Developments in Correspondent Banking in the South Pacific

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Abstract

This article examines the withdrawal of global financial institutions from providing correspondent banking services to the South Pacific region and the implications for remittances. Disruptions to the flow of remittances, an important source of income to many low-income island nations, could limit local consumption and adversely affect economic stability. So far, however, remittances to the South Pacific region have continued to increase.

Introduction

Correspondent banking involves a financial institution (the correspondent) providing a deposit account or other service to another financial institution (the respondent) for the purposes of currency exchange, handling trade-related documentation and cross-border money transfers. The correspondent bank executes payments on behalf of the respondent bank and its customers. As an example, the Reserve Bank of Australia (RBA), like most central banks, provides correspondent banking services to other central banks when transactions need to be settled in Australian dollars. The RBA also uses the correspondent banking services of other central banks in managing foreign currency reserves and those of commercial banks in providing transactional banking services to agencies of the Australian Government.

The need for correspondent banks is particularly important in developing countries, where there is a heavy reliance on foreign currency inflows, such as remittances to households, and where local banks are too small or do not have offices abroad to offer cross-border payment services themselves. In these situations, international banks offer account services directly through a physical presence in the region or provide accounts to local banks and other payment service providers from a location outside the region. Correspondent banking relationships also support the flow of remittances through non-banks, such as money transfer operators (MTOs). These institutions collect small-value remittances, typically less than

$500, and use the correspondent banks to send the aggregate amount collected to the account of their counterparts in the recipient country. It is then distributed to the beneficiaries, which normally are households. MTOs have a particularly important role in the transfer of remittances in the South Pacific. They range in size from sole traders to global companies, such as Western Union and MoneyGram.

This article examines the trend towards global financial institutions reducing correspondent banking services, including in the South Pacific, a process that has often been referred to as 'derisking'.[1] This has involved the global institutions either closing branches or closing or restricting the account services the correspondent banks provide to regional banks and organisations such as the MTOs. This shift potentially threatens the ability of individuals in developing regions, such as the small island economies of the South Pacific, to engage in international trade and to access the financial services that support household incomes, consumption and general economic activity. It may also drive international transfers into the unregulated sector, with adverse consequences for financial inclusion and combating the financing of terrorism. For these reasons, a decline in correspondent banking may be a source of concern for central banks in the South Pacific.

Derisking and the South Pacific

There are many factors behind the decision of global financial institutions choosing to withdraw from, or curtail, the scope of their correspondent banking services, many of which are interrelated. There has clearly been a reassessment of business lines based on cost-benefit considerations following the global financial crisis and the imposition of stricter rules relating to tax evasion, Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT). Central to an effective AML/CFT regime has been the need for financial institutions to enhance their systems to identify and verify customers to meet 'know your customer' (KYC) requirements. Not only is this information required at the outset of establishing relationships, but it has to be kept updated. As a result, the KYC due diligence process has been described as 'complex, costly, time-consuming and labour intensive.'[2] The possibility of large penalties and reputational risks associated with the enforcement of sanctions, tax transparency and anti-money laundering have raised the costs of compliance for global financial institutions and the pursuit of activities such as correspondent banking.[3] Global regulatory reforms have effectively raised the cost of capital for banks, so that high-volume, low-return businesses, such as correspondent banking, has become less attractive.

The global nature of the factors cited above means that the decline in correspondent banking relationships has not been confined to any particular region or payments corridor. Nevertheless, data compiled by the Financial Stability Board suggest that the largest fall in correspondent banking activity in the period 2011–17 occurred in the Pacific region (including the North Pacific).[4] The reported trends raise the question of whether financial institutions have been too conservative in their management of risk and overreacting to AML/CFT rules and related penalties.[5]

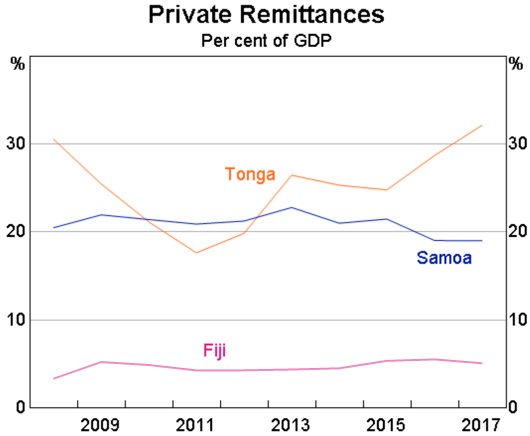
While the reduction in correspondent banking services to low-income regions is a global development, small island nations of the South Pacific region are considered to be particularly exposed for two reasons.

