 2016 ADB study, 90 percent of banks across 114 countries cited AML requirements as a major impediment specifically to trade finance; 77 percent cited Basel III.¹⁴⁵ Close to 50 percent of the smaller local and regional banks that responded to the relevant question in the World Bank survey on correspondent banking estimated that their ability to access (and in turn provide to their customers) trade finance services had been significantly or moderately affected by the decline in the provision of foreign correspondent banking services.¹⁴⁶

B. Effects on Remittances

Money transfer organizations (MTOs) rely on correspondent banking to move funds across borders, and they are essential service providers in markets with few banks. Money- and value-transfer systems are mechanisms or networks of people that receive money for the purpose of making the funds or an equivalent value payable to a third party in another geographic location. MTOs provide one such mechanism, using correspondent banks as third parties to coordinate with beneficiary banks and facilitate international fund transfers.¹⁴⁷ The importance of MTOs to a financial sector is amplified in jurisdictions, such as small countries, where there are a limited number of banks in operation. Services offered by MTOs include credit card payments, settlement of international credit and debit cards, cash management, investment services, clearing and settlement, international wire transfers, and remittances.

MTOs play a critical role in international remittances, a key source of financing for some economies. Many emerging market households rely on remittances, or cross-border money transfers, for large portions of household income.¹⁴⁸ The income generated by migrants working overseas and returned home as remittances underpins domestic consumption and household saving. According to global estimates by the International Labor Organization (ILO), migrant workers accounted for 150 million of the world's approximately 232 million international migrants in 2015.¹⁴⁹ Migrants who want to send money home and the families who rely on that money need a healthy MTO sector. In many markets, more than 90 percent of international remittances are processed by MTOs, according to the IMF.¹⁵⁰ Officially recorded remittances to developing countries in 2015 reached \$432 billion—more than three times foreign aid—representing a vital source of finance for poor countries.¹⁵¹ The dollar value of annual remittances to developing countries is slightly above private debt and portfolio equity fund flows in terms of capital flow.¹⁵² In approximately 20 percent of countries (primarily emerging markets), remittances represent close to ten percent of GDP.¹⁵³ Analysis of data from the World Bank shows that for certain countries, including a number of FCS countries, remittances can make up a significant share of GDP (Figure 4.3).

Figure 4.3. Remittances as Percentage of GDP, 2015, Selected Countries and Territories

Source: World Bank World Development Indicators.

MTOs are seeing banking services terminated or reduced. Vijaya Ramachandran of the Center for Global Development (CGD) discussed evidence of this trend at length in her November 2016 IFC Emerging Market Compass Note on de-risking and remittances.¹⁵⁴ In 2012, following a series of strategic assessments initiated in the wake of financial settlements with U.S. and U.K. authorities, HSBC decided to close the accounts of a number of MTOs in several jurisdictions.^{155,156,157} In 2013, more than 140 U.K.-based remittance companies were told by Barclays Bank that their accounts would be closed within 60 days. Barclays reviewed these customers according to its new risk-based eligibility criteria and, as a result, the bank decided to no longer work them. By end-2014, Barclays had completely withdrawn its support for the remittance sector. Similar situations have developed in the Pacific Islands and the Middle East and North Africa. Australia and New Zealand are the primary sources of remittances for most Pacific Island nations, where remittance inflows as a share of GDP are among the highest in the world. As of end-2015, Commonwealth Bank and National Australia Bank had exited the MTO market, and the two other largest banks, ANZ and Westpac, had terminated the majority of accounts held by remittance firms.¹⁵⁸ In 2016, banks in the Middle East and North Africa surveyed by the IMF and the Union of Arab Banks also reported winding up relationships with MTOs.¹⁵⁹ A recent IMF working paper reports that in many small Pacific states, MTOs have had bank accounts unilaterally closed by banks, and there is a possibility that MTOs could cease operating completely, leaving parts of the population without ready access to financial services.¹⁶⁰

Regulators have repeatedly noted MTOs' decreasing access to banking services. For example, as early as 2005, a joint statement by the U.S. Financial Crimes Enforcement Network, the U.S. Federal Reserve, and several other regulators noted that "money services businesses are losing access to banking services as a result of concerns about regulatory scrutiny, the risks presented by money services business accounts, and the costs and burdens associated with maintaining such accounts."¹⁶¹ The statement goes on to say that these

concerns may stem in part from “the erroneous view that money services businesses present a uniform and unacceptably high risk of money laundering or other illicit activity.”

Banks’ termination of relationships with MTOs appears to be escalating. In the World Bank’s report on de-risking activities in the remittance market, nearly half of the MTOs surveyed indicated that they had at least one bank account closed last year.¹⁶² About half of participating governments said that they had received complaints from such organizations about access to bank accounts. Participants from the United States, the United Kingdom and Australia are suffering the most significant impacts, the survey found. Industry bodies have reported that many smaller MTOs have been forced to close or become agents of larger business—leaving only larger MTOs with access to formal bank accounts. In some cases, to remain banked, small players have been forced to disguise the true nature of their operations by, among other maneuvers, channeling funds through third parties or “smurfing” —that is, breaking up transactions into smaller amounts to remain below regulatory thresholds for intensive KYC reviews.¹⁶³

Further CBR concentration could also push fund transfer activities into the informal sector, raising transparency concerns. The reduction of services offered by the formal sector may be increasing the use of services in the informal sector.¹⁶⁴ One such channel is the traditional *hawala* system of money transfer. *Hawala* is an informal money transfer network that enables two parties to exchange cash across long distances, relying on the honor system rather than on the legal enforceability of formal instruments like promissory notes.¹⁶⁵ While some companies in this business have begun to respond to the changing global regulatory environment by keeping careful transaction records, performing identity checks and vetting all transaction parties against blacklists, there are still many other firms that do not take such precautions.¹⁶⁶ Another channel for international flows is bulk currency exchanges, which entail bank-to-bank transfers of large volumes of bank notes through shipping companies. These exchanges are often used by individuals and businesses that generate currency from legitimate cash sales of commodities, other products or services, or certain industries, such as tourism or commerce.¹⁶⁷ In recent years, however, the smuggling of bulk currency has become a preferred method for moving illicit funds across borders.¹⁶⁸ For example, bulk cash smuggled out of a jurisdiction can be reintegrated into the global financial system through numerous intermediaries and layered transactions that disguise the origin of funds. Remittance flows that are driven through less transparent channels become substantially more difficult to track and secure from diversion, undermining efforts to limit terrorism financing and money laundering and shore up the stability of the global financial system.

In some cases, correspondent banks have requested that their respondents limit or end their relationships with certain customer segments, and these terminations could have a negative impact on financial inclusion and system stability. In many cases, requests from correspondents for emerging market respondents to reconsider their customer pools lead to local bank de-risking from local customers, including MTOs, among others, in an effort to protect their existing cross-border CBRs. For example, withdrawal of correspondents from small states in the Pacific has put pressure on some respondent banks to reconsider their customer base (for example, by terminating the accounts of MTOs), increasing fragility of remittance corridors in that region. A halt or slowing of remittances in economies that rely on these cross-border funding flows could pose a significant threat to socioeconomic stability. Thus, there is legitimacy to the concern that de-risking may be excluding a growing number of people and businesses from access to finance and international trade.¹⁶⁹ In Haiti, for example, the impact of this spillover would be immediate: about 75 percent of remittances from the Bahamas to Haiti are paid and received in the same day, and a decrease in speed of these flows would affect the availability of funding.¹⁷⁰ The IMF has further noted that, withdrawal of financial services threatens to

undermine recent progress on financial inclusion in some cases, and it has highlighted cases where customers were exposed to the higher-risk activity of conducting transactions through cash and carry.^{171,172}

C. Effects on Foreign Currency Settlements

De-risking has the potential to affect the availability of foreign currency in emerging markets. As noted in the preface, banks clear and settle formal financial transactions, and thus a large portion of all cross-border transactions. As CBRs are required for emerging market banks to clear and settle many of these transactions in foreign currencies, CBRs play an essential role in the movement of money, and all that entails, across borders.¹⁷³ In its 2016 Belize Country Report, the IMF notes that, in general, virtually all balance-of-payment flows require movement of money between domestic banks and their foreign counterparts, linked through CBRs.¹⁷⁴ U.S. dollars are used for 45 percent of all global payments (both within and between countries), followed by the euro at 28 percent.¹⁷⁵ The U.S. Clearing System—the largest clearing system the world—processes millions of transactions, valued in the trillions of dollars, that are conducted between sellers and purchasers of goods, services or financial assets on a daily basis.¹⁷⁶ In 2015, U.S.-approved reserve banks—the only institutions licensed to settle U.S. dollar transactions—handled over \$178 trillion in domestic and cross-border wire transfer and automated payments, representing more than twice the value of global GDP and highlighting the criticality of foreign currency movements throughout the world economy.¹⁷⁷

Compliance regulations governing all U.S. dollar and euro transactions create additional complexity for emerging market banks. All U.S. dollar transactions must be cleared through U.S. banks and are subject to layers of U.S. jurisdictions; likewise, all euro transactions must be cleared through financial institutions in the Eurozone and are subject to EU and national requirements.¹⁷⁸ As Ramachandran wrote:

The United States has a complex regulatory environment with many agencies, both at the national and state level, that are relevant to AML/CFT regulation and enforcement. This creates a challenging environment for financial institutions and other entities that wish to comply. ... [I]f a bank wants to settle a transaction in U.S. dollars, it is required to be based in a country hosting one of the few U.S. dollar clearinghouses or must bank with a correspondent in that country. If emerging market banks lose access to their primary correspondent accounts and cannot establish a new one through another bank based in their target country, the terminated bank must rely on a third party with access to a correspondent account to process cross-border transactions. Such 'nested' relationships are inherently less transparent and invariably more expensive.^{179,180}

In the EU, the regulatory environment is similarly complex, despite efforts to synchronize approaches through EU directives.¹⁸¹ Complying with this wide range of requirements is a particularly daunting challenge for many emerging market banks with little direct experience with U.S. and EU regulations. For potential new entrants to the dollar- or euro-clearing space, these compliance hurdles are barriers to entry that undermine a healthy competitive environment.

The services identified as being affected by the withdrawal of CBRs include lending, structured finance, foreign exchange services, investment services, cash management, trade finance, check clearing, clearing and settlement, and international wire transfers. Large international banks have noted a drop-in provision of the following services: check clearing, clearing and settlement, cash management services, international wire transfers, investment services, foreign exchange, lending, trade finance, structured finance, and foreign investments. Local and regional banks have had significant trouble accessing check clearing, clearing and settlement services, and trade finance; to a lesser extent, these entities also experienced declines cash

management, investment services, international wire transfers, foreign exchange, lending, and structured finance.¹⁸²

Most developing countries have found alternatives to mitigate macro-material effects to date, though at a cost.

According to the IMF, “in many cases where CBRs have been lost, financial institutions have been able to find alternative arrangements including by relying on their remaining CBRs, finding replacement CBRs or using other means of transferring funds across borders.”¹⁸³ However, the ability of financial institutions to find replacement CBRs has varied. Authorities in many of the affected countries have reported that maintaining existing CBRs has come at a price, including (1) newly imposed minimum activity thresholds below which the account is closed; (2) higher costs (often associated with due diligence) passed on to the consumer when establishing a new CBR; and (3) pressure on the respondent banks to limit their exposure to certain categories of customers (for example, MTOs) in order to maintain a CBR.¹⁸⁴ Thus, many emerging markets have seen changes to the nature, cost and extent of correspondent banking-related services. According to the CPMI, correspondent banking networks are becoming more shallow as nested accounts and other finance providers are being reduced.¹⁸⁵ However, recent research suggests that, in some cases, nesting may be increasing as some emerging market banks lose CBRs and turn to their “peer” local banks which still have CBRs, thus accessing CBRs indirectly.¹⁸⁶ Fewer banks are providing correspondent banking-related services, thus increasing market concentration for the offering.¹⁸⁷

Rising costs for service users may present an additional challenge for emerging market firms. Costs of using services reliant on correspondent banking and sending wire transfers appear to be increasing in some places, along with the time it takes to execute—in some cases, from hours to days.¹⁸⁸ Customers using these services may also face their own additional costs for complying with their banks’ requirements to continue having access to services: the customers may require additional time and resources to complete due diligence requested by their bank. The fact that various banks’ reporting policies and processes may not be in unison and the information required may be different for each relationship would only serve to increase this cost burden further and increase switching costs should current banking relationship not be able to supply all that is needed. In cases where customer income may already be limited, rising prices could force bank customers to abandon the use of these services, limiting their ability to generate wealth and take full advantage of growth opportunities.^{189,190}

D. Effects on Smaller Markets and Firms

Declines in CBRs are curtailing the availability of financial services, particularly in smaller banks and markets perceived as having higher risk. CPMI’s 2016 study noted that respondent banks, in particular smaller banks located in jurisdictions perceived to be higher risk, have been especially affected by the reduction in the number of CBRs.¹⁹¹ During CPMI’s informal fact-finding, banks cited rising costs and uncertainty about how far customer due diligence should go in order to ensure regulatory compliance (for example, know your client’s client, or KYCC) among the main reasons for cutting their CBRs. Since 2010, more jurisdictions have been labeled as risky than in prior years, and evidence indicates that this label affects payment volumes received. Between 2010 and 2015, as many as 50 countries across all regions were identified as having strategic AML/CFT deficiencies (gray-listed) at any one time¹⁹² following FATF’s reinvigorated International Co-operation Review Group process, adopted in June 2009 (as called upon by the G20). Multiple conversations suggest that being gray-listed significantly increases that country’s risk perception by banks and regulators. CGD has found a robust negative relationship between being gray-listed by FATF and payment volumes received by an affected

country.¹⁹³ CGD examined interbank messages sent through the SWIFT network from January 2004 to August 2014, looking at the effects of FATF gray listing and risk-rating changes on interbank payment counts; the path of interbank payments; and the use of third-party jurisdictions to complete payments. Since 2008, being added to the FATF list is correlated with a decline of between 8 percent and 11 percent. In May 2017, FATF noted that since inception it has publicly named 61 countries with deficiencies and has de-listed 49 as necessary reforms have been enacted.¹⁹⁴ While this shows progress in the global AML/CFT effort, and the potential for reengagement of certain CBRs exists, the effect of being de-gray-listed has not been studied. While potential for reengagement of certain CBRs in these 49 countries exists, the costs of reestablishing these relationships may also limit that reengagement.

