An aerial view of a city skyline at dusk or dawn, with a large, colorful, multi-colored triangle graphic overlaid on the image. The triangle is composed of many smaller, overlapping triangles in various colors (red, green, blue, yellow, orange). Numerous banknotes of various denominations (including US dollars, Euros, and British pounds) are shown falling from the top of the triangle, creating a sense of financial loss or disarray.

Derisking and the demise of correspondent banking relationships

A research report by Accuity

Executive summary

Correspondent banking is the cornerstone of the global payment system, designed to serve the settlement of financial transactions across country borders. It allows companies and individuals to safely move money around the world and supports and encourages global trade.

Since the financial crisis, tighter regulations - and in particular the regulatory penalties imposed for violations of anti-money laundering (AML) – have caused western banks to rethink their global strategy. The risks of doing business in many developing nations are beginning to be seen as outweighing the financial benefits brought by correspondent banking activity. As a result, US and European banks have reduced their correspondent banking activity in the riskiest regions.

Overall, our research shows a 25% fall in global correspondent banking relationships since the global financial crisis, largely the result of the derisking strategies of US and European banks.

This has left a gap in the market in some regions and the signs are that eastern financial institutions, predominantly Chinese banks, are moving to fill the gap. Correspondent banking relationships operated by Chinese banks increased by 3,355% between 2009 and 2016. While some of this can

be attributed to the growth of the Chinese banking sector during that period, it is clear that Chinese banks see a need for expanding their correspondent banking networks to other regions in the world, particularly Africa, South Asia and Latin America. This wholesale derisking provides Chinese banks with the opportunity to expand their correspondent banking network, possibly due to differing risk tolerance levels when compared with US and European banks.²

These trends suggest a continued shift in correspondent banking relationships from West to East with AML penalties a factor in withdrawal by western banks.

Meanwhile, businesses in the regions most affected by derisking are struggling to access the global financial systems to finance their operations. Without this access, local banks and individuals will be forced to use other channels that include non-regulated, higher cost sources of finance and expose themselves to nefarious actors and shadow banking.

‘Allowing derisking to continue unfettered is like living in a world where some airports don’t have the same levels of security screening – before long, the consequences will be disastrous for everyone.’

Dr. Henry Balani

Global Head of Strategic Affairs, Accuity

¹ <http://www.scmp.com/business/companies/article/2043215/agricultural-bank-china-pay-us215-million-new-york-state-money>

² <http://news.err.ee/589372/deutsche-bank-suspends-dollar-clearing-service-in-estonia>

Background: How we got here

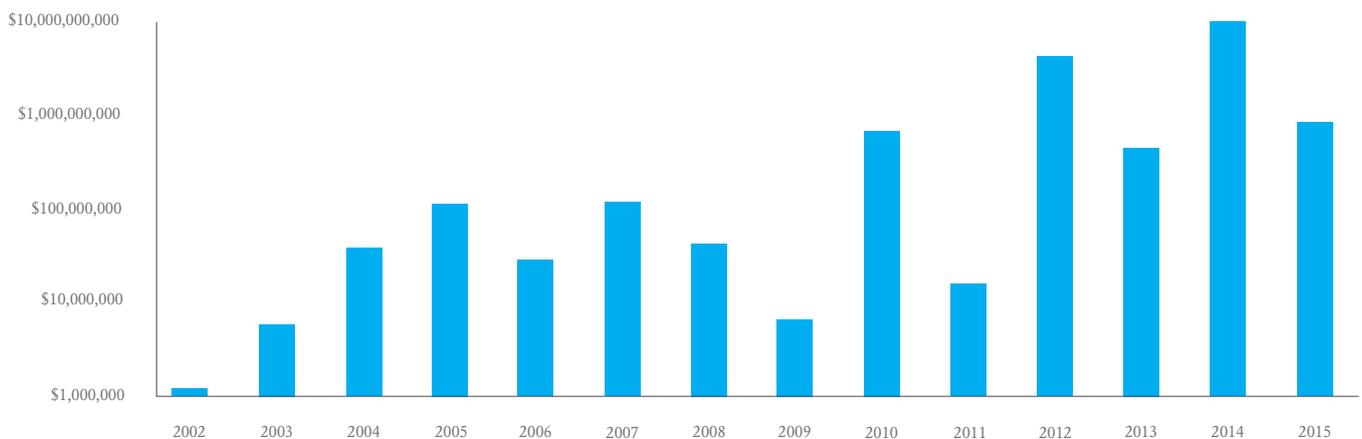
The 2008 financial crisis sent shockwaves through the global financial sector. In the years that followed, regulation of the sector in the US and Europe tightened; liquidity thresholds rose, transparency requirements increased and most significantly for this research, the penalties imposed for violations of anti-money laundering (AML) legislation soared. For western banks in particular, managing risk has become the first priority – and that has put their businesses in riskier developing economies in the strategic spotlight.