Firstly, remittance transfers from nationals working overseas comprise a significant share of national income in the South Pacific compared with other low-income regions of the world. World Bank Group estimates from 2015 indicate that remittances average around 10 per cent of GDP in the Pacific Islands compared with 5 per cent in other developing regions.[6] There are, of course, significant differences within the region. Remittances are the equivalent of just over 30 per cent of GDP for Tonga and nearly 20 per cent for Samoa (Graph 1). Kiribati, the Marshall Islands and Tuvalu also report remittances as a percentage of national income well above the regional average. The main sources of these flows to the Pacific are the United States, Australia and New Zealand in roughly equal share.

The second factor that makes the Pacific particularly vulnerable is that a significant share of remittances to the region is transferred through MTOs. There are two types of MTOs: the global MTOs, such as Western Union and MoneyGram, which operate through a network of agents; and small family operations which specialise in particular communities and corridors, say, the Tongan community in Australia sending funds to Tonga. MTOs handle some 80 per cent of the number of remittance flows to the Pacific and a similar share of the value of remittances of less than $500.

The advantage of MTOs for international money transfers is that they offer a cheaper service compared with money transfers sent directly through a bank. Generally speaking, the cost of sending remittances via a MTO is around 40 per cent lower, both in terms of the outright fee and the margin on the exchange rate.[7] Moreover, small MTOs are far more mobile and can travel to remote areas and small villages which are otherwise not serviced by banks or even the global MTOs.

Correspondent banks report that the activities of some MTOs are not sufficiently transparent thereby making it difficult for banks to comply with AML/CFT and KYC requirements. MTO business models also vary widely. Some are quite small – there are some in which the owner is the only employee. In these cases, they operate through a connection to another single-employee operator in the source country for the funds. MTOs also aggregate large numbers of small gross payments into a small number of large payments for transferring through correspondent bank accounts. This complicates



Sources: Country authorities; IMF; RBA

monitoring for both the correspondent bank and the local respondent bank, as the inability to identify the source of payment and the ultimate recipient is perceived as limiting banks' ability to fully monitor the activities of their customers and respond to regulator requests for information.

There is little doubt that correspondent banks have adjusted their service to the South Pacific. Data from the Australian Transaction Reports and Analysis Centre (AUSTRAC), for example, indicates that some 720 bank accounts of remittance service providers and affiliates were closed by banks in Australia between early 2014 and mid-2015.[8]

However, there are few signs that the changes have had a lasting material impact. Remittances to the South Pacific have continued to grow both in value and volume. In Tonga, for example, the value of remittances in local currency terms is now at record levels, while those to Fiji and Samoa also remain at high levels.

Furthermore, while there has been a reduction in the number of accounts held by remittance service providers at correspondent banks, most providers still have access to account services. Indeed, AUSTRAC data showing the number of accounts closed also highlighted that few service providers had all of their accounts closed. In addition, of those service providers that initially had all of their accounts closed, AUSTRAC reported that many were able to secure banking arrangements with another bank that allowed them to continue operating.

Importantly, there has been only a small reduction in the number of MTOs servicing the region over the past five years – with the number of active MTOs remaining above 20 in the 12 months to January 2017.[9] In Tonga, the number of licensed MTOs dipped several years ago, but has returned to its recent high of 13. Reflecting this, the costs of sending remittances have not increased. Over the past six years, the average cost of sending remittances from Australia has eased from an average of around 14 per cent to closer to 10 per cent . This reflects banks charging lower fees on sending remittances, as well as increased competition from low-cost digital services.[10] Of course, this remains well above the global (unweighted) average of 7.1 per cent and the G20 commitment to bring average costs down for all corridors to below 5 per cent .[11]

Where to from Here?

The management of risks from money laundering, terrorist financing, tax evasion and fraud will remain a high priority and continue to demand transparency of financial services providers and their customers. While there is no evidence of a material impact at present, the reduction in correspondent banking services remains a risk to the small island economies of the South Pacific.

In this respect, the International Monetary Fund (IMF), the Bank for International Settlements (BIS) and participants in the payments industry have suggested various actions to improve the operation of cross-border payments, which can be applied to the island nations of the South Pacific to reduce the risk to correspondent banking services. Some of the key suggestions are to:

1. Establish a KYC database utility

The BIS Committee on Payments and Market Infrastructures (CPMI) has suggested that a centralised multilateral utility of KYC-related data on bank customers and, potentially, ultimate beneficiaries, could be used to verify information on bank customers and help address concerns about transparency and AML/CTF compliance.[12] Respondent banks would access such a utility to provide the initial information and then update as necessary in line with a standardised template, while correspondent banks could access the utility to retrieve the relevant information.

According to the CPMI, the use of KYC utilities has a number of advantages, including: (i) the accuracy and consistency of the information could improve, as banks would maintain only one set of updated information; (ii) the use of a single template might promote the standardisation of the information that banks provide to other institutions as a starting point for KYC obligations; (iii) the use of a central KYC may speed up the process of verification; and (iv) costs could be reduced because less documentation would need to be exchanged.