Specific regions have felt the effects of de-risking acutely. De-risking affects sectors and stakeholders across emerging markets, with some correspondents terminating over 60 percent of their CBRs.¹⁹⁵ Data collected in the World Bank's 2016 survey of national regulatory bodies and local banks showed the global de-risking footprint and its resulting financial exclusion have especially affected smaller developing economies in Africa, the Caribbean, Central Asia, Europe and the Pacific.¹⁹⁶ The IMF has noted that where this issue was discussed in the context of Article IV consultations, staff highlighted similar regional pockets of CBR withdrawal as identified in other surveys, namely in the Caribbean, the small islands of the Pacific, the Middle East and North Africa (MENA) region, Central Asia, and Africa.¹⁹⁷

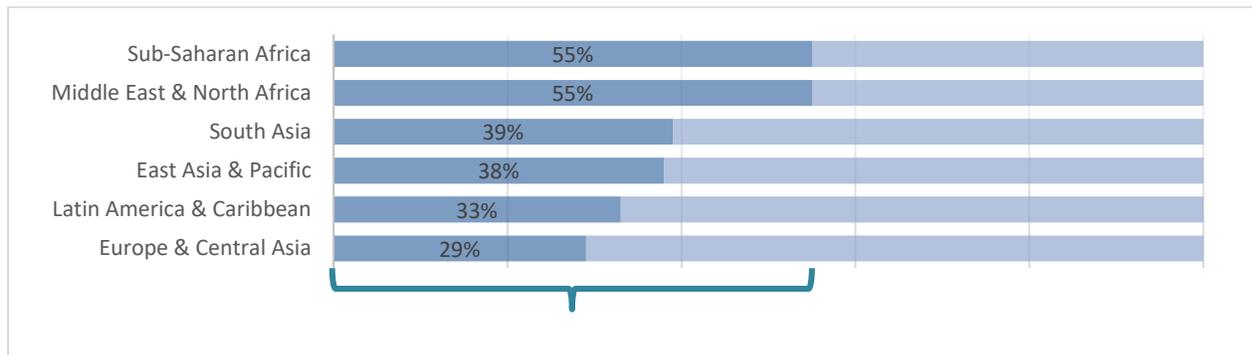
The Caribbean region, which relies heavily on cross-border funding for trade, offers a telling example of de-risking.¹⁹⁸ The region's capacity to conduct cross-border payments is being put at increasing risk from the pressures that reduce correspondent banking. According to the Caribbean Development Bank (CDB), external trade for export-oriented and oil-importing Caribbean countries accounted for approximately 94 percent of those countries' collective GDP in 2014.¹⁹⁹ Countries in the region import a large portion of their essential food, energy and medical supplies and are beneficiaries of significant remittance inflows. Hence, a lack of access to cross-border payment systems could have ruinous consequences. De-risking in the Caribbean has been closely examined and monitored by a cross-functional group, including the Caribbean central banks, the FSB, the World Bank, the IMF and the Caribbean Community (CARICOM). An IMF's 2016 study, found financial institutions in the Bahamas, Guyana, Haiti, Jamaica and Trinidad and Tobago have experienced reductions in CBRs.²⁰⁰ In nearby Belize, only two banks have maintained CBRs with full banking services.²⁰¹ Each country in this region is currently facing specific challenges due to de-risking, and most are also losing new business since the available correspondent banks refuse to enroll new customers from this region, constricting new sources of economic growth.

Evidence suggests that SMEs are among the customers that are likely affected by de-risking. Anecdotal evidence suggests the reason for this may be a so-called flight to quality as risk appetite diminishes. The John Howell & Co (for the U.K.'s Financial Conduct Authority) found that customers with higher AML/CFT risks have been disproportionately impacted through a mixture of strategic business reviews, thinly stretched compliance capacity and reduced risk appetite. During the period examined, two large U.K. banks were together closing around 600 business and corporate accounts per month for risk appetite-type reasons. John Howell & Co. noted that SMEs were more likely to be de-risked in many cases than larger firms in the same sector, and that SMEs tended to underreport incidence of CBR termination, as well as the related costs.²⁰² Globally, over half of trade finance requests by SMEs were rejected in 2015, according to the ICC.²⁰³ This is of consequence, as SMEs in emerging markets contribute up to 60 percent of total employment, almost 40 percent of GDP in emerging markets,²⁰⁴ and also a significant contribution to exports. SMEs already face significant capital

constraints, as the global financing gap for SMEs was estimated by IFC and McKinsey to be as much as \$2.6 trillion (Figure 4.4).

There is a concern that smaller markets and businesses, as well as poorer families, are particularly vulnerable to the effects of de-risking. Replying to the IFC’s 2017 Correspondent Banking Survey, a Sub-Saharan African bank described the ramifications of this challenge for its customers. “The level of currency supply [does not meet] the demand of importing customers of various local products (fuel, construction, industrial, etc.),” the bank wrote.²⁰⁵ The risk of a jurisdiction losing access to the global financial system—or reducing throughput with fewer access points—is likely to have serious consequences.

Figure 4.4. Capital-Constrained SMEs by Region (Percent of Total)



Source: IFC and McKinsey, 2014.

CBR withdrawals are inhibiting other types of cross-border transfers, including transactions by non-profit groups. Vulnerable people in post-disaster or conflict situations often rely on NPOs to deliver humanitarian assistance. These organizations function as intermediaries between banks and the financially excluded poor, in many cases by linking informal community-based savings groups to formal financial services. As banks exit relationships with these organizations, links may become unsustainable. Many NPOs, particularly those working in high-risk countries, have already reported difficulties in carrying out their operations due to closed bank accounts, often because the organization has fallen outside of a bank’s narrowed risk appetite.²⁰⁶ In jurisdictions in which NPOs play a sizable role in the economy and rely on cross-border funding flows to receive funding and conduct their operations, withdrawal of CBRs could affect growth, poverty reduction and security.^{207,208,209} Disruptions of NPOs that directly aim to provide banking services to more people in the developing world may further inhibit growth opportunities. NPOs, financial institutions and governments have developed innovative solutions to reach the rural poor and other unbanked to address high transaction costs with new branches and businesses using digital services, mobile technology and other fintech solutions. A majority of these platforms rely on connectivity into the formal banking system, but these platforms often fall into a regulatory gray area with limited AML/CFT oversight. As many banks’ willingness to employ these technologies is diminishing, putting development objectives to increase availability of financial services at risk.

SECTION 5. CUMULATIVE EFFECTS ON ECONOMIC GROWTH AND FINANCIAL INCLUSION

De-risking potentially limits the speed and depth with which a country can grow and can impair components of economic stability by reducing contributions of the financial sector. Cutbacks in number of CBRs, changes in the nature of correspondent banking services provided, a scale-back of higher-risk services, growing market concentration, increased costs, and cutbacks to correspondent banking services all have impacts on growth.²¹⁰ A reduction in trade finance supply, or an increase in the cost of trade finance services, threatens to reduce economic growth by disrupting external trade and financial flows that go through banks affected by loss of CBRs. Reductions in trade either directly result in fewer exports, a driver of GDP growth, or indirectly in fewer growth-oriented imports (for example, primary goods used in the local manufacturing and processing industry). It can interfere with linkages across economic sectors and add to supply pressure for critical commodities (energy, food imports), thus putting upward pressure on domestic prices for those goods. A reduction in remittances, particularly in countries where remittances are high relative to GDP, can put downward pressure on consumption, which impacts GDP as well as potential non-performing loans and, thus, bank capital and lending capacity. Increasing concerns over banks' capacity to settle in U.S. dollars, combined with increasing transaction time or costs for U.S. dollar settlements, raises the costs of all 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. Even slight reductions in capital account flows hinder economic growth and development, and the combined effect of each can be significant. For example, the IMF has argued that the reduction of CBRs in Latin America and the Caribbean has inhibited further financial integration, raised the cost of finance for SMEs, and led to firms losing access to credit from U.S. exporters.²¹¹

There is broad consensus in the international development community that financial sector development, greater financial inclusion and financial deepening matters for economic development. Financial inclusion refers to the provision of accessible, usable and affordable financial services to underserved populations, including an estimated two billion individuals who lack access to a formal bank account.^{212,213} Increasing financial inclusion means expanding provision of financial services to reduce the number of people who are unbanked or underbanked. Financial deepening represents greater sophistication in a country's financial sector and an expansion of products and services offered to customers, further supporting their capacity to grow. A large body of evidence has found a strong causal relationship between the depth of the financial system and investment, growth and productivity.^{214,215} Development of a well-functioning financial sector is a critical component of private-sector development strategy, and it has been associated with absolute poverty reduction, declines in income equality and declines in child labor.^{216,217} There is extensive theoretical and empirical evidence for a link between financial development and economic growth,^{218,219,220} as well as between growth and poverty reduction.²²¹ Nevertheless, the complexity of the nexus between financial development, financial inclusion and poverty remains a challenge for researchers and policy makers alike.^{222,223} Recent results however indicate a robust relationship between banks and poverty reduction,²²⁴ financial inclusion, inequality and poverty,²²⁵ financial development and poverty reduction²²⁶ as well as financial development and inclusive growth,²²⁷ leading to the conclusion that financial development is beneficial to the poor and reduces poverty overall.

The effects of financial inclusion and financial deepening on poverty reduction and other international development objectives have moved universal financial access up the reform agenda. Increases in depth of the financial system have been shown to speed up the eradication of poverty and reduce income

inequality.^{228,229} Financial inclusion further reduces income inequality, even when controlling for real per capita GDP growth, a range of country-specific variables, time trends and endogeneity.²³⁰ Cross-country evidence shows that increases in financial inclusion not only result in larger decreases in income inequality, but also help alleviate poverty at a faster rate.²³¹ These results hold when using different poverty lines, eliminating outliers in the data and controlling for the possibilities of reverse causality and a third factor driving the results. Due to the strong link between financial sector development and poverty reduction, universal financial access, the idea that every person on the planet should have access to basic financial services, has grown in importance in recent years. Access to financial services has been identified a key enabler for many of the Sustainable Development Goals (SDGs), agreed to at the United Nations in 2015 to end poverty, protect the planet and ensure prosperity for all over the next 15 years.²³² Beyond helping eliminate extreme poverty, expanding access to these services makes a critical contribution to reducing hunger and food security, achieving good health and well-being, fostering quality education, and promoting general equality.²³³ In particular, broader financial inclusion in LICs and FCS, as well as among women, SMEs, agribusinesses and renewable and clean energy firms, promotes economic growth that is sustainable and shared by all.

