Policy brief

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Correspondent banking relationships and trade

KEY POINTS

- Anti-money laundering and countering financing of terrorism (AML/CFT) regulations are essential to combating financial crimes and ensuring the integrity of the financial system.
- Limited capacity in developing countries to implement AML/CFT raises compliance risks and costs for banks, leading to a decline in correspondent banking relationships (CBRs).
- Least Developed Countries (LDCs), Landlocked Developing Countries, and Small Island Developing States (SIDS), that lose more CBRs experienced larger reductions in export growth.
- Efforts are required to reduce divergence in the banks' implementation capacity and step-up support for LDCs, LLDCs, and SIDS.

Correspondent banking relationships and trade

Banks often use intermediary banks through CBRs to enable cross-border payments. These relationships are, therefore, critical for international trade transactions that rely on those payments. In recent years, CBRs have declined in many developing economies, and the de-risking strategy of some banks contributes to this trend. This decline in CBRs creates a challenge for LDCs, LLDCs, and SIDS to conduct trade. This brief examines the cause of declining CBRs, and presents a preliminary assessment of how it can affect trade, and proposes possible pathways of action.

What are CBRs

Correspondent banking involves a financial institution (the correspondent) that provides banking services to another financial institution (the respondent). The CBR is the agreement authorizing the correspondent bank to provide financial services on behalf of another bank in a different country. Banks use CBRs to facilitate a range of international transactions and services, including cross-border retail payments[1], cross-border remittance transfers, trade finance, and providing documents supporting transactions.[2] According to the Bank of England, the global value of cross-border payments will increase from $150 trillion in 2017 to over $250 trillion by 2027.[3] The majority of those transactions will be done through correspondent banking.

Banks with a CBR operate internationally and must comply with various international financial requirements, including the AML/CFT regulations and those set by the authorities governing the currencies they settle in, such as the US dollar and the Euro. For instance, in the European Union, the Anti Money Laundering Directive, initially enacted in 2015 and last amended in 2018, serves as a key pillar in anti-money laundering and countering terrorism.[4] These regulations mandate enhanced due diligence for banking relationships and transactions involving high-risk third countries.

Following the global financial crisis of 2008, increased enforcement of AML/CFT regulation created a challenge for some banks in developing countries to meet compliance standards.[5] Some of these banks have inadequate resources to comply with these requirements effectively, and some have limited capacity to implement the AML/CFT regulation by conducting a risk assessment for their consumers.

1 Bank for International Settlements, 2018. Cross-border retail payments.

2 International Monetary Fund, 2017. Recent trends in correspondent banking relationships.

3 Congressional Research Service, 2022. Overview of Correspondent Banking and “De-Risking” Issues.

4 European Commission, 2023. High-risk third countries and the international context content of AML/CFT.

5 International Finance Corporation, 2019. AML/CFT risk management in emerging market banks. International Monetary Fund, 2011. Compliance with the AML/CFT international standard.

The Financial Action Task Force (FATF) has proposed a global standard for AML/CFT, which employs a risk-based approach that allows banks to address money laundering and financing terrorism.[6] These international standards are then implemented at the national level, with each country interpreting and adapting them to local conditions. Both correspondent and respondent banks operating internationally are subject to the resulting ambiguity and inconsistencies in AML/CFT regulations across jurisdictions.[7]

As a result, those banks face a compliance risk that may raise costs in four areas: (i) the sanction and penalty risks that heighten cross-border exposure, (ii) increased due diligence on customers, (iii) the lack of harmonization in compliance requirements across jurisdictions, and (iv) constantly evolving compliance requirements continue which banks need to keep up with them.[8] To avoid compliance risks, certain banks have de-risked entire categories of clients based on risk profiles or geographic locations. De-risking means a situation where financial institutions terminate or restrict CBRs to avoid risk instead of conducting risk analyses and applying risk-based approaches.[9] The de-risking strategy, in turn, had led to the decline of CBRs in some developing countries.[10]

Declining CBRs

The Bank for International Settlements (BIS) has measured the number of active correspondents since 2011, and declining trends have been observed across all regions, with the biggest falls in Latin America, the Caribbean, and Oceania.[11] The decline in that number would mean fewer CBRs handle a larger share of cross-border transactions, concentrating the market on larger banks that can maintain the global network.[12]

In addition, the market concentration among correspondent banks results in less competition, fewer available payment channels, and longer payment chains. Consequently, this has impacted the costs of international payments. As a result, the decline in CBR and the increased cost of cross-border payments will have an impact on financial flows to de-risked jurisdictions. For example, between 2011 and 2022, Barbados and Tonga, both classified as SIDS, saw a 48 per cent drop in CBRs, resulting in respective declines of 21 and 33 per cent in the value of cross-border transactions.[13]

A report by the International Monetary Fund highlights that the decline in CBRs is notably higher in smaller economies across Africa, the Caribbean, Central Asia,

[6] Financial Action Task Force, 2023. The FATF Recommendations: International standards on AML/CFT.

