Reserve Bank of New Zealand
Te Pūtea Matua

Correspondent banking in the Pacific.

Te tariwai hononga pēke o Te Moana-nui-a-Kiwa

1 July 2021

Whakarāpopototanga | Executive Summary

Correspondent banking relationships are vital to the economic prosperity of Pacific nations. By facilitating domestic and cross-border payments and currency exchange, they enable trade, foreign investment, and remittances. Australian and New Zealand banks are important providers of correspondent banking relationships and broader financial services in the region.

However, correspondent banking relationships in the Pacific region are in decline. Globally, rising risk management and compliance costs in relation to anti-money laundering and countering financing of terrorism (AML/CFT) requirements and economic sanctions are contributing to a worldwide contraction in the correspondent banking network. In the Pacific, these global factors are exacerbated by challenging commercial conditions and under-development of regulatory compliance capabilities. As a result, some Australian and New Zealand banks are choosing to reduce or withdraw their services to some parts the region.

The consequences of an unchecked withdrawal of correspondent banking services could be significant for many small Pacific nations. The cost of accessing financial services throughout the Pacific is high, and many countries are heavily dependent on the international payments flows that come from tourism and remittances. Continued contraction in the already sparse correspondent banking network would result in a concentration of payments services through a few fragile channels or force payments flows into riskier networks, increasing financial system risk, putting upward pressure on the cost of remittances, and potentially disrupting crucial payments channels.

He aha te mate? | The withdrawal of correspondent banking relationships in the Pacific

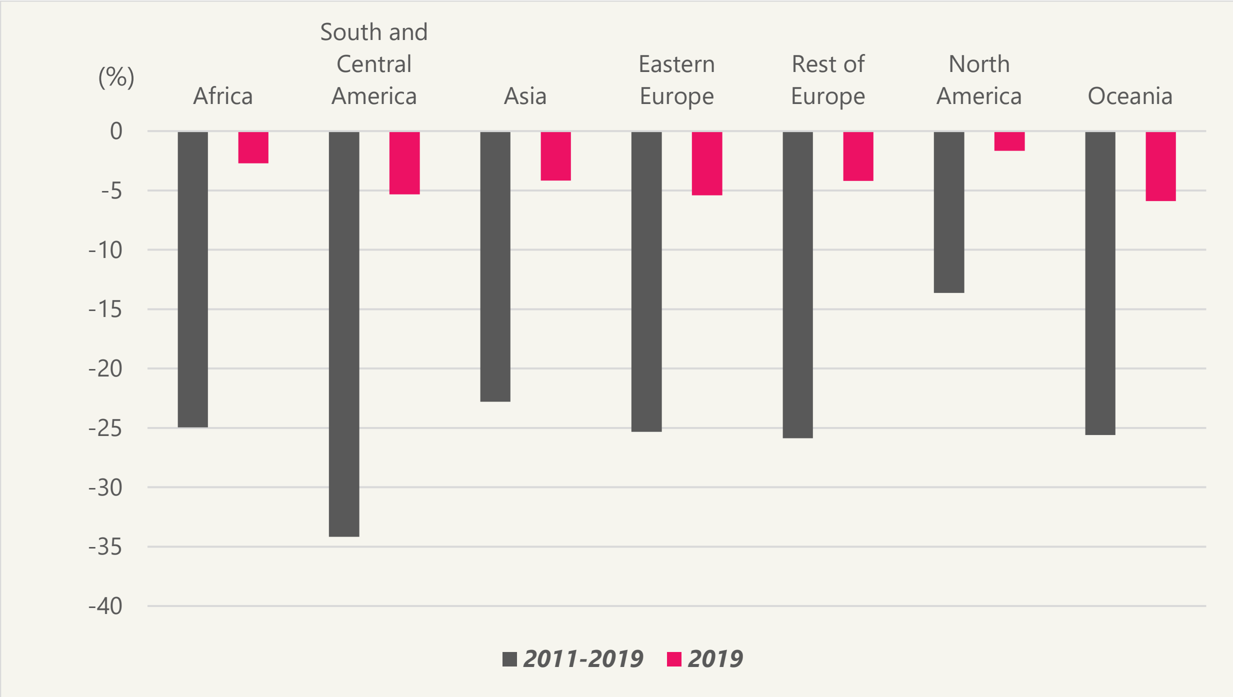
In the context of cross-border payments, a correspondent banking relationship is the provision of a deposit account by one bank (the correspondent) to another (the respondent) in another country, generally for the purposes of cross-border payments and currency exchange.[1] Globally, correspondent banking relationships are the primary mechanism for international cross-currency payments which enable trade, foreign investment, and remittances.