A utility of this kind would best be established as a collaborative effort by the industry. This would not be an unusual approach. In several jurisdictions, banks and other financial service providers have established, or are establishing, shared platforms to authenticate customer identities as part of digital frameworks for domestic payment systems. The Society for Worldwide Interbank Financial Telecommunications (SWIFT), for example, has been working with banks in high-risk jurisdictions, using SWIFT's KYC Registry to improve payment transparency.

These platforms could be easily applied to cross-border payments in the South Pacific, given the relatively small population sizes of the islands.

2. Clarify AML/CTF obligations and enhance capacity

Correspondent banks are typically concerned about knowing their customers' customer, even though in most jurisdictions, they are not required to do so to comply with AML/CTF and tax evasion reporting requirements. Ideally, payment service providers servicing the South Pacific need to remain abreast of the intention and interpretation of laws that govern their business and how they will be monitored and enforced, thereby minimising the risk of a misunderstanding about their obligations. In practice, this may be challenging because of capacity constraints and highlights the need for training. For example, in Samoa, the authorities have been particularly active in not only strengthening the country's AML/CFT framework but also combining the reforms with training the staff of MTOs and other financial institutions on their legal obligations.

External organisations also have an important role in enhancing capacity. For example, AUSTRAC, through funding provided by Australia's Department of Foreign Affairs and Trade, provides technical support to its counterparts in the region by working towards: the enhancement of financial intelligence units; the development of a sound regulatory capacity; and the promotion of information sharing.

3. Clarify risks and the meaning of 'risk-based approach'

The reduction in correspondent banking services in various jurisdictions suggests that, while most AML/CTF and anti-tax evasion laws promote a risk-based approach to threat assessment, correspondent banks may continue to perceive that a 'zero-tolerance' approach is taken to detecting and prosecuting breaches. Clarifying the acceptable level of risk tolerance and, in assessing breaches, to determine the extent to which reasonable risk assessments have been carried out appears then to be an ongoing process, as is the need to reinforce the intention for assessments to be risk-based.

Relating to this, it can be helpful in promoting a risk-based approach for there to be broad guidance on the level of risk in a particular region. It would assist cross-border payment service providers, including MTOs, to be aware of the level of transparency they may be expected to provide. For example, a recent report published by AUSTRAC assesses the money laundering and terrorism financing risk associated with remittances sent through providers from Australia to the South Pacific. The work, which was commissioned by the Department of Foreign Affairs and Trade, assessed the risk as low.[13] This assessment was based on the low level of criminality associated with remittance providers in the region, the low-risk profile of customers, the low value of transfers (around $390 each) and general compliance with reporting requirements (MTOs submit around 680 suspicious matter reports to AUSTRAC annually).

4. Utilise the potential of technology-based solutions

The geographical dispersion of populations among the small island nations of the South Pacific and the relatively small size of these populations, a proportion of which are outside of the formal banking system or 'unbanked', provide the ideal conditions for low-cost technology-based money transfer solutions. Indeed, this is already occurring in other low-income regions of the world, such as in Africa, where mobile money facilities that use local mobile phone networks are providing inexpensive and accessible alternatives to conventional cross-border money transfers.

Of course, technology solutions also have their challenges. Many still rely on an interface with existing financial infrastructure for clearing and settlement. In these cases, combining the technology solution with the other solutions noted above, particularly the database utility, would bring together convenience and accessibility.

Innovative solutions do not necessarily have to come from technology start-ups and Fintech companies; the traditional players also have a role. For example, the Tongan Development Bank in partnership with the World Bank Group has developed a remittance facility, the 'Ave Pa'anga Pau voucher, for use in the New Zealand–Tonga corridor. This product is purchased online in New Zealand and redeemed or remitted to a bank account in Tonga. The Tonga Development Bank receives the funds only via electronic payments in New Zealand before disbursing them in Tonga using the liquidity obtained by importers.

5. Standardise payment message formats

Financial institutions engaged in cross-border payments could look to reduce costs by standardising the format for payment messages. There are presently a number of proprietary formats used for making payments even though there is a recognised international standard, ISO20022. Although using different message formats is not directly contributing to the threat of derisking, adopting a uniform format for cross-border payment messages will contribute to minimising transaction costs by reducing administrative costs in handling different proprietary message formats.

Using the international standard ISO20022 will also allow financial institutions to send KYC information together with a payment in a format that, again, is administratively easier for the recipient to receive and interpret. In short, it may also make it easier for financial institutions to share information.