Regulatory pressure may be undermining the increase of financial inclusion. Efforts by international organizations, governments and others to combat money laundering and curb illicit financial flows are necessary for a safer and more secure financial system, both globally and within individual countries. Yet countries also aim to achieve efficient and competitive financial flows. This enables global economic growth and brings additional people into the financial system in a formal and transparent manner.²³⁴ However these two objectives can conflict, as policies intended to counter financial crimes may obstruct capital flows.²³⁵ The withdrawal of financial institutions from certain markets and segments threatens to inhibit financial flows into smaller and poorer markets and stall the significant progress made over the past several decades in expanding access to finance for the poor and bringing more people into the formal banking sector. As early as late 2015, Oxfam reported that existing banked populations are being cut off from financial services—whether directly or through the curtailment of services provided by alternative financial service providers.²³⁶ The opportunity costs of lost potential for the unbanked population heightens barriers to inclusion.²³⁷ In March 2017, the U.S. Comptroller of the Currency discussed the potential effects of de-risking: “Long standing business relationships may be disrupted. Transactions that would have taken place legally and transparently may be driven underground. Customers whose banking relationships are terminated and who cannot make alternate banking arrangements elsewhere may effectively be cut off from the regulated financial system all together.”²³⁸

In 2016, the IMF warned that, if not contained, adjustments to bank capital allocation decisions across markets and customer segments threaten to result in negative effects on financial inclusion, stability, growth and development goals.^{239,240} In July, 2016, IMF Managing Director, Christine Lagarde warned that both small and larger emerging markets are under threat of some degree of de-risking noting that such activity is “just not conducive to activity, to growth, to jobs and to legitimate business.”²⁴¹ Multiple econometric studies have identified positive correlations between GDP and bank credit, imports, exports, remittance flows and foreign direct investment.^{242,243,244,245,246,247} An IMF scenario analysis for Belize found that a loss of 70 percent of its correspondent bank capacity could, in a worst-case scenario, cause a drop in real GDP of up to 6 percentage points over the next five years, and the financial sector’s cumulative capital adequacy ratio could fall by up to 9 percentage points, driven by related limitations of cash flow that support the economy and thus banking sector assets.²⁴⁸ The same IMF scenario noted the importance of banks in the mobilization of savings and the capacity to extend credit to the economy.²⁴⁹ The IMF specified that the reduction in CBRs can ultimately affect bank capital and their lending capacity. The reduction leads to higher transaction costs, reduced sales volume

from correspondent-related services and incremental increases in loan portfolio risk.²⁵⁰ Reduced lending capacity would ultimately decrease an economy's growth-supporting aggregate credit. As local businesses lose access to financial products that enable cross-border flows, they may opt to bypass the formal financial system,²⁵¹ reducing transparency, raising transaction risks for their customers²⁵² and potentially contributing to destabilization.²⁵³ From a national security perspective, regulatory policies may be self-defeating to the extent that they reduce the transparency of financial flows and undercut efforts to bolster system stability and remove threats to economic growth.²⁵⁴

SECTION 6. SOLUTIONS AND RECOMMENDATIONS

This IFC Research Paper concludes with a discussion of specific solutions and recommendations for addressing the de-risking of emerging market financial institutions and related compliance challenges. All country types covered in this survey are experiencing de-risking and/or related external challenges in some way. Banks from each country grouping has experienced and/or expects a decline in CBRs, and is facing other, sometimes related, external challenges. This hampers the development of countries' financial systems and limits their ability to achieve their potential. This paper articulates a combined set of recommendations for participants in the de-risking challenge, including correspondent banks, emerging market respondents, their real-sector customers, regulators, DFIs and the broader international community. It unites potential solutions previously identified by other multiple institutions with solutions identified through IFC's 2017 Survey on Correspondent Banking in Emerging Markets. In general, successful execution of regulatory improvement, particularly in the AML/CFT space, ultimately contributes to financial sector and economic stability. The solutions identified herein, however, may also help manage some of the potentially detrimental, consequences of compliance regulations on cross-border banking. These recommendations may also support the continued advancement of global development objectives for increasing financial inclusion, particularly by ensuring that emerging market banks and their customers maintain access to financial services. They may also help strengthen financial stability, since emerging market financial institutions, and thus the countries they support, may be more likely to retain or improve links to global finance and trade. In some cases, the solutions may simultaneously contribute to advancing development goals and support tangible improvements in the collective community's capacity to identify and address suspicious transactions.

A. Solutions Raised to Date

Since 2014, the G-20 has monitored de-risking and has tasked several global organizations with assessing the issue. Multiple institutions, including at least 16 multilateral bodies,⁸ support the clarification and consideration of broad guidance on compliance, application of said guidance by individual regulators, and the implications for participants in the formal financial system.²⁵⁵ In the absence of systematic, comprehensive data, many of these bodies have attempted to quantify de-risking from multiple, often complimentary, perspectives. They have contributed to the evidence gathering effort, typically via surveys of national regulators and financial institutions. Many national regulators are continuing to evolve their application of the risk-based approach, clarifying and further developing their national AML/CFT strategies in conformity with international standards.

Last year, the G-20 asked the FSB to initiate a response to address some of the potentially detrimental effects of de-risking on financial inclusion. The FSB created a four-point work stream that includes further examination of the issue, clarification of regulatory expectations, capacity building in jurisdictions where respondent banks are affected, and strengthening of tools for correspondent banks to perform KYC due diligence checks. The FATF also recently provided additional guidance on correspondent banking services, among other topics, and it plans to provide guidance on best practices for customer due diligence ("CDD") to facilitate financial inclusion

⁸ The G-20, WTO, World Bank, IMF, IFC, FSB, Basel Committee on Banking Supervision, ACAMS, CPMI, PMPG, FATF, Wolfsberg Group, Basel Institute on Governance, BAFT, BBA, ICC, and IIF, among others.

and a guidance paper on the better facilitation of information sharing for the purposes tackling financial crime and improving risk management.^{256,257}

The World Bank, IMF and IFC are among the DFIs actively engaging to build the capacity of and further support emerging market and locally-based financial institutions in responding to de-risking. The G-20 has called on its member states, as well as the World Bank and the IMF, to intensify support for domestic capacity building.²⁵⁸ The World Bank has executed a CBR survey²⁵⁹ and next plans to assess the effects of de-risking on real-sector banking customers. It is also leveraging its multi-stakeholder convening capacity to bring together financial sector participants, standard-setting bodies, and regulators to address the effects of de-risking on access to finance on more vulnerable parts of the financial system. The IMF has evaluated other market forces that affect de-risking; it has made several recommendations, including to clarify, strengthen and align regulatory and supervisory frameworks; provided assessments of the relative impact of recommended responses; and has indicated which responses would be most appropriate across multiple scenarios. It also facilitates effective dialogue among multiple stakeholders to achieve practical responses; works extensively with member countries to strengthen legal, regulatory and supervisory frameworks; and identifies best practices in national policy responses. It continues to surveil economies for effects of CBR terminations, engaging quickly when material macroeconomic challenges appear imminent.²⁶⁰ A joint report issued in April 2017 by the World Bank, IMF and WTO proposed a set of policies to promote trade openness to continue to encourage higher productivity, greater competition and lower prices to benefit in particular lower-income households.²⁶¹ IFC supports the availability of trade finance in emerging markets by enhancing existing emerging market trade finance channels and investing directly. Using the results of this survey, IFC will continue to work with its partners to assist them in addressing the implications of regulatory changes and cross-border de-risking.

There remains a need to balance the prevention of access to financial services by illicit actors with the expansion of access to finance to companies, small businesses, households and individuals. It is widely recognized that a global effort to fight money laundering and terrorist financing could ultimately contribute to both better financial stability and a safer world, and potentially support, if not expedite, many countries' development trajectories. However, the variance and ambiguity of regulatory expectations and applications can drive compliance costs to levels that make legacy compliance approaches infeasible and can reduce, if not reverse progress with financial inclusion. An effective effort to address this will focus on clarifying and making consistent regulatory requirements across jurisdictions, as well as exploring and applying emerging technologies to improve efficiency and enhance risk assessments. Four main recommendations by CPMI are intended to strengthen due diligence tools for banks: wider use of KYC utilities, legal entity identifiers (LEI), information sharing across institutions, and standardization of payment message formats.²⁶²

Further clarity regarding regulation application is needed. While regulatory authorities note the importance of a risk-based approach to AML/KYC, it is important that a clear set of policies, procedures, and standards are developed and enforced through an aligned agreement among banking regulatory bodies—multilateral, national and subnational. Collaboration could include standardized due diligence processes to assess risk for a particular customer or by actors along the payment process, including the trade finance supply chain, remittance flows and others. Risk assessment criteria could include the establishment of identification and verification requirements for customers and businesses that track their use of funds. Several steps in this direction have already been taken. FATF recently issued clarifications on how correspondent banks are expected to apply a risk-based approach, and the Basel Committee recently produced a draft revised annex for correspondent banking to the BCBS guidelines on the sound management of risks related to money laundering and financing terrorism. In addition, efforts are underway with EU supervisory institutions and other bodies to

further strengthen, harmonize and clarify expectations regarding AML/CFT. Efforts towards this have been initiated by international standard setters and some national regulatory authorities, for example, the U.S. Treasury and the Office of Comptroller of Currency's efforts to articulate the U.S. regulatory approach of following a graduated spectrum of supervisory involvement and enforcement.²⁶³ However, industry groups, including the IIF and BAFT, have indicated that under the Basel draft guidance, there are still areas that remain opaque (for example, in addressing the need for KYCC) or which apply a one-size-fits-all approach (such as grouping certain types of CBRs into a single risk category).²⁶⁴ Furthermore, while some institutions highlight the difference between regulatory clarity versus certainty (which is likely not feasible), emerging market bank survey responses suggest that there are still significant challenges with clarity on expectations from multiple fronts. Thus clear guidance that facilitates and communicates regulatory clarity and transparency for regulatory applications and their interpretation should continue and be expanded.

Many stakeholders recognize that harnessing emerging technology can enhance financial institutions' risk management capabilities. The emergence of new financial and regulatory technologies (*fintech* and *regtech*) from the private sector has significant potential to contribute to a reduction in compliance costs and an increase in risk assessment precision.²⁶⁵ There is a shift toward a customer-centric infrastructure that takes advantage of multiple disruptive technologies in the areas of enhanced identity verification. This includes biometric technology and LEIs); transparency (for example, Distributed Ledger Technology (DLT) such as blockchain); interoperability (open-sourced, real-time global payment systems); and the use of big data, driven by progress with artificial intelligence for enhanced security, among others. Biometrics contribute to remote and/or more highly accurate identification of individuals, supporting requirements for financial institutions to gather customer information and assess their potential for, among other behaviors, money laundering.²⁶⁶ As DLT requires that any change to relevant data includes notification and verification by relevant parties, providing notification/verification requests immediately upon the attempted updates, it provides better transaction security and faster and more complete information sharing among secured stakeholders across a financial transaction, customer or ecosystem.²⁶⁷ These innovations are also facilitating technologies for joint KYC utilities, potentially reducing KYC costs and improving due diligence for CFT/AML efforts. Multiple achievements in technology have contributed to improved capacity for transmitting, storing and analyzing larger or less organized sets of sometimes incomplete or otherwise noisy data in a more intelligent way.²⁶⁸ There is great potential in the KYC field for the deployment of more advanced analytics and automatic learning capability (such as artificial intelligence), which can provide more information and a clearer signal. Successful systemic applications of this technology could help financial institutions and countries know more about activities in their market faster, and potentially for less cost. Several of the largest global banks are independently experimenting with multiple fintech innovations, each of which might help resolve AML/CFT issues.²⁶⁹ Multilateral and national regulatory understanding of and engagement with advanced technology is also important.

Central banks have proposed a number of specific changes to global payments systems to improve safety and lower barriers.²⁷⁰ Working together under the auspices of CPMI, the representatives of central banks of two dozen countries have leveraged their expertise on payment system issues to put forth the following four main recommendations:

- 1. Standards or sound practices for KYC registries:** KYC registries are facilities managed by third-party platforms and intended to streamline the way data is collected and exchanged between banks and their customers. Because emerging market respondents are required to share extensive information with each of their correspondents, a shared depository of KYC data could help lower assessment costs for correspondents and respondents alike. However, multiple banks indicate that issues around data

privacy, confidentiality and currency—as well as the fact that banks are still liable when registry data is inaccurate—inhibit financial sector participation, which ultimately hinders the AML/CFT effort.²⁷¹ Setting global standards or sound practices regarding, for example, KYC data collection processes, cross-border privacy issues, intercountry differences in legal status, and the format and content of bank documents, could promote wider use of these utilities. Greater clarity around potential liabilities in cases in which violations may occur as a result of faulty or outdated details in a KYC registry may also lead banks to have greater comfort in using registry data in their internal risk assessments. The tension between facilitating more efficient data sharing and accountability remains, and continued efforts to optimize this balance will contribute to efforts to prevent and/or address de-risking going forward.

- 2. Standards for unique institution identifiers:** Proper identification of respondents and their customers in a transaction is essential for correspondent banks to manage risk and ensure regulatory requirements are properly applied. The application of an efficient global standard to identify specific legal entities, such as LEIs (for which there is already an International Organization for Standardization (ISO) standard), and the use of such an identifier in payment messages could further assist correspondents and respondents in reducing compliance costs by facilitating KYC screening through simple and unambiguous identification of transaction parties. Though LEIs were not intended for payments, use of an identifier in correspondent banking is likely to facilitate information sharing and data collection in KYC registries.
- 3. Improvements in information sharing:** Under certain circumstances (for example, transactions occurring in high-risk jurisdictions), correspondents may need to monitor the parties of specific transactions to complete thorough CDD. However, data privacy laws may limit cross-jurisdictional information sharing between correspondents and respondents. If they are unable to collect specific transaction details and information on customers, correspondents may have no alternative but to reject all transactions of uncertain origin. If this issue applies to many or all transactions or customers for a single respondent, this could lead to CBR termination. Removing barriers to information sharing between banks through the use of centralized databases could reduce de-risking for these reasons. Recent recommendations from the IIF resulting from a survey providing information on information sharing across 92 countries include ensuring: (i.) that national secrecy/privacy laws do not inhibit the exchange of relevant information across borders, intra- and inter-entity or between enterprises and governments for the purpose of managing financial crime risk; (ii.) that adequate legal protection be encouraged for banks that share information; and (iii.) that laws facilitate the inclusion of information obtained from outside parties and from multiple jurisdictions in financial institutions' suspicious activity reporting. It also called for legal, structural and/or technological approaches to enhanced public-private sector information sharing to combat money laundering, noting several country examples as advanced practices.²⁷² Multilateral groups exist, such as those that convene heads of in-country financial intelligence units, to facilitate and improve cross-jurisdictional information sharing.²⁷³
- 4. Standards for payment message formats:** A significant portion of banking activities are conducted between correspondents and respondents that do not have a direct relationship. In these cases, transaction settlements may be routed through intermediaries that have a relationship with at least one of the parties. Interbank transaction messages issued through SWIFT for this purpose have recently been adapted to carry the necessary details about the identities of all parties involved in the transaction, as well as relevant payment information, so that banks that may be one or more steps removed from the transaction are privy to these details and can use them to perform their own risk assessments. By ensuring that they are using these adapted message formats, banks can facilitate the CDD of intermediaries and ensure that all relevant information is included in payment messages.