Globally, correspondent banking relationships are in decline. In the period from 2011-2019, the number of active cross-border correspondent banks worldwide fell by 22 percent, with significant declines across all major regions (Figure 1).[2]

[1] A number of broader definitions of correspondent banking relationships have been used elsewhere. For example, the Anti-Money Laundering and Countering Financing of Terrorism Act 2009 provides a broader definition which covers the provision of all banking services.

[2] CPMI correspondent banking chartpack (2020). The count of active correspondents measures, corridor by corridor, the number of banks that have sent or received messages via the SWIFT network. As a result, correspondents present in more than one corridor are counted several times. This measure differs slightly from the broader notion of correspondent banking discussed in this paper, but serves as a useful proxy.

Figure 1: Decline in the number of active correspondents by region



Source: SWIFT BI Watch and National Bank of Belgium, CPMI

The decline in correspondent banking relationships in Oceania is broadly in line with global averages over this period. However, this masks the disproportionate effect on small Pacific island nations. While Australia and New Zealand continue to maintain strong global payments connections, the retreat of correspondent banking from the rest of the South Pacific has been among the largest in the world. For the period from 2011 to 2019, correspondent banking relationships fell 48 percent in Melanesia and 44 percent in Polynesia. (Figure 2).

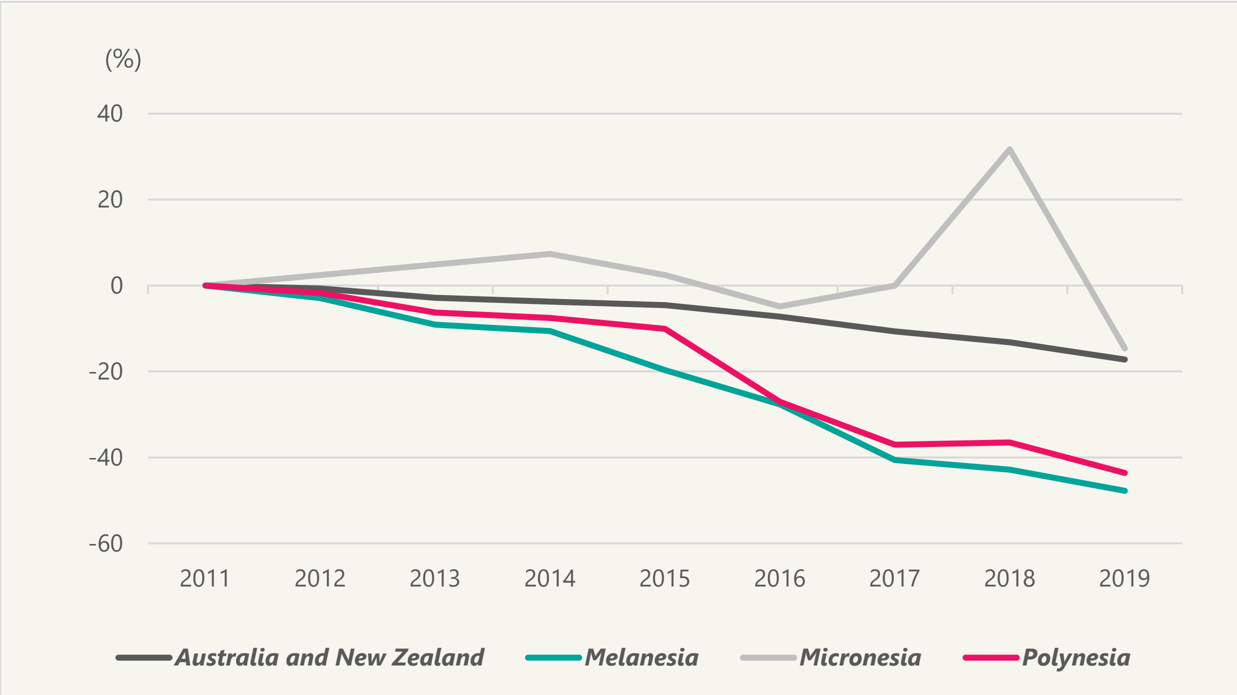
While the rate of retreat of correspondent banking relationships appears to have plateaued in many parts of the world, this is not the case in the South Pacific. In 2019, the number of active cross-border correspondents fell by 11 percent in Melanesia and 9 percent in Polynesia, compared to a global decline of 3 percent.