The total AML penalties paid by banks peaked at \$10 billion in 2014 (Figure 1). At this level, the threat to banks of doing business in higher risk nations potentially outweighs the benefits of providing services to their clients in these regions, even if there may be good business opportunities to pursue.

Our research suggests that many western clearing banks have already withdrawn from correspondent banking relationships in high-risk countries. While a number of factors will have contributed to this derisking strategy, the most compelling is the increased regulatory risk, combined with higher due diligence costs. Put simply, providing correspondent banking services to some international customers is no longer economically viable; banks cannot justify the increased compliance cost.

Figure 1: Total AML penalties by year

Total AML penalties by year



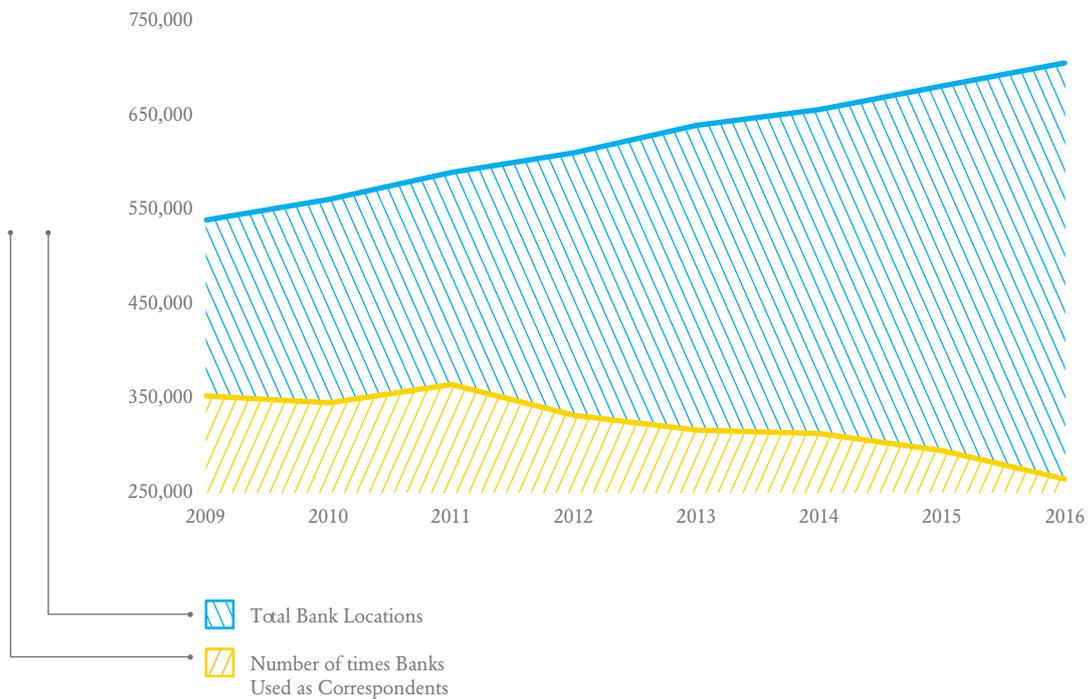
Source: US Department of Treasury, Office of Foreign Assets Control

‘The irony is that regulation designed to protect the global financial system is, in a sense, having an opposite effect and forcing whole regions outside the regulated financial system.’