Other solutions have been proposed to mitigate de-risking effects. Many solutions further focus on the actions of global, regional and national regulators. These include: (i.) revising data protection and privacy laws to enable relevant information sharing; (ii.) improving regulatory frameworks and standards at some national or subnational levels; (iii.) properly staffing regulatory bodies; (iv.) ensuring timely communication about implementation of, and (if necessary), clarification of regulations; (v.) guaranteeing equal implementation across market players to avoid “regulatory arbitrage” made possible by compliance variance; (vi.) delivering appropriate feedback to financial institutions regarding AML/CFT assessments; (vii.) considering limitations for incident liability for institutions which have a proven robust KYC process; and (viii.) collecting data on correspondent banking, especially in smaller markets where the impacts of CBR withdrawals are most acute.^{274,275,276} Additional solutions consider how correspondents, respondents and their customers could effectively respond. For correspondents, these include: (i.) providing ample notice and transparency in reasoning for respondents whose relationships are being terminated; (ii.) providing time for respondents to identify alternative financing challenges or to make adjustments; and (iii.) establishing relationships with parent-level financial institutions to mitigate costs of performing KYC on subsidiaries across a number of markets. For emerging market respondents, these include: (i.) reviewing and fine-tuning KYC policies and procedures and customer onboarding practices to collect necessary information; (ii.) formulating risk tiers that allow for the capture of multiple layers of complexity; and (iii.) establishing a fee structure for high-risk accounts. For respondent banks’ customers, these include: (i.) adapting internal procedures to manage AML/CFT requirements and flag questionable transactions; (ii.) understanding respondents’ and correspondents’ information needs to create standardized and consolidated documentation; and (iii.) forming national groups to strengthen their relationship with regulators and bring market challenges to light. Greater awareness of the challenges faced by specific customer segments and countries will allow the international community to move resources toward the most pressing cases and the neediest markets.

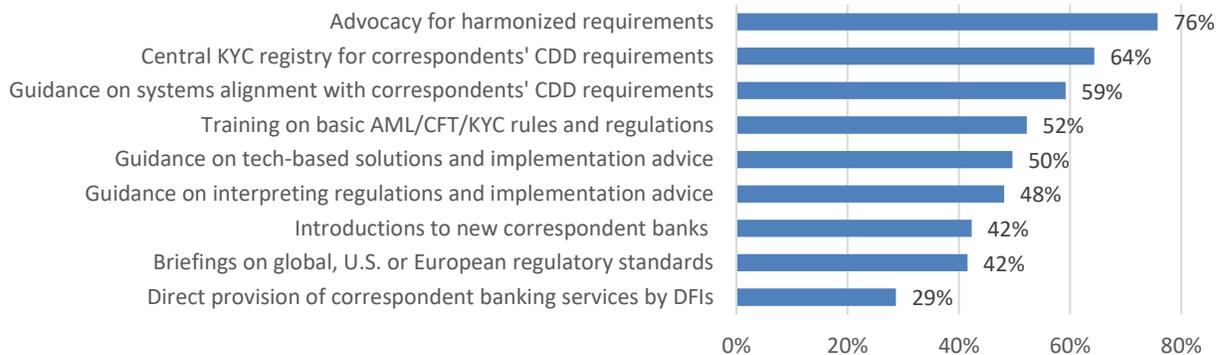
B. Solutions Raised in the IFC Survey

The results of IFC’s survey offer a new perspective on what actions to address de-risking would be most valued by private-sector emerging market financial institutions. In addition to the information discussed at length in Section 5, the IFC survey captured feedback on the potential solutions that would be of greatest value to emerging market banks. The findings from these particular queries are intended to enlighten the global dialogue by enabling the incorporation of their views into considerations while formulating a global solution.

Emerging market banks identified potential solutions, with advocacy for harmonization of regulations across jurisdictions, establishment of a centralized registry for due diligence data, and guidance on reporting to correspondents generating the strongest interest (Figure 6.1). One question in the IFC survey prompted banks to indicate whether they would value specific potential solutions to their compliance challenges or to propose their own alternatives. Over three-quarters of respondents said that advocacy for harmonizing regulatory compliance requirements across international, national and local levels would help them grow or strengthen their business. This was the most frequently requested solution for banks in every global region except South Asia, where banks expressed greatest interest in advice on fintech. Establishment of a central KYC registry for correspondents to access CDD data on respondents (64 percent) and guidance on how to align their bank’s KYC procedures and systems with correspondent banks’ requirements and best practices for compliance data reporting (59 percent) came in second and third globally. Nearly 30 percent of banks were interested in direct provision of correspondent services by DFIs. Other valuable solutions noted by more than one-quarter of respondents were training on basic AML/CFT rules and regulations (52 percent); guidance on technology-

based solutions and assistance in implementing those solutions (50 percent); guidance on interpreting international, national or local regulations and advice on how to implement their requirements (42 percent); introductions to new correspondent banks (42 percent); and briefings on global, U.S. or European regulatory standards (42 percent). Results across regions were largely consistent with the global trend, as harmonization and a centralized database were the top two responses in every region except South Asia. In that region, banks indicated greatest interest in guidance on technology-based solutions and training on basic compliance regulations.

Figure 6.1. Banks Identified Compliance-Related Solutions that Could Help Them Grow



Source: IFC 2017 Survey on Correspondent Banking in Emerging Markets.

Prioritization of potential solutions differed across country income groups. Interest in harmonization and establishment of a central registry increased with country income level. In five areas—regulatory briefings, training on basic rules and regulations, introductions to new correspondents, guidance on reporting to correspondents, and direct provision of correspondent services by DFIs—request frequency waned as country income rose. In high-income countries, interest in establishing a central KYC registry for respondent data slightly surpassed interest in harmonizing requirements (71 percent to 64 percent), but both were cited more than three times as much as any other potential solution. In upper-middle-income countries too, harmonization (53 percent) and central registry (43 percent) were far and away the most popular, with new correspondent introductions coming in third (30 percent) and no other solution exceeding one-quarter of respondents. Meanwhile, in LICs, there was a wider distribution across all potential solutions: interest in nine of 10 exceeded 25 percent, with guidance on reporting to correspondents most often requested (36 percent). These divergences reflect a need for tailored responses across emerging markets; they also support the view that poorer countries are in greater need of guidance, training and advice to manage de-risking challenges, as well as help in reconnecting to the global correspondent network through new correspondent introductions and potentially direct support from DFIs.

Globally, the solutions proposed by emerging market banks are similar to what IFC found in a 2014 study. IFC undertook a survey of members of its GTFP network in April 2014 (which surveyed both emerging market respondent banks and global correspondent banks) in an attempt to assess emerging market banks' access to CBRs and the costs of maintaining those relationships. In a poll of 333 global and emerging market correspondent and respondent banks across 107 countries using IFC's emerging market trade facilitation program to support customers, survey participants were asked to identify initiatives that could help them manage rising compliance costs. The three most common proposals were: (1) developing a central registry of respondents' data to facilitate due diligence; (2) harmonizing regulatory requirements across jurisdictions; and

(3) providing guidance on how to meet regulatory requirements.²⁷⁷ Given that these solutions continue to be of greatest interest to emerging market financial institutions, the international community could most effectively address CBR de-risking by incorporating these areas, as well as other barriers and challenges these banks discussed in the 2017 survey.

C. Recommendations

A carefully organized, focused response will be necessary to address de-risking challenges effectively. The international community recognizes the importance of balancing the prevention of access to financial services by illicit actors with the expansion of access to finance to companies, small businesses, households and individuals. Different contributors to the global solution will have different expertise to contribute while addressing the challenges; the identification of each institution's role and responsibilities will be integral to ensuring the efficiency of this international effort. This section offers a full set of broad action groupings for each stakeholder to consider.

There are a number of actions that the international community can undertake to respond to emerging market banks' de-risking challenges. We have grouped this paper's proposals into two levels based on this paper's analysis of survey findings in Section 5, prior research efforts by multiple stakeholders, and emerging market bank input regarding solutions, challenges and barriers. The first level of recommendations involves working directly with emerging market banks to respond to de-risking drivers. The second level is intended to support broader financial sector development in emerging markets which, in the long term, should improve fundamental financial sector risk and support increased economic stability, growth and capital in these countries. This section offers a broad range of proposals for how multilaterals, regulators and banks could respond, and we acknowledge that each recommendation has different levels of feasibility between and among organizations given specific expertise, budget limitations, internal risk thresholds and other factors.

Level 1. Managing Compliance Risk and Costs

The following actions are intended to assist emerging market banks in managing compliance risk and costs, reducing compliance complexity, increasing knowledge in the compliance space, shoring up access to correspondent banking, and leveraging relationship-building opportunities to ease or reverse the negative effects of CBR withdrawals. The recommendations below are intended to present a full set of potentially helpful actions that could apply to multiple stakeholders in different ways or circumstances. A logical next step would be for those interested in contributing to a global de-risking solution to consider each, balancing the degree of effectiveness in the target country or region with the feasibility of implementation for their specific institution.

Regulatory:

- **Continue to work toward achieving greater harmonization of regulatory requirements.** Emerging market banks are looking to international organizations to advocate for their interests and voice their concerns before global regulatory bodies. Essential elements of the effort to effectively address continuously increasing requirements and costs and limit cross-border differences should include clarifying expectations around the risk-based compliance approach, nested accounts, KYCC, real-time monitoring and other areas where guidance to date may be ambiguous, incomplete or divergent. Continued articulation of effects on financial inclusion and economic development, even among higher risk segments, is needed. DFIs with a poverty alleviation mandate have in-depth knowledge of barriers to economic growth and stability as well as financial inclusion from market to market and are

appropriately placed to advise global regulators on the existing and potential repercussions of requirements on emerging markets and the CBRs available to banks therein. A consistently engaged voice for private-sector banks in emerging markets, as well as the clients they serve, with a development lens is also required.

- **Maintain regulatory capital requirements for short-term, low-risk lending supported by correspondent banking and reconsider liquidity ratios.** Even with typically short-term, low-risk exposures, correspondent banking products have nevertheless been caught in the net of higher capital and liquidity requirements by the Basel Committee on Banking Supervision. Proposed adjustments, including changing the basis for assessing the credit risk of bank exposures, raising credit conversion factors on off-balance sheet exposures, and clarifying the continued waiver from holding longer term capital for trade finance exposures with a maturity of less than one year, would have a significant impact on the treatment of products dependent on CBRs and ultimately emerging market banks' decisions to allocate capital to these low-margin services. At a minimum, when finalizing Basel III, maintaining the appropriate regulatory treatment provided by the earlier Basel standards for contingent instruments would sustain local banks' ability to offer trade finance and other international banking services such as LCs, which have small, loss-given-default rates and hence low probability of falling into banks' balance sheets. At the same time, updating regulatory expectations on the definition of correspondent banking deposits under the Liquidity Coverage Ratio (LCR) would allow for a more rational application of liquidity premiums applied to these deposits, thus allowing for greater bank capacity in undertaking CBR business.
- **Enhance support to emerging market regulators in developing compliance regulations and applications.** Emerging market regulators face the same challenges as many correspondent banks in interpreting multilateral regulators' requirements and expectations and determining how to best apply them to ensure compliance by the banks operating in their jurisdiction. Many efforts are already underway to support these regulators. They would benefit from international organizations' advice, as well as knowledge-sharing opportunities with their counterparts in other jurisdictions, during which they could identify best practices and potentially develop new solutions for establishing, implementing and managing compliance oversight in their markets. Knowledge exchanges would promote harmonization through the dissemination of global best practices; they would also support local regulators in adapting requirements to address evolving challenges, including those related to compliance, privacy and consumer protection as new market players in the fintech and regtech space emerge.

Capacity Building:

- **Provide more training opportunities to emerging market banks to improve understanding of international and local compliance requirements.** Many emerging market banks have had little direct exposure to and experience with U.S. and EU regulators that oversee correspondent banks and supervise all U.S dollar and euro transactions that those banks settle. To ensure their continued ability to transact business with correspondents, respondents in emerging markets would benefit from training on what the current requirements are and how to interpret rules and regulations. Awareness and understanding of AML/CFT 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. Many DFIs have advisory programs already in place that could be adapted or expanded for this purpose.
- **Provide additional funding and guidance to assist emerging market banks in adapting their KYC systems and processes, along with any additional AML/CFT reporting requirements, if any.** Emerging market banks will need to make internal adjustments – sometimes significant ones – to

accommodate new and changing expectations of regulators. Many of these institutions would benefit from advice on how to most efficiently develop and implement changes to policies and procedures, automate and enhance systems, and invest in new resources to enable effective AML/CFT management. Organizing knowledge-sharing roundtable discussions for banks would enable respondents to share experiences and identify best practices for setting up compliance units, training staff to use new systems, managing differences in and conflicts between reporting expectations across multiple jurisdictions, and making other internal adaptations to incorporate compliance requirements. As an example, IMF recently organized a round table bringing together global correspondent and respondent banks to identify actionable solutions to CBR withdrawal in the Caribbean, creating a venue for banks on both sides of the CBR to articulate challenges and exchange ideas for improving CBR prospects going forward.²⁷⁸ Furthermore, the coordination of donor funding to facilitate system and process upgrades for more efficient AML/CFT compliance could increase emerging market banking capacity while addressing the excessive cost burden associated with dedication to this initiative.