Data for 2020 and beyond are not yet available. However, emerging reports indicate that the retreat of correspondent banking relationships has continued, and even accelerated in some parts of the Pacific. The contraction in the network has reached a critical level where some domestic Pacific banks may find themselves cut off from safe, reliable, affordable access to the global financial system.

The International Monetary Fund (IMF) reports that in some small states, the loss of correspondent banking relationships has reached critical levels. [3] To highlight a recent example, in April 2021 the IMF reported that the National Bank of Tuvalu is at risk of losing its only correspondent banking relationship with an Australian bank.[4]

[3] International Monetary Fund (2017) Challenges in Correspondent Banking in the Small States of the Pacific
[4] International Monetary Fund (2021) Tuvalu: Staff Concluding Statement of the 2021 Article IV Mission (imf.org)

Figure 2: Changes in the number of active correspondents in Oceania by sub-region[5]



Source: SWIFT BI Watch and National Bank of Belgium, CPMI

He aha i pērā ai? | Drivers of withdrawal

The global and domestic drivers of the retreat of correspondent banking relationships are complex and closely linked. In 2015 and 2017, global surveys by the World Bank[6] and the Financial Stability Board's Correspondent Banking Coordination Group[7] found that the primary reasons banks cited for withdrawing correspondent banking services were;

- Low profitability
- Change in business strategy
- Risk management and regulatory compliance costs
- Low risk appetite

In the Pacific, these factors have come together to result in an environment where some banks have chosen to exit existing correspondent banking relationships, and there is low willingness to extend new ones.

At the global level, one of the primary drivers of the retreat is the increasing burden associated with AML/CFT regulations, tax transparency codes, and compliance with global economic and trade sanctions. Over the last decade, increasingly stringent regulatory requirements have increased the costs of managing the risks associated with correspondent banking. At the same time, global sentiment towards the seriousness of financial crime has shifted. As a result, many banks have opted to close correspondent bank accounts rather

[5] Counterparties abroad receiving MT 103 and MT 202, excluding MT 202COV
[6] World Bank (2015) Withdrawal from correspondent banking: where, why, and what to do about it
[7] Financial stability Board (2017) Correspondent banking data report

than investing in the due diligence that is necessary to operate them responsibly. This activity is widely known as “de-risking”.

Pacific banks are particularly vulnerable to de-risking for a number of reasons. Firstly, the small, low-income markets of the Pacific provide challenging commercial conditions. Even without regulatory compliance costs, low profitability results in weak incentives for Australian and New Zealand banks to continue to service existing correspondent banking relationships, and even weaker incentives to establish new relationships.

Secondly, while the Pacific is not generally considered a high-risk region, some Pacific economies present elevated levels of AML/CFT risk. For example, remittances are incredibly important to some Pacific economies. While remittance flows are desirable and legitimate, the large volumes of low value payments associated with remittances can create additional risk of money laundering and terrorism financing, and therefore require careful risk management. Other factors, including the use of offshore banking licences, high perceived corruption scores, and historical appearance on Financial Action Task Force and EU monitoring lists affect individual country risks.

Thirdly, regulatory compliance capabilities amongst Pacific banks and the other financial institutions they service are less developed than in other parts of the world. This issue is exacerbated by the low proportion of Pacific populations that have formal government identification records such as ID cards, birth certificates or passports.

Finally, reputational risk is another important factor contributing to banks’ general reluctance to have correspondent banking relationships. Given the nature of the crimes sometimes associated with money laundering and terrorism financing, the reputational consequences can be severe. In 2019, Westpac Australia was required to pay AUD 1.3 billion in fines after a series of AML/CFT infringements which included failing to report a large number of payment instructions to the Australian regulator AUSTRAC. Contained within this large number of unreported transactions were some that were linked to child exploitation in the Philippines. This link dominated media headlines and caused a number of Australian and New Zealand banks to review their Pacific positions.