[7] International Finance Corporation, 2018. Increased Regulation and De-risking are Impeding Cross-Border Financing.

[8] Idem

[9] UNCTAD, 2021. Financial Inclusion for Development: Better access to financial services for women, the poor, and migrant workers, Financial Action Task Force, 2014. FATF clarifies risk based approach.

[10] International Finance Corporation, 2019. AML/CFT risk management in emerging market banks.

[11] Bank of International Settlements, 2022. CPMI correspondent banking chartpack.

[12] Rice, T., von Peter, G. and Boar C., 2020. On the global retreat of correspondent banks.

[13] Bank of International Settlements, 2022. CPMI correspondent banking chartpack. International Finance Corporation, 2018. Increased Regulation and De-risking are Impeding Cross-Border Financing.

and the Pacific.[14] These economies, often classified as LDCs, LLDCs, and SIDS, rely heavily on CBRs as a lifeline to facilitate cross-border transactions and access the international financial market due to their small size, remote locations, and vulnerability. These economies also depend on trade to support their economic growth, including from export of commodities and trade in services such as tourism, with the share of trade to GDP in LDC and Pacific Island small states reaching 52 per cent and 106 per cent, respectively, in 2022.[15]

Trade Challenges of losing CBRs

Banks use CBRs to intermediate trade finance, which is particularly vulnerable to declines in these relationships. CBRs facilitate cross-border trade by settling transactions, providing payment guarantees, and handling related documentation necessary for conducting trade.[16] Therefore, the reductions of CBRs could hinder trade activities, may widen the trade finance gap,[17] and limit businesses' ability to engage in international trade.

Preliminary assessment suggests that during the period from 2011 to 2022, the LDCs, LLDCs, and SIDS that lost the largest shares of CBRs also experienced larger reductions in export growth.[18] The observations are based on trade data from UNCTADStat and secondary banking data collected by BIS, covering aspects such as the number of CBRs, transaction volumes, and changes in transaction values between 2011 and 2022 within specific regions or countries. This observation serves as a preliminary check to determine whether there is any correlation between the decline in the corresponding banking and export growth, while no causality is discussed at this stage.

Figure 1 illustrates how the average export growth rate changed between the country groups most and least impacted by the changes in CBRs, using the average export growth before (2000-2014) and after (2015-2022) in 72 countries that are categorized as LDCs, LLDCs, and SIDS. The year 2014 serves as a cut-off period, marking the accelerated decline in CBRs as the result of broader enforcement of AML/CFT regulation.

The figure indicates that, on average, export growth of the ten LDCs, LLDCs, and SIDS countries most affected by the loss of CBRs slowed by 12.8 percentage points from 2015 to 2022 compared to the period between 2000 and 2014. An estimated assessment suggests that countries that lost more CBRs show a higher deceleration in export growth than those that lost fewer CBRs. For example, Bhutan, which lost 1.5 per cent of its CBRs, experienced only 1.3 percentage points less export growth during this period. In contrast, Mauritius, which lost 60 per cent of its CBRs, saw a 12-percentage point decrease in export growth

[14] International Monetary Fund, 2016. The withdrawal of correspondent banking relationships.

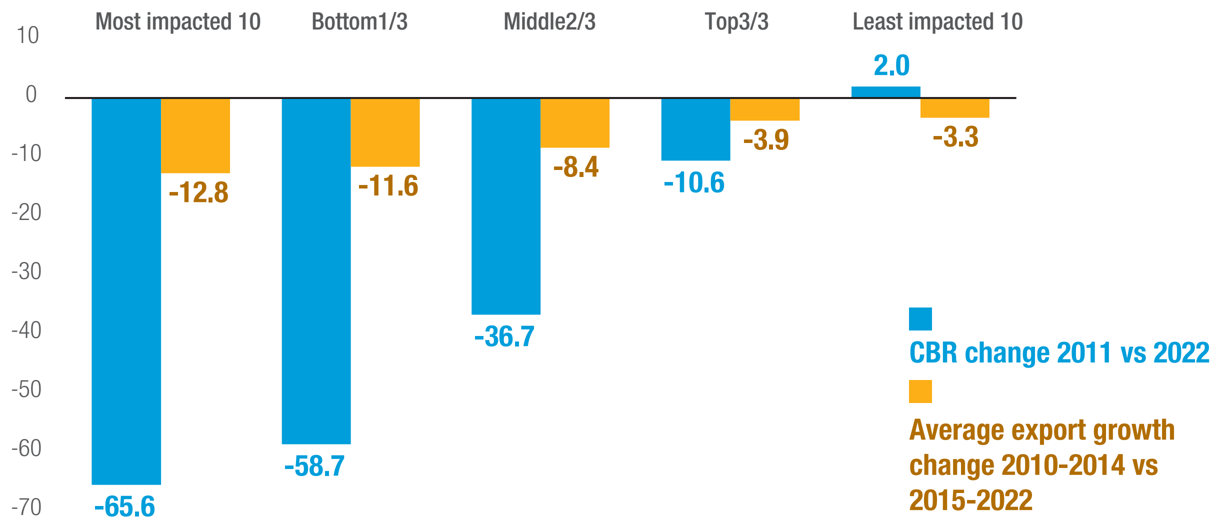
[15] Data from World Development Indicator.