Dr. Henry Balani

Accuity

Global



Source: Accuity

Our research findings

We analysed settlements data collected through our payments solution, Bankers Almanac for Payments, between 2009 to 2016, looking at the numbers of bank branches, headquarters and correspondent banking relationships. The data is compiled from an average of 29,000 banks in 238 countries or regions across the world.

Our research points to a global shift in correspondent banking activity:

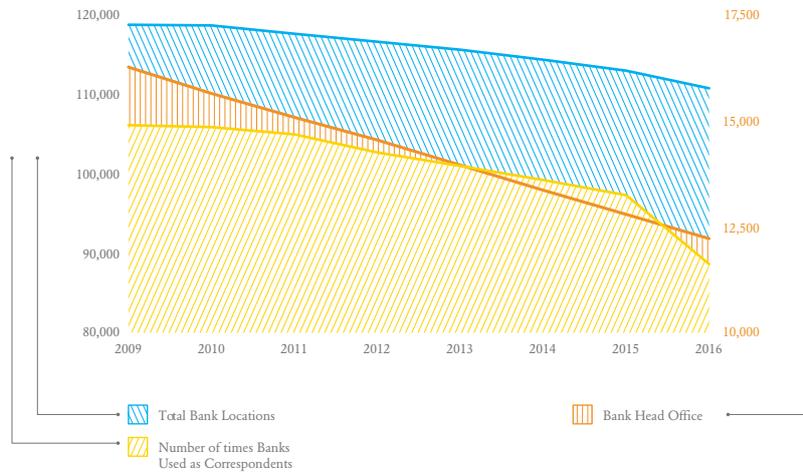
Global banking locations increase, but correspondent activity falls

The number of global bank locations has increased by 31% since 2014, and by 20% since 2009, which can largely be

attributed to growth in emerging economies around the world, including China and the Asia Pacific region; the number of banks in established global financial centres is in decline.

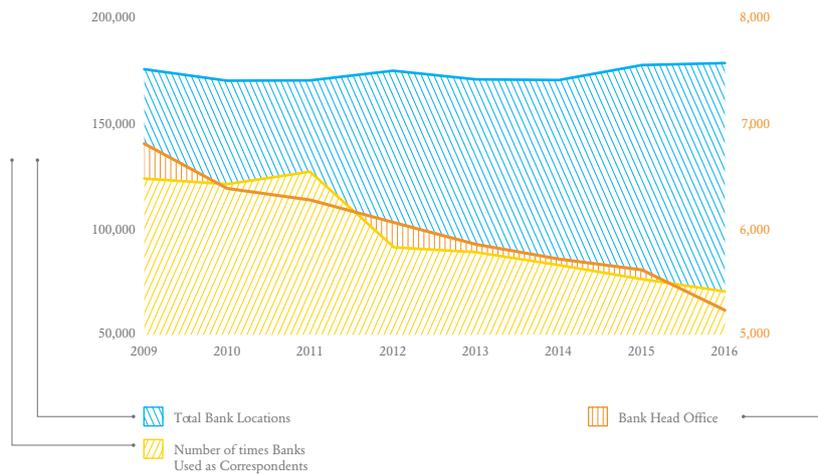
Despite the overall increase in bank branches and locations, the number of worldwide correspondent banking relationships – where one financial institution provides services on behalf of another in a different location – has been in steady decline since 2009, falling by 25% overall.