6. Share information

Most importantly, all parties – correspondent and respondent banks, MTOs and regulators – should endeavour to maintain a dialogue about industry developments and emerging risks. For example, in a study of trends in the Caribbean region, the IMF noted that respondent banks have at times been taken aback by the withdrawal of correspondent banks after many years of the relationship without an opportunity to address the (unknown) concerns; similar events have occurred in the South Pacific.[14] Enhanced communication helps all parties concerned. Correspondent banks can clarify their risk tolerance policies, while respondent banks can publicise the steps they have taken to address the factors behind the withdrawal of the correspondent banking relationship.

Emphasising the global nature of the solutions as well as the problem, the importance of communication was highlighted at an IMF and South African Reserve Bank-sponsored conference in May 2018 focused on seeking solutions to the withdrawal of correspondent banking relationships in Sub-Saharan Africa. In a communique, the participants concluded that:

… building trust is critical and called for: strengthening communication channels with global banks, communicating expectations including by providing policy statements; and respondent banks providing requested information in a timely manner.[15]

Such priorities are as important for the South Pacific region as for the Caribbean and Sub-Saharan Africa regions.

Conclusion

While there has been evidence of derisking in correspondent banking services in the South Pacific, there are few signs that the shift in the provision of services has resulted in lower remittances (in both value and volume terms). While some MTOs have closed, these have typically had a small market share and their closure has not materially affected the overall market. If anything, conditions for transfers to the region have improved in the past few years after deteriorating slightly in the middle of this decade. Remaining MTOs have been forced to upgrade their systems to ensure compliance with AML/CFT requirements, while there has been increased competition from the establishment of new low-cost digital services. In this respect, the derisking of global institutions has possibly improved the quality of the region's remittance services.

Nevertheless, the risk of a decline in access to financial services and associated income flows for several countries in the South Pacific remains. The MTOs continue to be vulnerable to the closure of their bank accounts, despite efforts to strengthen their AML/CFT frameworks. The cost of transfers also remain high relative to other regions of the world.

Just as there have been many factors behind the shift towards derisking, there is no single solution. At the same time, there is a need for financial institutions to maintain the highest standards in managing the risks relating to money laundering, terrorism financing and tax evasion. Balancing these issues is not always easy and to do so requires openness and dialogue among respondent and correspondent banks.

Footnotes

[*] The authors are from Business Services Group and International Department respectively.

[1] The term, 'derisking' generally refers to financial institutions withdrawing from particular types of businesses, regions or institutions on a wholesale basis, without a case-by-case assessment of the risks of individual customers. Refer to Erbenová *et al* (2016)

[2] BIS (Bank for International Settlements) (2016) Committee on Payments and Market Infrastructures, 'Correspondent Banking', page 19.

[3] See for example, Lagarde C (2016).

[4] Caution should be exercised in drawing firm conclusions given that the data are based on transactions reported on The Society for Worldwide Interbank Financial Telecommunication (SWIFT) network. While SWIFT is the most commonly used messaging system for cross-border payments, financial institutions have other means to exchange information about their financial transactions. Moreover, the value of transactions partly reflects changes in the US dollar exchange rate. Refer to the Financial Stability Board (2018) and (2017).

[5] See for example Lagarde C (2016).

[6] Alwazir J *et al* (2017)

[7] World Bank (2018), Remittance Prices Worldwide. Available at https://remittanceprices.worldbank.org/sites/default/files/rpw_report_march2018.pdf

[8] AUSTRAC (2015), 'Banks De-Risking of Remittance Businesses', Strategic Analysis Brief, November

[9] AUSTRAC (Australian Transaction Reports and Analysis Centre) (2017), 'Remittance Corridors: Australia to Pacific Island Countries – Money Laundering and Terrorism Financing Risk Assessment', Strategic Analysis Brief, November

[10] Data on the costs of sending remittances are sourced from SendMoneyPacific <www.sendmoneypacific.org>, a joint initiative of the Australian and New Zealand Governments. Some caution should be exercised in interpreting aggregate costs data as the data are not weighted by the volume of transactions.

[11] World Bank (2018) 'Remittance Prices Worldwide. Available at https://remittanceprices.worldbank.org/sites/default/files/rpw_report_march2018.pdf

[12] BIS Committee on Payments and Market Infrastructures (CPMI) (2016), 'Correspondent Banking', July, p 19.

[13] AUSTRAC (Australian Transaction Reports and Analysis Centre) (2017), 'Remittance Corridors: Australia to the Pacific Island Countries', risk assessment produced in collaboration with the Department of Foreign Affairs and Trade, November.

[14] Alleyne T *et al* (2017)

[15] IMF-SARB High-Level Workshop on the Withdrawal of Correspondent Banking Relationships in Pretoria – Working Towards Solutions, 2018. Media release available at: https://www.imf.org/en/News/Articles/2018/05/17/pr18178-imf-sarb-workshop-on-the-withdrawal-of-correspondent-banking-relationships-in-pretoria

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