- **Provide training to emerging market banks' customers.** In addition to the challenge of properly identifying transaction parties, emerging market banks face difficulties in obtaining information from their customers. Customers are often unaware of the AML/CFT regulations to which their transactions are subjected, ill-prepared to provide relevant business and transaction details, or overwhelmed by the multiplicity and complexity of reporting requirements – making them less likely to share information with their respondents. Providing training to respondents' customers on proper compliance reporting requirements and processes would reduce the chance that respondents have to limit or eliminate their exposure to these firms, curtailing these businesses' ability to engage in cross-border transactions. DFIs are in position to address this issue through existing client networks.

Technological Innovation:

- **Support the development of central registries for respondent customer data and reconsider current liability standards for those who use it.** Emerging market banks note that they are having 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 KYC 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, facilitating the development of new CBRs. To ensure that such a registry would actually be used, regulators and international bodies would have to address two key issues: (1) clearing the way for information sharing across jurisdictions by helping countries enact data privacy and confidentiality laws that do not restrict banks from including their details to the registry; and (2) clarifying how liability will be assigned in cases of AML/CFT violations resulting from inaccurate or outdated information contained in the registry, so that correspondents only feel compelled to perform customized, more rigorous assessments to obtain more detailed respondent data when the risk warrants that action. Some central banks may have a role to play as well. While FATF has provided information regarding best practices and other communication of discussions on information sharing, and some countries have made progress, many banks continue to indicate that there remain legal impediments that sometimes prevent them from sharing information, even within their own group, that could help to identify money laundering or terrorist financing risks.
- **Support the development of national identity registries in certain countries.** According to emerging market banks' responses to the IFC survey, there are at least seven emerging markets in which local banks have difficulty identifying transaction parties because of the absence of a national identification

system or a formal convention for physical addresses. National registries that contain specific details, for all firms operating in that country, would remove the customer identification challenge faced by respondents. A specific set of information, e.g., ultimate beneficial owners (individual shareholders with what is deemed significant influence) of each firm, has been mentioned by some regulatory bodies. However, multiple countries note that obtaining these types of information presents significant challenges. With effective national registries, respondents would be able to access this registry to confirm data and proceed with onboarding customers or processing their transactions.

- **Promote focused adoption of emerging technology-based solutions where relevant and secure.** Many emerging market banks have already embarked on efforts to use fintech and regtech solutions to simplify customer identification and improve the efficiency of customer risk assessments. Survey responses indicate that many of those banks that have yet to implement newly developed technologies acknowledge their potential value. Banks are also interested to learn more about the potential benefits of these technologies' use. Improving awareness about and understanding of options would help banks identify solutions (such as LEI, blockchain, entity extraction, consolidation and enrichment, artificial intelligence and other data-based risk identification) that would be most effective for their particular circumstances. International organizations already engaged in the technology space could share their expertise and knowhow, and serve as a channel for information sharing and application advice.

Financing:

- **Provide additional capital and liquidity by investing with correspondent banks to sustain and/or expand their CBRs.** On the supply side, correspondent banks face pressure, as a result of both regulatory requirements and business dynamics, to reconsider their risks, costs and revenue potential of engaging with certain emerging market banks and in particular countries. Direct investments and DFI mobilizations of additional funding in correspondent banks, through capital injections, loans, risk-sharing facilities or other interventions, would help mitigate the capital constraints placed on correspondents and enable them to maintain or increase lending levels. This capital relief would support correspondents' continued engagement with respondents and provide opportunities for them to onboard new respondents, particularly those that have difficulty in accessing the global correspondent network or in meeting the growing demand of their customers.
- **Encourage multilateral organizations to innovate their correspondent banking-related product offerings, particularly trade finance.** Over the past 15 years, IFC, AfDB, ADB, the European Bank for Reconstruction and Development (EBRD) and the Inter-American Development Bank (IDB) have built trade facilitation programs that offer guarantees and, in some cases, short-term funding to support emerging market banks' access to cross-border trade finance. These organizations have already established relationships, performed extensive customer due diligence on, and processed thousands of transactions with large numbers of financial intermediaries. Enhancing DFI offerings so that they serve as correspondents where needed, if feasible, would be an effective way to protect emerging market trade and where risk-appropriate, sustain other international banking services.

Harnessing Network Knowledge and Collaboration:

- **Assist in the development and incorporation of strategies to maintain existing or establish new CBRs.** To help individual banks maintain existing CBRs, assistance with understanding cross-jurisdictional compliance requirements, adapting their processes and incorporating technology-based solutions would be beneficial. Beyond these, sharing best practices on how to align KYC procedures and systems with the potentially varied requirements of multiple correspondent banks, along with guidance on how to publicize actions taken to improve compliance risk management, could reduce

costs for respondents and improve their risk profile, further supporting their maintenance of CBRs. Efforts to proactively connect banks across borders and present KYC procedures may both strengthen both CBRs at risk and help build new ones. DFIs with active correspondent banking-related networks could leverage existing client connections to proactively facilitate relationship development and/or guide such presentations.

- **Facilitate central banks' interest in offering temporary support for cross-border transactions and participating in information gathering where appropriate.** In the event of a complete loss of CBRs by emerging market banks, the IMF has noted that consideration may be given to the use of public entities or centralized payment systems, including the use of central banks' platforms and CBRs. However, the design of any public vehicles requires care in assessing the legal and operational feasibility and mitigating the potential risk exposures to central banks. In addition, any proposed public intervention should be time-bound and limited, with exit strategies encouraging the re-establishment of commercial CBRs in the medium and long term. Coupled with the passage of local AML/CFT/KYC rules to ensure that respondents are in compliance with regulatory requirements that apply to the central banks' CBRs, this would help respondents continue to process cross-border transactions and provide services to their customers until long-term solutions can be identified and implemented.
- **Seek enhanced opportunities for multilateral collaboration.** As interest in de-risking solutions is high among many multilaterals, an organized, collaborative effort would detect and observe challenges, identify solutions and transform these solutions into a plan for action. This effort would seek to establish a common vision, that is, to understand what complete resolution of the problem would look like. It would identify both key milestones to achieve the common vision and each organization's specific contributions to achieving those milestones.

Level 2. Continuing to Support Financial Sector Development

Banks in emerging markets face challenges beyond compliance risk that impact correspondents' de-risking.

More generally, continued support for financial system improvement will contribute to greater financial system integrity and stable growth, further supporting economic stability and development of each country.

- **Encourage multilateral organizations to develop or augment their liquid trade loan capacity.** Challenges noted by multiple banks in the IFC survey regarding access to liquidity and foreign currency challenges can be addressed by enhancing trade finance offerings. This will provide the liquidity and foreign exchange needed to realize more of an economy's potential for trade. Some multilaterals already have some form of trade liquidity offerings; encouraging them to seek innovative ways to expand those offerings would be valuable.
- **Provide banks with guidance on operational and risk management issues.** Emerging market banks sometimes require additional information to continue to innovate, grow and respond to changes in their external environment. For example, one bank in eastern Europe reported that "insufficiently developed software tools for operations to assess large customer databases ... [limit the] analysis and creation of product offerings adjusted to the characteristics of certain micro customer segments." Many DFIs already offer extensive technical assistance programs to emerging market banks in areas not directly related to compliance, including business strategy, product development, risk management and corporate governance. Increasing access to trainings and advice for banks would help them improve efficiency and reduce costs, opening up banks to reallocate internal resources, innovate systems and processes, expand service offerings to existing customers, and pursue new customers.

- **Protect and expand banks' access to capital to boost their lending base, particularly for targeted segments.** Emerging market banks will need access to funding to support the maintenance and growth of their lending portfolio if they are to continue supporting their countries' economic growth and stability, including the growth of firms in critical economic sectors. Coupled with the guidance mentioned above, direct financial support from DFIs would help make firms more attractive to potential local and foreign investors, drawing capital into the financial sector and bolstering the capital base of local banks. Beyond the equity that investors could provide, survey participants noted supplier finance, commodity finance, risk-sharing facilities, derivatives (particularly currency hedging instruments), and general medium and long-term financing would help them respond to market demand and, in some cases, help local banks more effectively manage risk.
- **Support the deepening of financial capital markets.** The development of capital markets is necessary for emerging market real and financial sectors to raise long-term funds using a domestic market for securities, both through debt and equity, as well as to hedge against risk. As one South Asian bank reported: "As our bank continues to grow, successful capital raising will be the cornerstone to growth." The expansion of "capital release" products (for instance, price risk management) to banks would help them manage and overcome increasing capital requirements from regulators and allow them to take on credit exposure for a wider range of customers, including smaller firms with high-risk weightings that might otherwise be unviable investments. Deep, efficient local capital markets increase the amount of capital available for domestic investment; create access to long-term, local-currency finance; protect economies from capital-flow volatility; and constitute the foundation for a thriving private sector. Much expertise in financial market development already lies within international organizations, including the World Bank Group and the IMF.
- **Support the development of financial infrastructure.** Well-functioning financial infrastructure is integral to the development of effective financial markets.^{279,280,281} Regulators would benefit from support and advice from international organizations on building and enhancing financial infrastructure, including credit bureaus, collateral registries and related institutions and policies, that would enable financial intermediaries to increase access to information, increase the efficiency of capital allocation, improve the management of risk and innovate. For emerging market banks, financial infrastructure improvements would make it less costly to identify and vet potential customers; harness details about investment opportunities to move capital toward its most productive uses in the economy; facilitate the onboarding of new customers and the diversification of credit risk; and open the door to more sophisticated financial products, including agricultural insurance and rural finance, which were specifically mentioned by survey participants.
- **Encourage responsible mastery and incorporation of fintech/regtech solutions.** The advent of fintech and regtech in many emerging markets is offering new opportunities for regulators and local financial institutions to apply innovative solutions to adapt to a changing global risk environment. Firms innovating in this space are helping to bring new, previously unbanked customers into the financial system. Providing financial and advisory support to the safe, relevant launch and expansion of these technologies in emerging markets would expedite their uptake, and advice with financial system partnerships would help to address specific business and compliance management needs.

APPENDIX A. FULL TEXT OF IFC 2017 SURVEY ON CORRESPONDENT BANKING IN EMERGING MARKETS

Serving Your Customers

1) During 2016, which of the following reasons, if any, decreased your bank's ability to serve its customers? (Please check all that apply.)

- Requirements associated with AML/CFT/KYC as imposed by your national/local regulators
- Requirements associated with AML/CFT/KYC as required by your cross-border correspondent banks
- Increased costs associated with AML/CFT/KYC compliance
- Reduced number of your active correspondent bank relationships
- Reduced line limits among your active correspondent bank relationships
- Limited alternatives to your existing correspondent relationships
- Increased capital reserves required under international or local regulatory regimes
- Foreign exchange availability in your local market
- Geopolitical or macroeconomic risk in your country
- Increased customer credit risk
- Market competition/pricing
- Other - Please explain: _____
- My bank's ability to serve our customers has not decreased. It has increased or stayed the same. Please explain: _____

2) During 2016, did your bank reduce the number of clients served?

- Yes No

If yes, which segments?

- Retail customers
- SMEs
- Corporate customers
- Importers/exporters
- Other - Please list: _____

3) During 2016, in what other ways did your bank adapt its business? (Please check all that apply.)

Reduced geographic coverage (within country or region)

Reduced cross-border coverage to other countries/markets

Reduced the number of product offerings

If so, which products? Please list: _____

Reduced credit line limits or dollar volume of lending to certain clients

Increased interest rates, prices, fees or other charges to certain clients

Other – Please explain: _____

My bank has grown. Please explain how: _____

Correspondent Banking Customers

4) To how many customers did you provide international banking services (supported by correspondent banking) in 2016? _____

How many of these customers were small and medium enterprises (SMEs)? _____

5) How has your customers' demand for international banking services (supported by correspondent banking) changed since 2015?

Increased - Please note any reasons: _____

Stayed the same

Decreased

6) How has your capacity to meet your customers' requests for international banking services (supported by correspondent banking) changed since 2015?

Increased - Why? _____

Stayed the same

Decreased - Why? _____

Your Bank's International Correspondent Banking Relationships

7) In 2016, how many active correspondent banking relationships did your bank have?

8) How have your bank's active correspondent banking relationships changed since 2015?

Increased

Stayed the same

Decreased

9) How do you expect your bank's active correspondent banking relationships to change in 2017?

Will increase

Will stay the same

Will decrease

Impact of AML/CFT/KYC Compliance Requirements

10) Approximately how much did your bank spend on international AML/CFT/KYC compliance implementation in 2016, if available? _____

11) By how much do you expect your bank's compliance-related expenditures to change in 2017?

- Will increase 100% or more
- Will increase 50%-99%
- Will increase 25%-49%
- Will increase 10%-24%
- Will increase less than 10%
- Will stay the same
- Will decrease

12) What are the most challenging aspects of your bank's AML/CFT/KYC compliance efforts?
Please list: _____

Solutions

13) What solutions could help your bank grow or strengthen its business?