[16] International Finance Corporation, 2016. De-risking by banks in emerging markets – effects and responses for trade.

[17] Finance gap refers to the disparity between the funds needed by business to engage in international trade transactions (demand side) and the availability of bank to provide trade finance (supply side).

[18] In general, export growth rates decelerated after the 2008-2009 crisis. However, trade data shows that deceleration is higher in countries that are more severely impacted by CBR declines.

Figure 1
LDCs, LLDCs, and SIDS: Estimated Change in average export growth rate by level of change in CBRs
(Percentages)



Source: UNCTAD calculations, based on the Bank of International Settlements and UNCTADStat data.

during the same period. In contrast, a similar assessment for 132 developing countries shows that the 10 most affected developing countries by the loss of CBRs experienced only 3 percentage points fall in export growth for the same observation period. This suggests that the LDCs, LLDCs, and SIDS were more adversely impacted by the decline of CBRs.[19]

Another challenge of declining CBRs to trade in vulnerable countries is the high exposure to illicit financial flows (IFFs), especially in commodity-dependent countries. When CBRs pull back from these countries, legitimate trade finance and access to formal financial channels become disrupted. In turn, this can incentivize businesses to turn to underground banking systems or money laundering networks to move money.[20]

Regulatory authorities in the European Union and the United States of America have recognized some of the negative consequences of banks' de-risking practices. The European Banking Authority, for example, stated that de-risking entire categories of clients could negatively impact the fight against financial crime, as some excluded clients may resort to the less regulated non-bank channels.[21]

[19] The observation is consistent with recent study in emerging Europe and World Bank case studies. See European Bank for Reconstruction and Development, 2023. Broken relationships: De-risking by correspondent banks and international trade, Borchert, L., de Haas, R., Kirschenmann, K., Schultz, A., 2021. How the Withdrawal of Global Correspondent, and The World Bank, 2018. The Decline in Access to Correspondent Banking Services in Emerging Markets: Trends, Impacts, and Solutions Lessons Learned from Eight Country Case Studies.

[20] For an in-depth discussion on measurement and magnitude of illicit financial flows, see UNCTAD, 2020. Tackling illicit financial flows for sustainable development in Africa, and UNCTAD, 2023. First official estimates on illicit financial flows.

[21] European Banking Authority, 2022. Opinion of the European Banking Authority on 'de-risking'.

The United States Treasury Department noted the need to clarify and revise regulations and improve international cooperation to enhance AML compliance.[22] Some countries suffering from de-risking have engaged with the international community to address concerns related to AML requirements. For example, Barbados has worked with FATF to strengthen its AML regime.[23]

Despite these important efforts, more needs to be done for an exhaustive assessment of the impacts of losing CBRs on developing countries, especially in LDCs, LLDCs, and SIDS. Such analysis needs to take due consideration of the many other variables impacting export growth, including changes in market access, macroeconomic conditions, foreign direct investment flows, commodity prices, and the country's financial architecture.[24]

Possible pathways of actions

The likely connections between the CBR decline and export growth slowdown in LDCs, LLDCs, and SIDS suggest that the issue needs more attention for those countries to sustain trade and secure external earnings. The following possible pathways of action are for consideration by the international community and national governments:

1. **Expand the evidence base on the broader economic impacts of losing CBRs on international trade. A better understanding of the broader economic repercussions of losing CBRs on international trade is warranted. Such an understanding could mobilize support within countries to further prioritize compliance with financial requirements.**

2. **Enhance capacity-building efforts in LDCs, LLDCs, and SIDS to improve their implementation capacity to AML/CFT regulations. Targeted support is needed for the most affected LDCs, LLDCs, and SIDS. Priorities should be given to formulating effective policy responses to improve due diligence and reduce compliance costs, as well as providing guidance on industry-led solutions within the banking sector. Additionally, efforts to assess the current situation and consolidate evidence are crucial to identify pathways for increasing the implementation capacity of these countries.**

[22] The United States Department of the Treasury, 2023. The Department of the Treasury's De-Risking Strategy.

[23] Caribbean Financial Action Task Force, 2021. Anti-money laundering and counter-terrorist financing measures – Barbados.

[24] For discussion on the variables impacting export growth and export diversification, see UNCTAD, 2022. Economic Development in Africa Report.

3. **Increase clarity in compliance requirements and reduce divergence in implementation capacity. One of the main challenges faced by financial institutions in developing countries, particularly in LDCs, LLDCs, and SIDS, is navigating a diverse and complex regulatory environment. The international community should collaborate in harmonizing these regulations, recognizing that a one-size-fits-all approach is not viable due to differing implementation capacities across countries.**

UNCTAD stands ready to assist developing countries in pursuing these actions. This includes assisting countries in assessing the broader repercussions of CBRs decline on international trade and identifying policy responses.

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