USA



Source: Accuity

EU

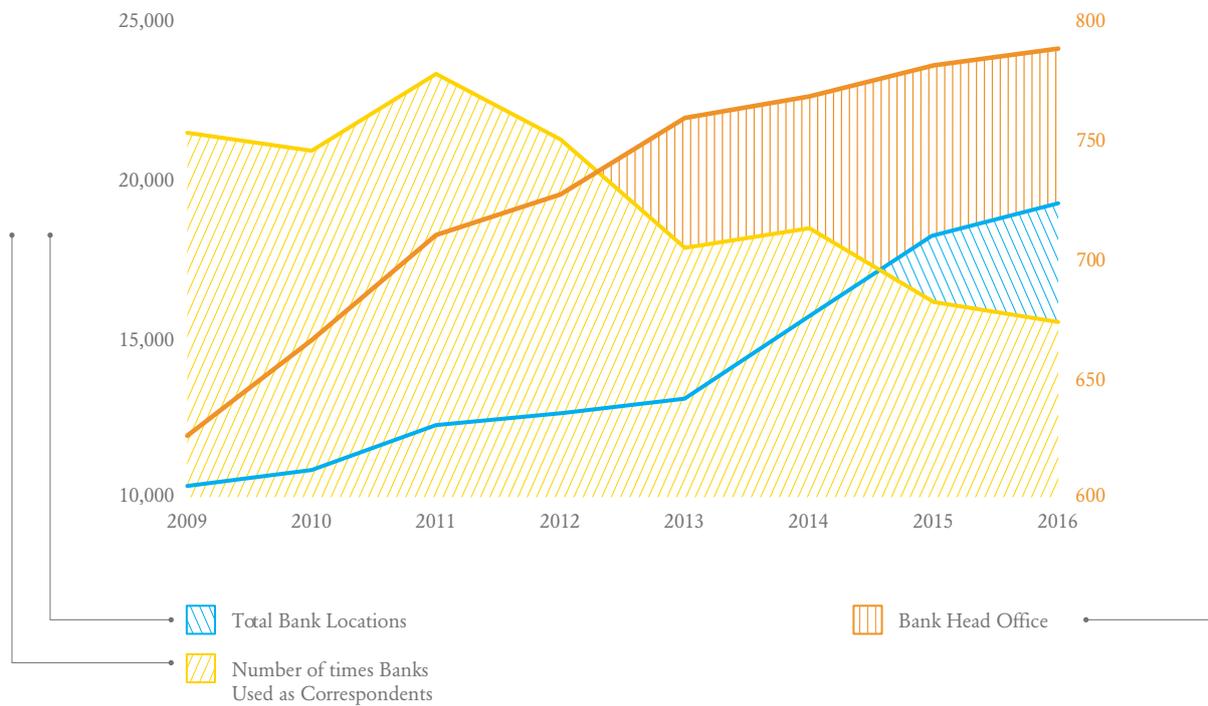


Source: Accuity

The fall in activity is concentrated around Western banks

Between 2009 and 2016, the number of bank head offices located in the US and European Union fell by 24% from 23,240 to 17,631. Over the same period, the number of times US and EU banks were used as correspondents fell by 30%.

Africa



Source: Accuity

The trend is hitting developing economies

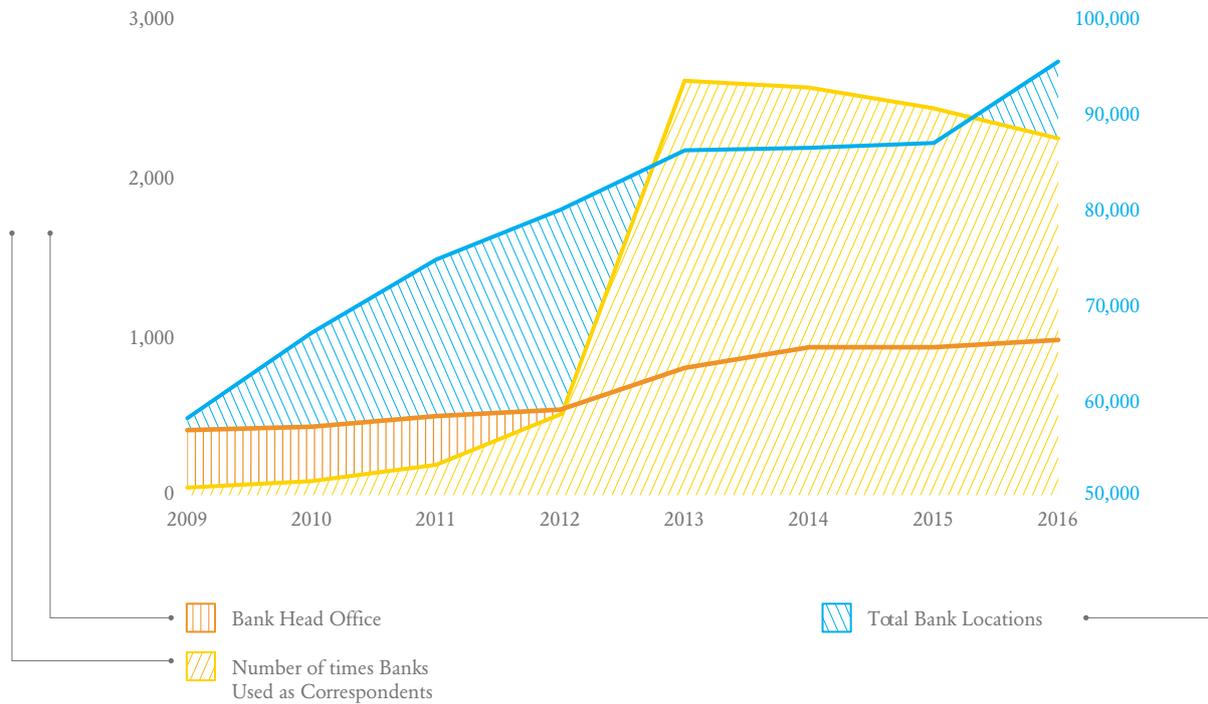
The impact on emerging economies can be seen through our analysis of bank locations, head offices and correspondent banking relationships in Africa. While the overall number of banks has increased on the continent, the number of correspondent banking relationships has fallen.

