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Cross-Border Banking Issues: Regulatory Compliance, Re-risking and Financial Integration

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Financial access and inclusion in Arab countries

- Access to finance and financial inclusion is critical for employment creation, raising incomes, mobilizing savings, expanding the class of entrepreneurs, and enabling people to invest in themselves and their families.
- Financial inclusion programs are intended to promote inclusive development by making formal financial services available, accessible, and affordable to all sectors of society.

  Populations of Arab countries, excluding those of the Arab Gulf, have limited financial access: Demirgüç *et al* estimate account penetration in Arab countries in North Africa in 2012, for e.g., is only 23% of all adults compared to 50% for all world adults.
- Adults with at least one loan outstanding from regulated financial institutions range between 1% in Algeria and 4% in each of Egypt and Morocco

External regulatory challenges confronting financial inclusion in Arab Region

- Economic and structural impediments in most countries, and political and security instability in others, are constraining Arab countries' ability to broaden and deepen the scope of financial inclusion. In addition, a number of international regulatory challenges are confronting all Arab countries, and are impacting their access to international financial markets.
- These challenges can be grouped under:
  1- De-risking by international correspondent banks
  2- Compliance with international laws and regulations
- They are typically interdependent in that compliant respondent banks operating in well-regulated jurisdictions, are unlikely to lose the services of all their correspondents unless their business is unprofitable. Conversely, respondent banks in violation of international laws and regulations, are bound to lose them.

The withdrawal of Correspondent Banking relations: de-risking and its effects on the MENA region

- **De-risking** or **de-banking** refers to financial intermediaries withdrawing relationships with and closing accounts of clients and banks considered high risk rather than managing them. It represents a market failure that creates negative consequences for financial inclusion goals.
- De-risking hits vulnerable communities: instead of including them financially, causes their financial exclusion and isolation from the global financial system.
- It heightens security implications and pushes high-risk clients to smaller FI's or out of the formal financial sector altogether.
- It encourages the development of underground shadow markets.
- It is feared pressures on CBRs can become systemic in nature if not addressed

Motives for de-risking or de-banking by Correspondent Banks

- The correspondent banking services of **G-SIFI**'s, the global systemically important financial institutions (around 30), facilitate the flow of international payments, and foster economic prosperity throughout the world.
- Due to their large international geographic coverage and interconnectedness they pose systemic threat to the international financial system, and are submitted to enhanced supervision and stringent rules. These include requirement to hold additional capital buffers.
- This has sparked restructuring and downsizing to circumvent the G-SIFI designation (restructuring evidenced in the US).
- Low-profit, reputational concerns, and intensifying AML/CFT examination contribute to de-risking.
- Together with other compliance issues, **G-SIF**I's have started to cut their **Correspondent Banking Relations (CBR)** and services to small and non-compliant banks for fear of offending regulators.

Evidence of withdrawal of correspondent banking relations

a. A joint **IMF-UAB** survey conducted in Spring 2015 demonstrates:

1. 40% of banks surveyed in 17 countries in the MENA region were facing higher compliance costs;
2. some Money Transfer Services had been cut-off;
3. banks have reduced foreign currency transaction services;
4. ten percent of correspondent banks have withdrawn relationships with respondent banks in MENA countries that were under economic and trade sanctions or whose AML/CFT policies were weak.

b. **IMF Staff discussion Note** published in June 2016 provides similar evidence of CBR withdrawal of correspondent services to smaller financial intermediaries in many small countries

The Burden of Compliance

All countries, including Arab countries, intending to operate in the international market place have to fully comply with all of:

a- **FATF** rules to combat money laundering (AML) & to counter terrorist financing (CTF);

b- **USA Patriot Act** and sanctions: Section 312 of PA requires each US FI that establishes, maintains, administers, or manages a correspondent account or a private banking account in the US for non-US citizens to subject such accounts to certain anti-money laundering measures, including enhanced due diligence policies and controls;

c- These sanctions call for acquiring additional identifying information from a wider variety or more robust sources. **FATF** and **AMLEG** (Expert Group) and **BIS** Committee on Payments and Market Infrastructure and the **IIF** are working to clarify to what extent banks need to know their customers (**KYC**) and customers' customer (**KYCC**);

d- Financial Institutions are now combining the US Foreign Accounts Tax Compliance Act, **FATCA** and the subsequent OECD's Common Reporting Standards, **CRS**, forms to collect for collection and validation of tax identification now required by some 100 signatory countries