In many cases, de-risking is justified at the individual bank level, for example where a bank lacks the capability to provide effective due diligence. However, in many cases, blanket de-risking policies among correspondent banks have resulted in a loss of access for many small banks without consideration of the broader negative consequences. This outcome is inconsistent with the risk-based approach recommended by the global AML/CFT body the Financial Action Task Force [8] and is directly in conflict with the purposes of New Zealand’s *Anti-Money Laundering and Countering Financing of Terrorism Act 2009*, one of which is to contribute to public confidence in the financial system. In March 2021, the Reserve Bank of New Zealand reiterated that banks’ obligations under the AML/CFT Act require measured risk management and do not justify blanket de-risking.[9]

A recent study[10] by the BIS attempts to untangle the country specific factors that contribute to the loss of correspondent banking relationships. It finds that strong GDP and trade growth are associated with a more modest withdrawal of correspondent banking services, whereas

[8] See FATF Guidance on Correspondent Banking
[9] Managing, not avoiding risk - improving financial inclusion Reserve Bank of New Zealand AML/CFT Newsletter 15 March 2021
[10] Rice, T, G von Peter, and C Boar (2020) On the global retreat of correspondent banks, BIS Quarterly Review

high corruption and perceived risk factor are strongly associated with a faster rate of decline. It is less clear from the study whether a country's size or starting level of income are key drivers of the retreat. However, it is clear that small and developing economies have smaller and more fragile networks of correspondent banking relationships to begin with, making them particularly vulnerable to further withdrawal.

Ngā tukunga iho | Consequences of withdrawal

The potential consequences of the continued withdrawal of correspondent banking relationships throughout the Pacific are significant. In the extreme case, a near-complete loss of correspondent banking relationships could severely limit a nation's access to the global financial system, and with it the ability to perform the basic payment and currency exchange transactions which facilitate remittance and trade. Many people could lose access to payment and remittance services, while others might turn to unregulated payment options outside of the formal banking sector.

Even if the extreme case is avoided, continued decline in access to correspondent banking in the Pacific could see prices for cross-border banking services rise, and may increase financial stability risks. As the number of active correspondent banking relationships falls, while the volume and value of payments continue to rise, the concentration of services increases. This increase in concentration makes the system more vulnerable to the disruption or failure of a particular channel. If concentration of services reaches levels where competitive forces are no longer effective, this could put upward pressure on the cost of accessing financial services.

Another unintended consequence of the de-risking by Australian and New Zealand banks is that Pacific banks may be driven to replace existing relationships with lower-quality ones. Banks rely on correspondent banking relationships to deliver the services they offer. If a bank loses its correspondent banking relationship with a New Zealand bank, it is unlikely to stop providing those services. Instead it will look for a replacement relationship, and may need to turn to a lower quality bank with weaker regulatory compliance capabilities in order to maintain access to global markets. If the new correspondent bank does not have significant trade and remittance links throughout the Pacific, transactions will likely be routed through costlier, less-direct routes, ultimately resulting in greater risk for domestic Pacific banks and higher costs for their customers.

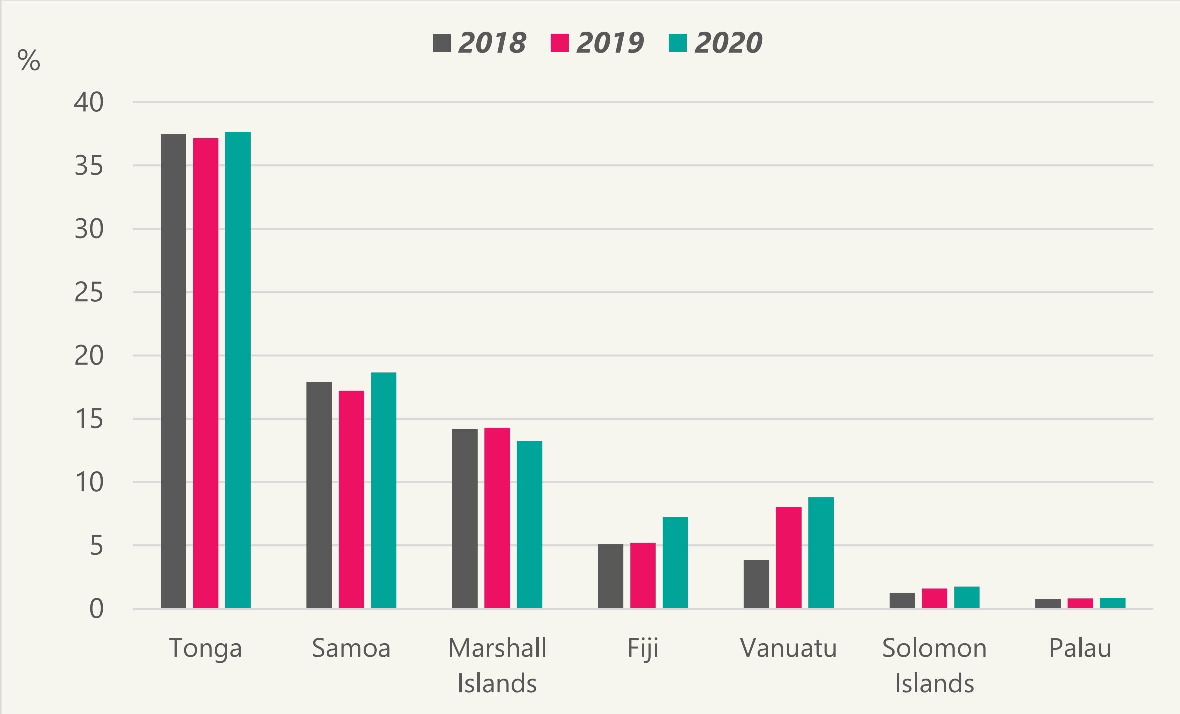
The negative consequences of declining access to correspondent banking services are non-linear. Where a country has a large and diversified correspondent banking network, the loss of some of those relationships may have only moderate impacts, as existing correspondent banks fill the gaps. However, where a country has only a few existing cross-border correspondent banking relationships, as is the case in some parts of the Pacific, the loss of even one relationship could have a material impact on the concentration of services and the fragility of the financial system. In 2017, an IMF report[11] acknowledged that the withdrawal of correspondent banking relationships in the Pacific had reached a critical level in some countries. Further withdrawal since that time has exacerbated the risks.