This suggests that while there is growing demand for banking services in Africa, the ability of businesses to conduct international transactions has been restricted. Businesses in the regions most affected are struggling to access the global financial systems to finance their operations. Without this access, local banks are forced to use alternative non-regulated, and potentially higher cost sources of finance and expose themselves to nefarious actors and shadow banking.

There are signs, though, that demand for correspondent banking services in high-risk regions is being filled by banks from the East, particularly China.³

³ <http://www.reuters.com/article/agriculturalbk-newyork-fine-idUSL4N1D7075>

China



Source: Accuity

China begins to fill the gap

China's banking sector has grown exponentially since 2009, albeit from a low base. The number of banks increased from 421 to 983 and the number of branch locations from 57,937 to 95,801.

Over the same period, the number of Chinese correspondent banking relationships has escalated sharply, from 65 in 2009 to 2,246 in 2016, with much of the increase recorded from 2012 onwards.

The Chinese global correspondent banking network is at a relatively early stage of maturity and its

exponential growth can be partly explained by the fact that it is expanding from a lower economic base. Even so, Chinese banks have a different view of and approach to the risk-reward ratio than their Western counterparts; in part, driven by only two Chinese banks having fallen foul of US AML regulations.

There is another factor in play, though. Our research also looked at the number of correspondent banking relationships transacting in US dollars, euros and in Chinese renmimbi – and revealed a decline in the number of US dollar correspondent banking relationships.