	Select the solutions your bank would find most valuable (up to three).	Select any other solutions that could be useful for your bank.
a. Central database registry for due diligence data requirements, to be accessed by correspondent banks with your permission	<input type="checkbox"/>	<input type="checkbox"/>
b. Harmonization of regulatory compliance requirements across international, national and local levels	<input type="checkbox"/>	<input type="checkbox"/>
c. Briefings on global, U.S. or European regulatory standards	<input type="checkbox"/>	<input type="checkbox"/>
d. Advocacy with multilateral regulatory bodies	<input type="checkbox"/>	<input type="checkbox"/>
e. Training on basic AML/CFT/KYC rules and regulations	<input type="checkbox"/>	<input type="checkbox"/>
f. Guidance on interpreting international, national or local regulations, and advice on how to implement their requirements	<input type="checkbox"/>	<input type="checkbox"/>
g. Guidance on technology-based solutions, and assistance in implementing those solutions (such as biometric or legal entity identifiers; blockchain; entity extraction, consolidation and enrichment; or other data-based risk identification)	<input type="checkbox"/>	<input type="checkbox"/>
h. Introductions to new correspondent banks	<input type="checkbox"/>	<input type="checkbox"/>
i. Guidance on how to align your bank's AML/CFT/KYC procedures and systems with correspondent banks' requirements, and best practices for compliance data reporting	<input type="checkbox"/>	<input type="checkbox"/>
j. Direct provision of correspondent banking services by DFIs on commercial terms	<input type="checkbox"/>	<input type="checkbox"/>
k. Other – Please explain: _____		

A Broader Perspective

14) Considering the importance of financial institutions to a country's stability and economic development, how would you describe your bank's role? Are there any initiatives from 2016 that you would like to highlight? _____

15) How has working with IFC helped your bank? _____

16) What are the biggest barriers to growth for your bank? _____

17) How can IFC help your bank grow, increase its resilience, or continue to serve your customers in today's environment? Specify any market segments, products, internal operations/processes or other areas where you would consider seeking IFC's support. _____

APPENDIX B. SURVEY PARTICIPANTS BY REGION

IFC's 2017 Correspondent Banking in Emerging Markets Survey received responses from banks in 92 countries. The number of survey participants per country ranged from one to twelve.

Figure B.1. Participants by Region

Region	No. Participants	% Total
East Asia and Pacific (EAP)	26	8%
Europe and Central Asia (ECA)	55	18%
Latin America and the Caribbean (LAC)	81	26%
Middle East and North Africa (MENA)	36	12%
South Asia (SA)	27	9%
Sub-Saharan Africa (SSA)	81	26%
Total	306	100%

Figure B.2. Countries Represented in Each Region

Country	Region
Afghanistan	MENA
Albania	ECA
Algeria	MENA
Angola	SSA
Argentina	LAC
Armenia	ECA
Azerbaijan	ECA
Bangladesh	SA
Belarus	ECA
Benin	SSA
Bhutan	SA
Bolivia	LAC
Brazil	LAC
Bulgaria	ECA
Burkina Faso	SSA
Burundi	SSA
Cambodia	EAP
Cameroon	SSA
Central African Republic	SSA
Chad	SSA
Chile	LAC

Country	Region
China	EAP
Colombia	LAC
Congo, Democratic Republic of	SSA
Congo, Republic of	SSA
Costa Rica	LAC
Cote D'Ivoire	SSA
Dominican Republic	LAC
Ecuador	LAC
Egypt, Arab Republic of	MENA
El Salvador	LAC
Gambia, The	SSA
Georgia	ECA
Ghana	SSA
Greece	ECA
Guatemala	LAC
Guinea	SSA
Haiti	LAC
Honduras	LAC
Hungary	ECA
India	SA
Indonesia	EAP
Iraq	MENA
Jordan	MENA
Kenya	SSA
Kosovo	ECA
Kyrgyz Republic	ECA
Lao People's Democratic Republic	EAP
Lebanon	MENA
Liberia	SSA
Macedonia, Former Yugoslav Republic of	ECA
Madagascar	SSA
Malawi	SSA
Mali	SSA
Malta	MENA
Mexico	LAC
Moldova	ECA
Mongolia	EAP
Morocco	MENA

Country	Region
Mozambique	SSA
Myanmar	EAP
Namibia	SSA
Nepal	SA
Nicaragua	LAC
Nigeria	SSA
Oman	MENA
Pakistan	MENA
Panama	LAC
Papua New Guinea	EAP
Paraguay	LAC
Peru	LAC
Philippines	EAP
Romania	ECA
Russian Federation	ECA
Rwanda	SSA
Sao Tome and Principe	SSA
Saudi Arabia	MENA
Serbia	ECA
Sierra Leone	SSA
South Africa	SSA
Sri Lanka	SA
Tajikistan	ECA
Tanzania, United Republic of	SSA
Togo	SSA
Turkey	ECA
Uganda	SSA
Ukraine	ECA
Uzbekistan	ECA
Vanuatu	EAP
Vietnam	EAP
West Bank and Gaza	MENA
Zambia	SSA

APPENDIX C. RESPONSES BY QUESTION AND COUNTRY/INSTITUTIONAL SEGMENT

Figure C.1. During 2016, did you have decreased ability to serve your customers for any reasons?

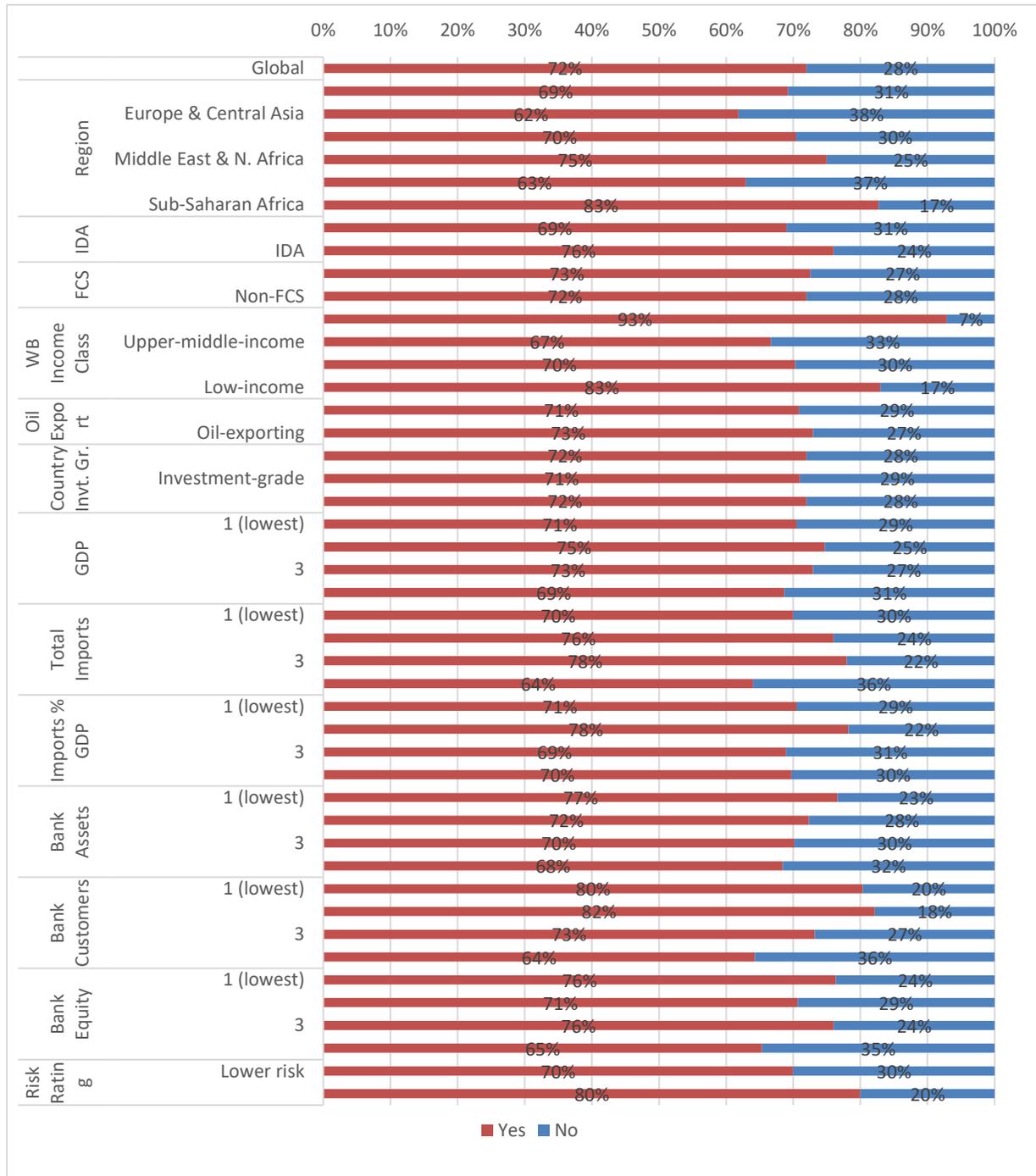


Figure C.2. During 2016, did your bank adapt its business?

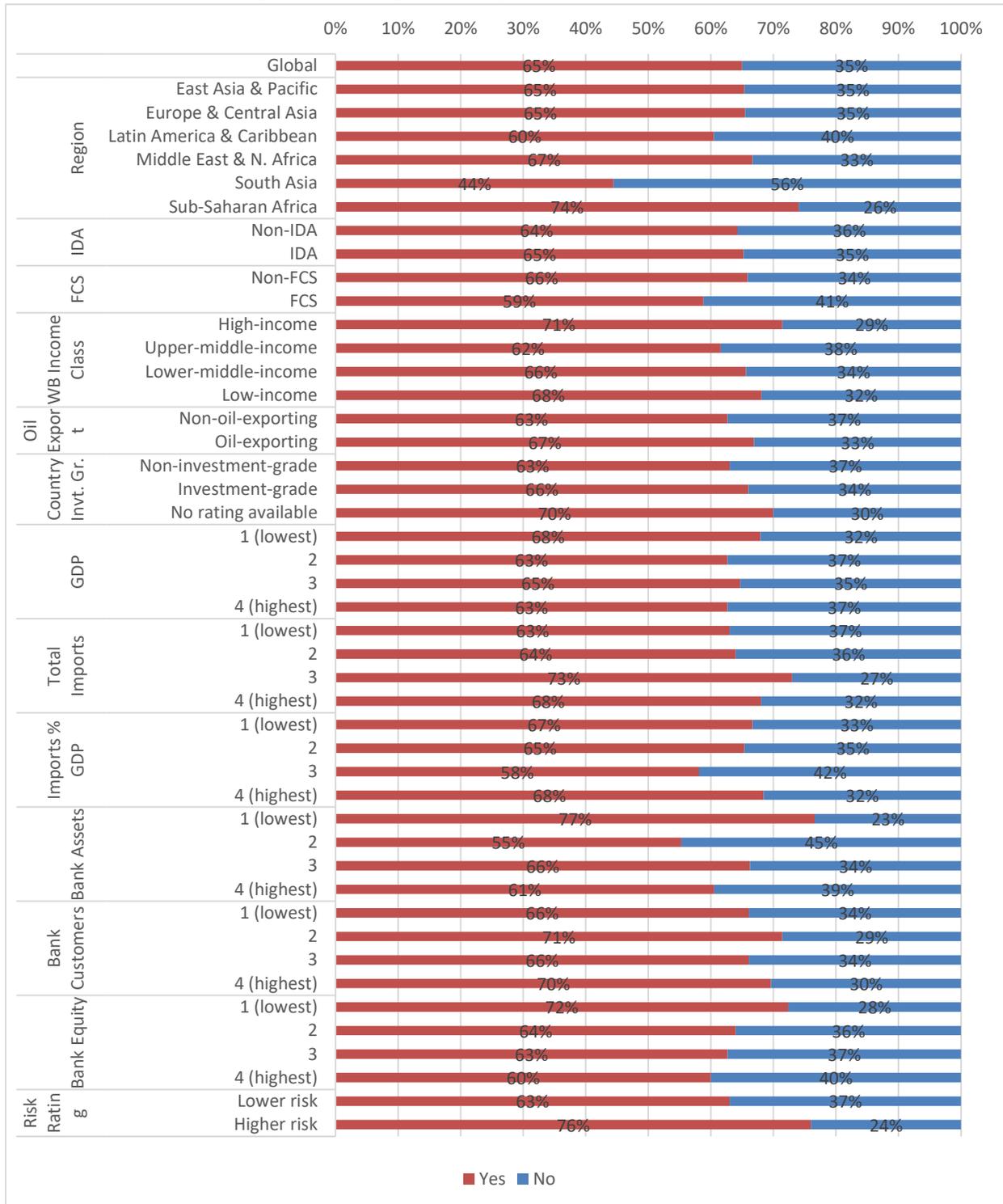


Figure C.3. How has your customers' demand for international banking services (supported by correspondent banking) changed since 2015?

