

Closing the loop: AML/CFT supervision of correspondent banking¹

Executive summary

International payments are cleared and settled mainly through correspondent banks. Although the cross-border payment market is evolving rapidly, the share of alternative channels in the market for cross-border payments remains small, so that correspondent banking still plays a critical part in the global economy. Correspondent banking relationships allow banks to process cross-border payments without having physical presence or legal domicile in other jurisdictions. This functionality provides a flexible and regulated channel with a potentially worldwide reach, thus supporting cross-border trade and investment, economic integration and financial inclusion.

A correspondent bank typically has limited information about the respondent bank's customers and the nature of their transactions. Correspondent banks rely on their understanding of the respondent banks' anti-money laundering (AML) and countering the financing of terrorism (CFT) and proliferation financing (CPF) programmes. This reliance may expose the correspondent bank to weaknesses in the respondent bank's programmes for AML/CFT/CPF, increasing the associated risks.

Correspondent banking has become more concentrated, to the potential detriment of market integrity, financial inclusion and economic prosperity. This results from the shrinking number of relationships combined with an increase in the value and volume of international transactions. The concentration reflects profitability issues and changes in global business strategy, as well as concerns over ML/TF/PF risks and regulatory uncertainty. If entire customer segments lose access to these financial services, trade, investment, remittances and economic growth may be endangered. The possible exclusion of customers from the regulated financial system may also increase money laundering (ML), terrorist financing (TF) and proliferation financing (PF) risks by driving activity into unregulated and non-transparent channels.

Measures are under way to address the decline in correspondent banking relationships. Under the auspices of the Financial Stability Board's four-point action plan, several international organisations have taken measures to assess the decline and implications for financial inclusion and financial stability; clarify regulatory expectations; support domestic capacity-building in jurisdictions that are home to affected respondent banks; and strengthen tools for due diligence by correspondent banks.

AML/CFT/CPF supervision at the national level is crucial to successfully addressing some of the concerns which may lead to loss of relationships. This paper aims to contribute to the international dialogue by focusing on supervisory practices relating to correspondent banking activities. In view of the observed decline in correspondent banking relationships, practices to address excessive de-risking were a particular area of consideration. As a general matter, while the study found that legal and regulatory

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frameworks are consistent with international standards, their implementation is more variable and sometimes needs further work to satisfy international standards.

Authorities have taken a range of measures to clarify supervisory expectations for correspondent banking in a two-way dialogue with the industry. These include regulatory standards, detailed guidelines and official statements, specifying in particular that no KYCC requirements apply. In addition, some authorities provide practical guidance and clarity in the form of typologies, good and bad practices and case studies to explain how banks fall short of expectations. Similarly, financial institutions provide valuable input in reaching national risk assessment determinations. This two-way dialogue on risk can significantly enhance the effectiveness of AML/CFT/CPF frameworks.

A key challenge of the risk-based approach (RBA) is to achieve supervisory consistency. This is a particular challenge in the supervision of correspondent banking and highlights the need to properly convey supervisory expectations. The RBA involves extensive use of judgment on the part of banks and supervisors. Accordingly, most of the supervisory processes surveyed include detailed supervisory manuals and a review stage to ensure a minimum level of quality and homogeneity in the supervisory findings. In addition, authorities employ a variety of tools to train personnel and disseminate good practice. There may be more authorities could do to publicise these tools and explain the principles of the RBA's application to supervisors, although some have already taken steps in this regard.

While the legal frameworks in most jurisdictions allow for flexible enforcement actions, authorities differ in the extent they use this flexibility in practice. Enforcement powers range from simple notification of gaps all the way to enforcement actions such as large fines or revoking licenses. Jurisdictions recognise that robust enforcement actions should be reserved for serious breaches of regulatory requirements. In addition, authorities largely agree that sanctions should carry a message for the public in principle and several jurisdictions make sanctions public in sufficient detail to accomplish this goal. However, jurisdictions appear to diverge in applying dissuasive enforcement actions for the most egregious cases. More stringent and targeted enforcement, including against natural persons, and more robust communication may therefore sometimes be needed to avoid blanket de-risking by correspondent banks. The more rigorous the supervision that respondent banks undergo, the less risk those respondents will pose to their correspondents and the more confidently those correspondent banks will provide their services. Applying strong enforcement with clear and detailed explanations for the public in serious cases will add to that confidence.

Cooperation and information-sharing within and across jurisdictional borders is an essential component of surveyed jurisdictions and should therefore be regularly reviewed and where necessary updated. In general, authorities and foreign supervisors can help each other in conducting an investigation, examination or enforcement action. In some cases, however, authorities face obstacles in the form of data privacy or localisation requirements. These obstacles highlight the need for authorities to review and balance the objectives of data privacy vis-a-vis financial transparency as well as the need to review information-sharing frameworks to identify or establish appropriate legal gateways for exchanging data, bearing in mind that improved cooperation can help to reduce unwarranted de-risking.

Innovative tools and technologies can help overcome the supervisory and risk management challenges of correspondent banking. In this regard, several authorities in surveyed jurisdictions support banks' use of tools that facilitate customer due diligence (CDD) procedures, such as know-your-customer (KYC) utilities, the Wolfsberg Group's due diligence questionnaire and the incorporation of Legal Entity Identifier in payment messages. They also encourage the use of advanced technologies and innovation in bank risk management processes. At the same time, some authorities have adopted advanced technology in their supervisory processes to improve efficiency and tackle complex risks. By using innovative tools, including artificial intelligence, banks and supervisory authorities can sift data to identify suspicious activity and help mitigate ML/TF/PF risks and counter the decline in correspondent banking relationships.