US dollar correspondent relationships

15% fall since 2013

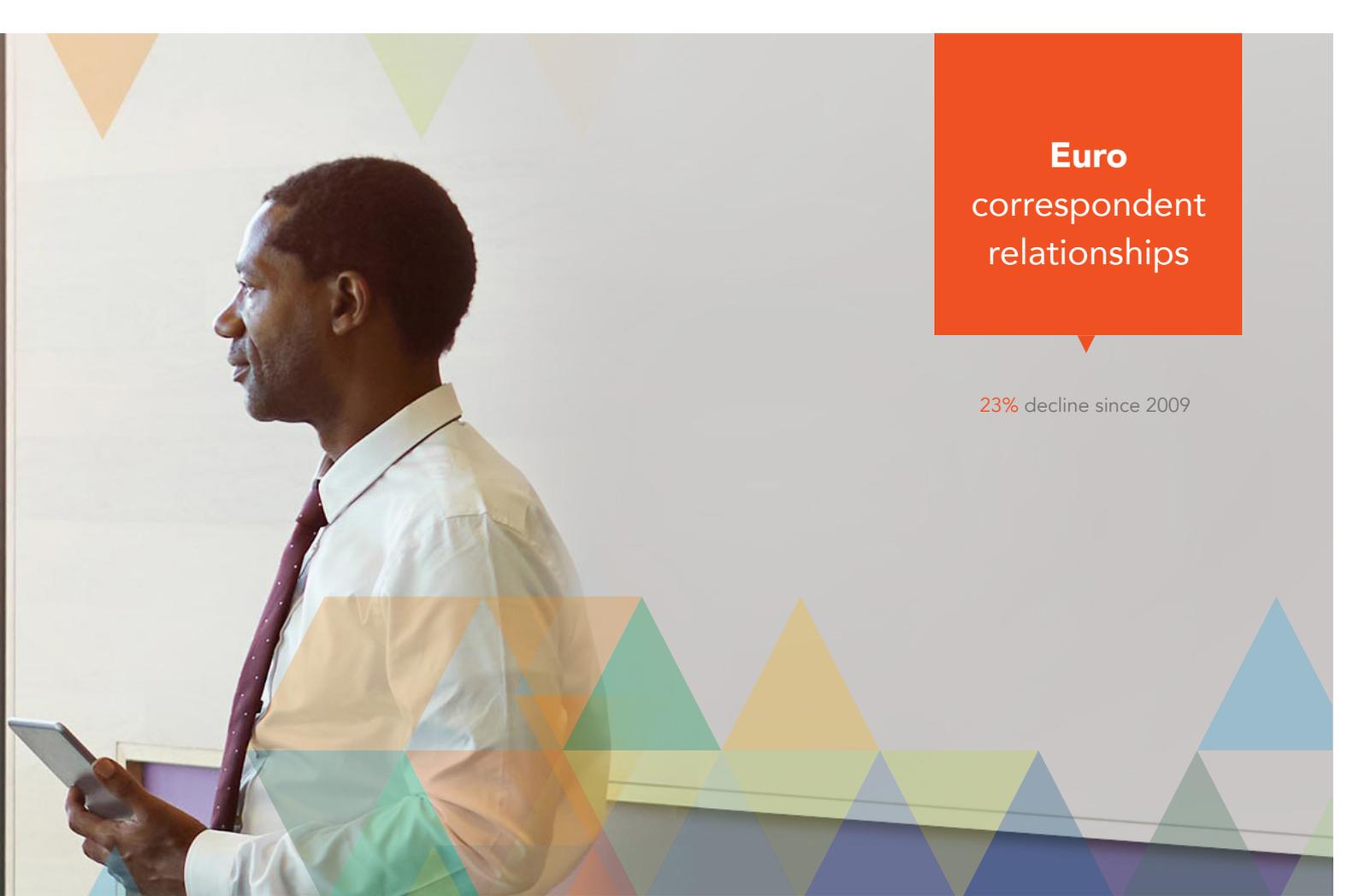
13% between 2015 and 2016

A decline in the dollar's dominance

The US dollar has dominated as the functional currency for most correspondent transactions – and remained the currency of choice as the global economy recovered from the financial crisis. But our research shows a 15% fall in US dollar correspondent relationships since 2013 – including a sharp 13% fall between 2015 and 2016. Correspondent relationships transacting in euros have also declined, by 23% since 2009, partly due to the integration of cross border payments across Europe into the Single European Payments Area (SEPA).⁴

At the same time, correspondent banking relationships in Chinese renmimbi have increased by 8% since 2013. Because our research concentrates on the number of correspondent banking relationships rather than the volume of transactions, these results could indicate a concentration in US dollar transactions among fewer banks. But it is also possible that we are seeing a growing trend towards the use of the renmimbi in world trade rather than the US dollar. The most likely explanation is that the effect is caused by a combination of these factors, and that banks are choosing to transact in other currencies, recognising that USD transactions are subject to US regulations and clearing through US based banks irrespective of physical location of the transaction.