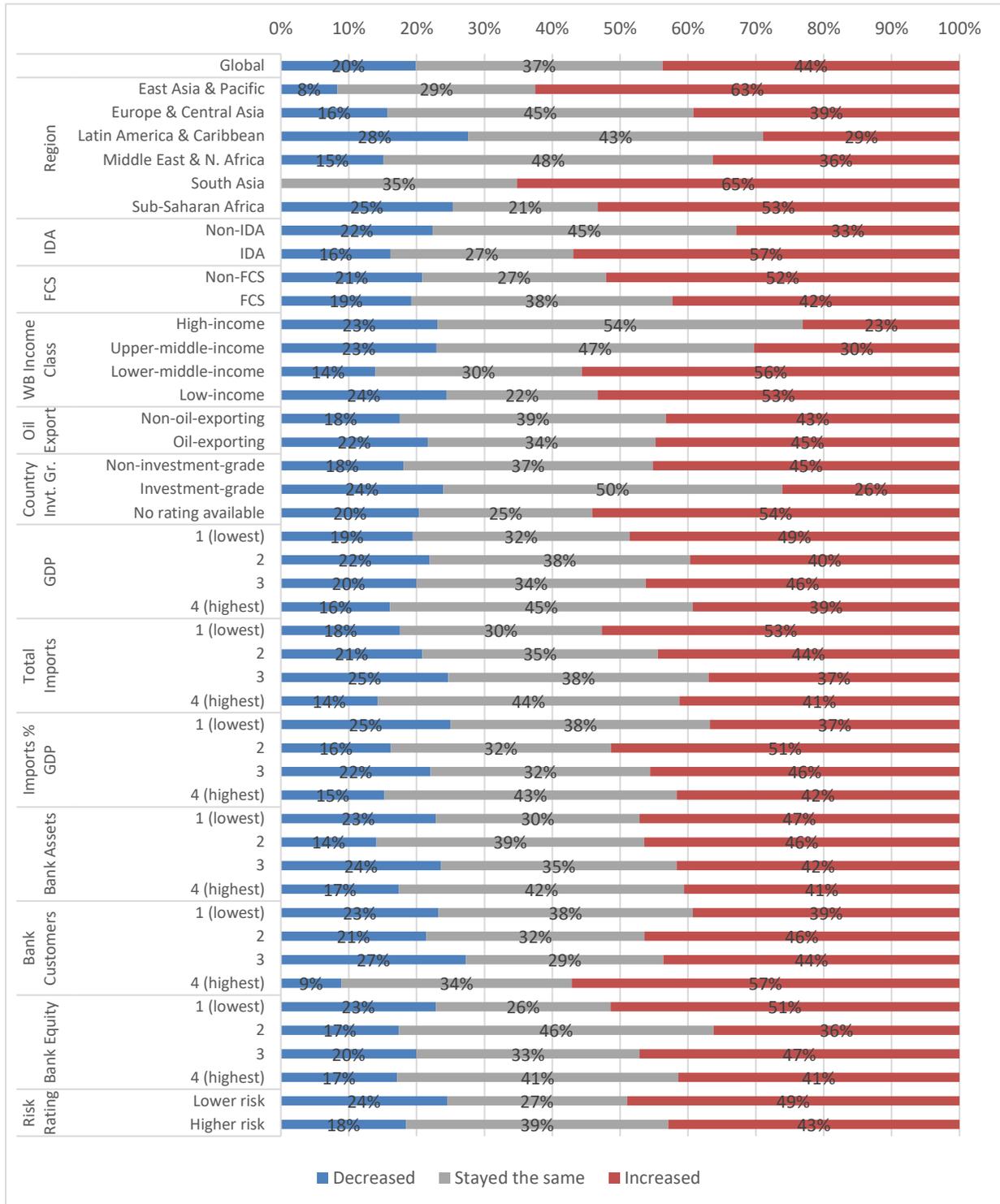


Figure C.4. How has your capacity to meet your customers' requests for international banking services (supported by correspondent banking) changed since 2015?

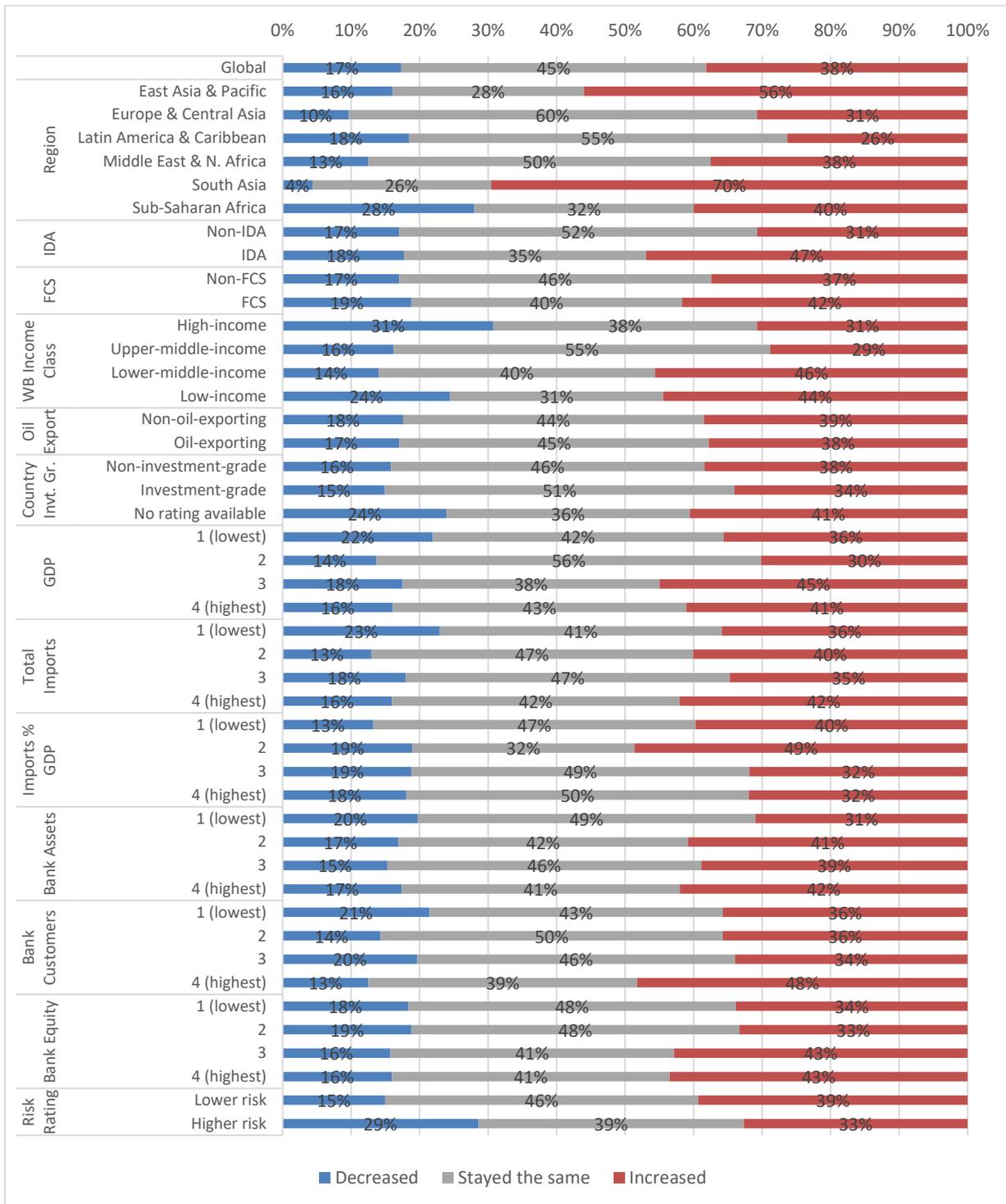


Figure C.5. How have your bank’s active correspondent banking relationships changed since 2015?

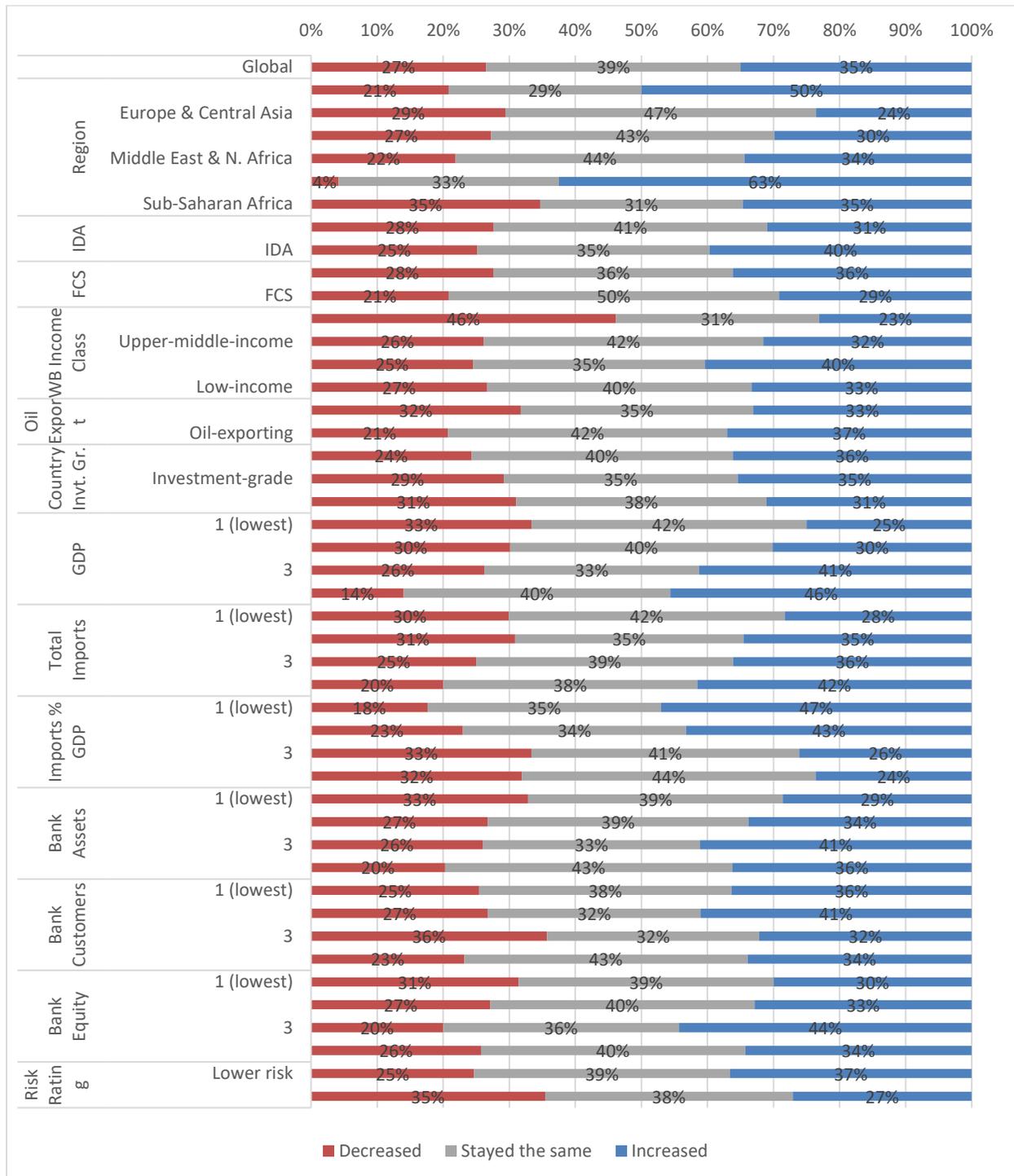


Figure C.6. do you expect your bank's active correspondent banking relationships to change in 2017?

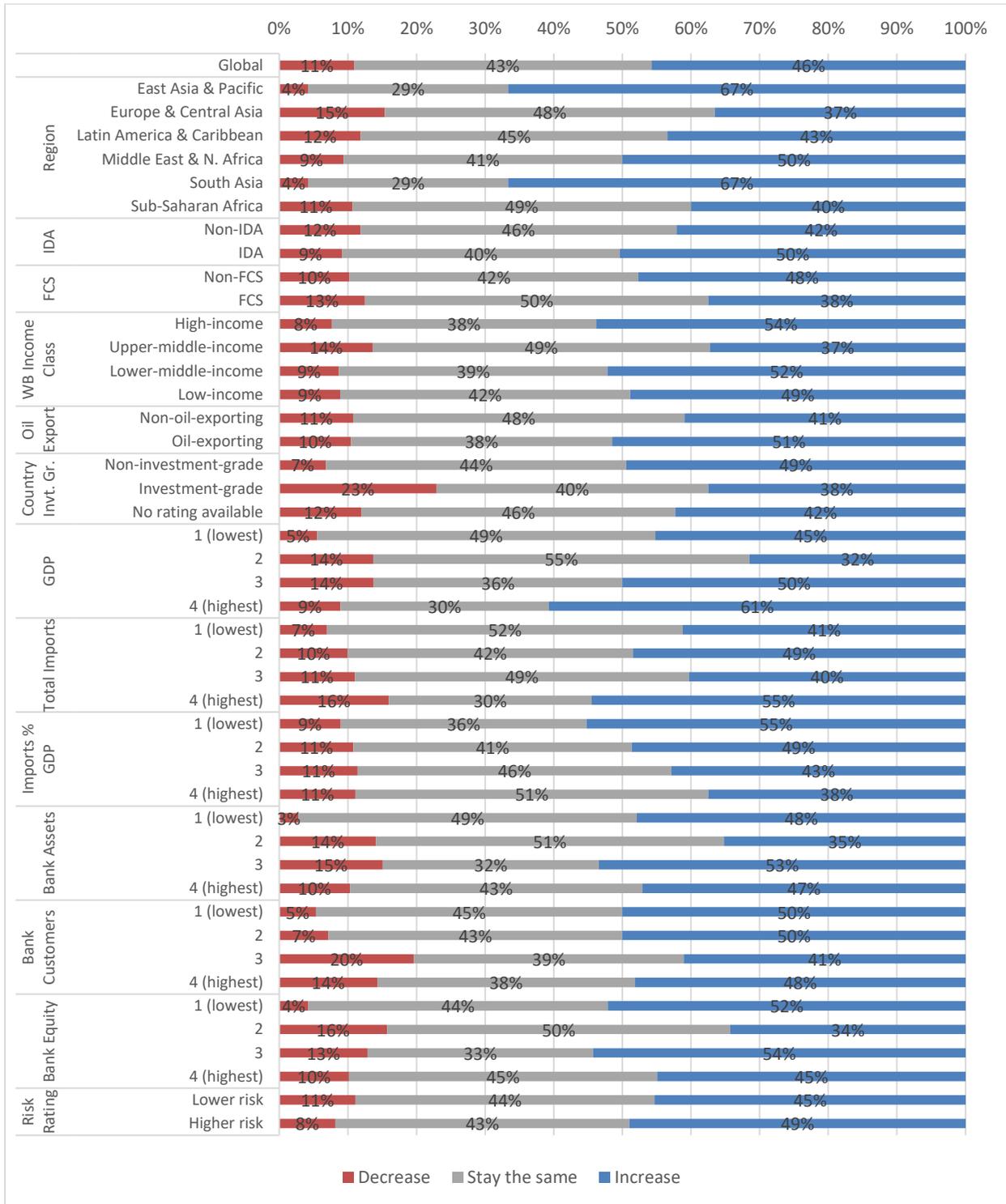


Figure C.7. How do you expect your bank’s compliance-related expenditures to change in 2017?