China's Cross-border Inter-Bank Payments System, CIPS, initiative

- China's intent on charting an autonomous path to internationalize the use of the **Renminbi** (**RMB**). In October 2016 it was added to the SDR basket of currencies with 10.9% weight (USD, 41.7%; Euro 30.9%; remainder Yen and Sterling)
- Its **Cross-border Inter-bank Payments System**, **CIPS**, may be an indication of frustration with the international community with financial exclusion driven by de-risking. It is also a serious search for alternatives to current payments systems. It may be an example to be embarked on by the Arab region.
- **China Europe International Exchange** (CEINEX) was established by Shanghai Stock Exchange, Deutsche Börse Group and China Financial Futures Exchange in November 2015. It is the first dedicated platform for China -and RMB- related investment products outside Mainland China – creating new opportunities for growth and diversification.

What is CIPS?

- **CIPS** is a payment system which offers clearing and settlement services for its participants in cross-border RMB payments and trade; with it, the RMB becomes a settlement currency.
- **CIPS** went live on 8 October 2015, and on 25 March, 2016 signed an MOU with **SWIFT**. Currently it has direct participation of 19 Chinese and foreign banks set up in mainland China and 176 indirect participants.
- **CIPS** will have 4 key features. It:
  - enables cross-border RMB clearing among both onshore and offshore participants
  - uses international standards and be multilingual
  - can handle payments 17 time zones simultaneously
  - Runs on ISO20022 standards, thus optimizing mapping between SWIFT message formats and CNAPS message formats

Proposals for “Compliant” re-risking to dampen consequent Financial Exclusion in Arab countries

a. Arab Payments System, APS

1. The IMF recommends for countries facing severe loss of CBRs and diminishing access to the global financial system to consider the feasibility of temporary mechanisms such as **regional arrangements** to provide payment clearing services.

2. The AMF's annual meeting in October 2016, reviewed and approved a study conducted by Booz which found an Arab Payments System can provide an efficient solution, with real-time settlement, and cost effectiveness (15-20% of current transaction costs) for intra-Arab payments and settlement. It will bring down the cost of intra-regional transactions substantially. Booz Allen Hamilton will complete a final study detailing the required infrastructure of the proposed **APS** in 2017. Issues relating to domicile, stages of implementation, denomination of the currency(s) to be used, amendment of national laws, where necessary, are under discussion.

3. The proposed **APS** is intended to serve Arab countries, members of the AMF, only. It does not side-step international compliance requirements. On the contrary: it would help member countries build a harmonized regional compliance system commensurate with international requirements. The feasibility of the **APS** derives from the fact that regional integration is not justified by trade flows only, but also by growing capital flows. It will support the development of bank systems and will help empower a large sector of the migrant Arab workforce and their families.

b. Regional Consultative Groups & Supervisory Colleges

1. **Regional Consultative Group (RCG)**: Arab countries members in the MENA Financial Stability Board region, have recently formed a RCG, the 6th such Group established by the Financial Stability Board.

2. The MENA RCG should work on establishing a **Supervisory College (CG)** to enhance information exchange and cooperation between supervisors at MENA regional level. This Supervisory College could be modeled on Basel Committee on Banking Supervision's "Principles on Supervisory Colleges" (BIS October 2010). It can also coordinate with G-SIFI's and other international banking groups that are key to financial flows of this region.

c. Need to grow MENA/Arab Regional-SIFI's

- MENA **RCG** and **CG**'s can pave the way to strengthen regional financial integration efforts. MENA/Arab banking systems possess some **domestic** banking institutions - **D-SIFI**'s - that are key and materially important for developing its markets and expanding financial inclusion to its populations. These D-SIFI's have limited presence in other MENA countries.
- These should step in and assume some of the financial intermediation functions of the G-SIFI's. MENA/Arab countries would need to relax their entry regimes to enable D-SIFI's to establish satellite branches, joint ventures, or subsidiaries.
- **D-SIFI**'s can grow into **R-SIFI**'s (Regional), similar to Japanese SIF's with activities linked to regional trade flows. In the initial stages they can build a regional correspondent banking web with international outreach: they can assume some of the international trade financing activities of their Global counterparts. **R-SIFI**'s can also assume underwriting functions for private and public sector debt issues. They should become central to the promotion of financial intermediation, and ultimately financial integration in the region.

d. The Digital World

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