⁴ https://en.wikipedia.org/wiki/Single_Euro_Payments_Area



Euro correspondent relationships

23% decline since 2009

The renmimbi will rise

There are three clear reasons why we should expect to see a continued rise in the use of renmimbi in correspondent relationships in the future:

- The Chinese economy and the size of its banking sector will continue to grow
- The currency will become more easily convertible over time; the renmimbi was added to the International Monetary Fund's SDR basket in 2016⁵, and
- The different risk-reward ratio approach of Chinese banks means that they are more willing to explore high-risk markets, and therefore will participate in more correspondent banking relationships.

What does this mean for US and European banks?

Initiatives by US and European regulators have clearly had unintended derisking consequences. Established western financial institutions are reducing their correspondent banking relationships as they shun high-risk countries or regions, with loss of banking services revenue as a result.

Banks in developed countries have a reputation for fairness and trust but are failing to pick up additional business because of their reluctance to pursue business in high-risk geographies.⁶ This comes at a time when the growth of larger banks is stagnating – they are losing business and banking opportunities as they are replaced by local, smaller banks across the world.

⁵ <http://www.imf.org/en/News/Articles/2016/09/29/AM16-NA093016IMF-Adds-Chinese-Renminbi-to-Special-Drawing-Rights-Basket>

⁶ <http://www.economist.com/news/finance-and-economics/21604183-big-banks-are-cutting-customers-and-retreating-markets-fear>

Conclusion

Despite the risks, developing economies remain an important potential market for all banks. The universal approach to risk management adopted by many western banks, though, has caused them to dismiss entire regions and countries – and the impact in terms of financial exclusion that this is having in some parts of the world has been identified as a serious social threat by the G20 nations and World Bank⁷ among others.

The ‘antidote’ to blanket derisking

There are many low-risk businesses in high-risk countries and valuable business to be found. The ‘antidote’ to blanket derisking is for banks to adopt a more granular approach to risk assessment and due diligence, which can securely and quickly determine the risk of a transaction in a high risk region. With a more technology-driven and detailed approach to risk management, western banks have much to gain.

From Accuity’s work with financial institutions in derisked regions, including in Africa, CEE and APAC, we have found that local banks that can demonstrate they meet international compliance standards – because they have the right compliance systems, processes and culture in place – can be trusted to act as local correspondent banking partners for the large international clearing banks. Ultimately, if large clearing banks can perform their due diligence and gain the confidence to work with low-risk businesses in high-risk jurisdictions, then we can begin to reverse the derisking trend and begin to ‘re-risk’.

‘Since the financial crash of 2008, we have seen significant commitment from financial institutions in emerging economies to demonstrate they are not high risk.

As we see more regulation come into place, global banks can support growth in local businesses by investing in technology that can securely and quickly determine the risk of a transaction in a high risk geography.’

Dr. Henry Balani

Global Head of Strategic Affairs, Accuity

⁷ <http://www.worldbank.org/en/topic/financialmarketintegrity/brief/de-risking-in-the-financial-sector>

About the research

Accuity compiled its research using data collected from its payments solution, [Bankers Almanac for Payments](#). The research focused on eight years of data from 2009 to 2016, and reviewed the creation of new banks vs. the demise in correspondent banking relationships. The data is compiled from an average of 29,000 banks in 238 countries or regions across the world.

The research is based on standard settlement instruction (SSI) data that Accuity collects for its Bankers Almanac for Payments solutions. Accuity proactively collects this information based on its relationships with banks around the world. While Accuity makes every effort to keep up to date with the constantly changing correspondent banking landscape, its data is limited to the SSIs that each bank chooses to publish with us.

About Accuity

Accuity offers a suite of innovative solutions for payments and compliance professionals, from comprehensive data and software that manage risk and compliance, to flexible tools that optimize payments pathways. With deep expertise and industry-leading data-enabled solutions from the Fircosoft, Bankers Almanac and NRS brands, our portfolio delivers protection for individual and organizational reputations.

Part of RELX Group, a world-leading provider of information and analytics for professional and business customers across industries, Accuity has been delivering solutions to banks and businesses worldwide for 180 years.

‘Correspondent banking represents the cornerstone of the global payment system designed to serve the settlement of financial transactions across country borders. Our Research highlights some important trends in derisking and its impact on international trade and global banking.’



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