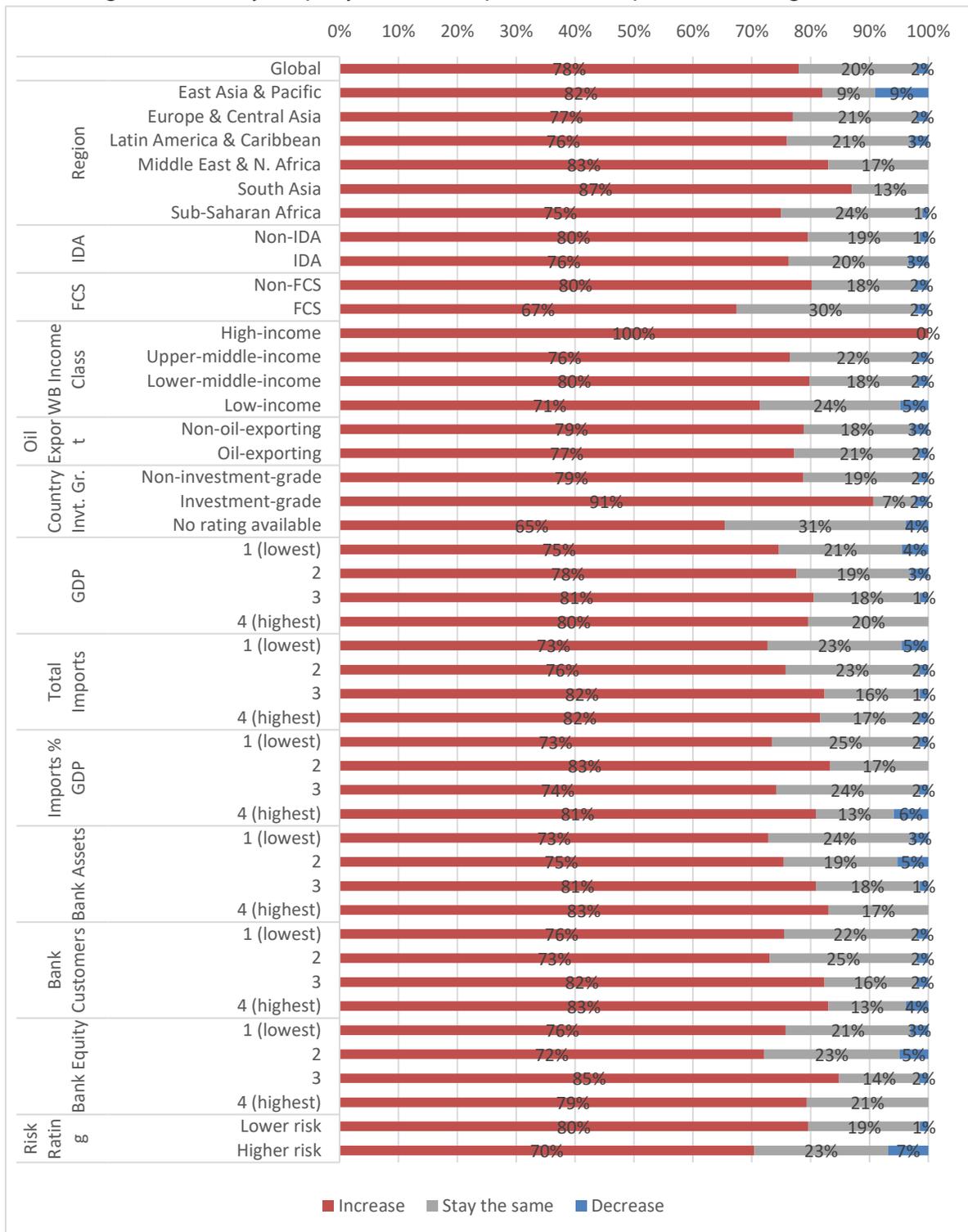


Figure C.8. Are there any challenging aspects of your bank's AML/CFT/KYC compliance efforts?

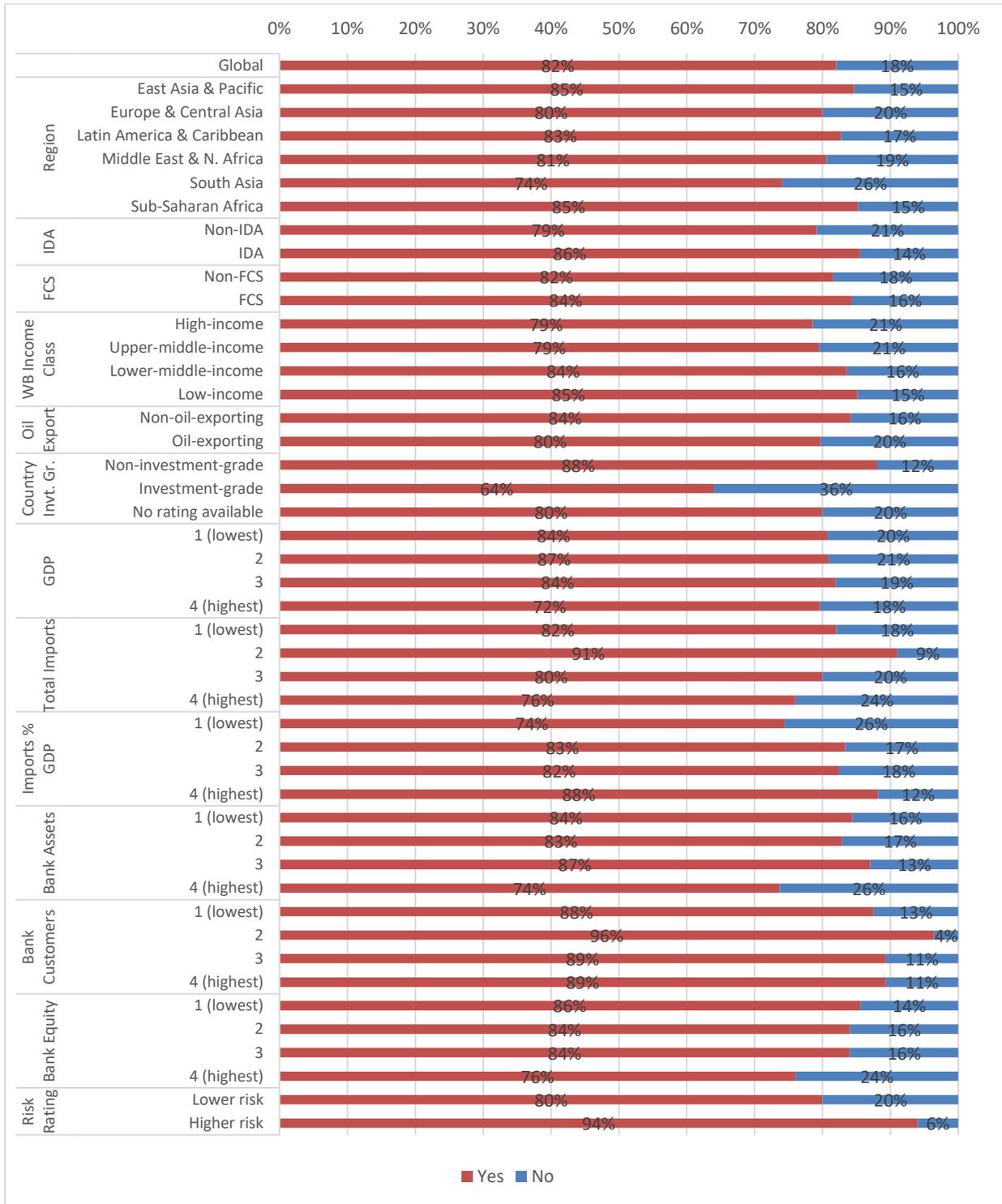
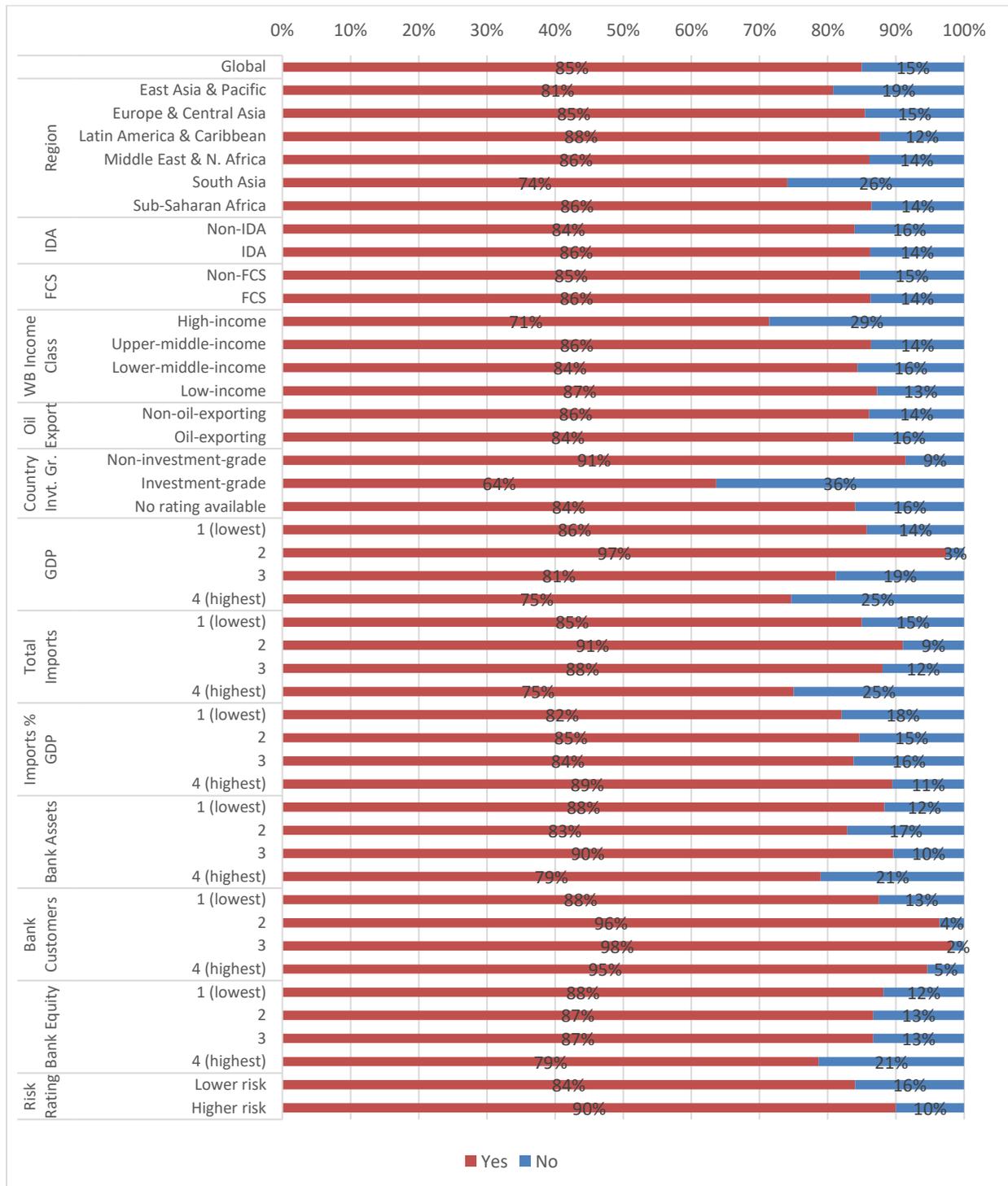


Figure C.9. Are regulatory challenges and/or costs one of the biggest barriers to growth for your bank?



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"The expert working Group advising advising the FATF on the risk-based approach and FATF Recommendations in 2010 said:

'As a basic principle, financial institutions and DNFBPs (Designated Non-Financial Businesses and Professions) should be required to take steps to identify and assess their money laundering/financing threat risks for customers, countries or geographic areas, and products/services/transactions/delivery channels. Additionally, they should have policies, controls and procedures in place to effectively manage and mitigate their risks, which should be approved by senior management and be consistent with national requirements and guidance.'

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