Many Pacific island nations are particularly vulnerable to disruption in cross border payments, due to the significance of remittance flows for the economic wellbeing of residents. In Tonga, for example, remittance payments are estimated to have accounted for up to 40 percent of GDP in 2020 (Figure 3). The relative importance of remittances for Pacific Islands has been

[11] International Monetary Fund (2017) Challenges in Correspondent Banking in the Small States of the Pacific

exacerbated by the impacts of COVID-19 on trade and tourism, and ongoing economic pressures both at home and abroad mean that remitters are sending smaller volumes more frequently. [12] ANZ, recognising this heightened vulnerability, is waiving fees on Pacific remittances until at least September 2021.

Figure 3: Remittances as a share of GDP for selected Pacific nations[13]



Source: World Bank

A recent World Bank study[14] explored the consequences of the withdrawal across eight emerging economies, including one Pacific economy, and found some cases of significant disruption at the firm-level. For example, one bank found that its average cost per transaction had risen from USD 9 to USD 50-60 after switching correspondent banks. In another country, one bank lost all its correspondent banking relationships for a period of four months, and was unable to meet some of its obligations or provide some foreign currency services during that period.

However, impacts at the macroeconomic level are harder to identify. Every country's situation is unique, and the same study did not find any systematic evidence of an increase in the costs or a reduction in the volume of international payments as a result of the withdrawal of CBRs. That said, Pacific nations are at the forefront of the global retreat. Given the likely non-linearities, it's possible that the consequences of a continued withdrawal of correspondent banking relationships in the Pacific could be more severe than those observed elsewhere to date.

[12] World Bank (2020) Pacific labour mobility, migration and remittances in times of COVID-19

[13]

[14] World Bank (2018) The decline in access to correspondent banking services in emerging markets

He aha te mahi? | Reserve Bank engagement

The potential costs of the retreat of correspondent banking relationships and the heightened risks in the small states of the Pacific are widely acknowledged in the international financial community. Recent studies by the IMF[15], World Bank[16], RBA[17], and others make recommendations along four key dimensions;

- better awareness, monitoring, and information sharing;
- improving AML/CFT risk-management and know-your-customer capabilities for respondent banks;
- clear articulation and enforcement of a risk-based approach to AML/CFT regulation; and,
- development of technology-based solutions to support payments and remittance flows.

The Reserve Bank of New Zealand's Pacific Remittance Project was established in mid-2019 with the aim of enhancing access to, and reducing the costs of remittances to the Pacific. The project is currently exploring a range of initiatives including ongoing information gathering exercises, policy/legislative changes and the development of a regional electronic know-your-customer facility. Elements of the project, such as the use of digital identity and increasing compliance levels, have the potential to positively influence some of the underlying factors contributing to the withdrawal of correspondent banking relationships. However, there is a risk that our efforts could be undermined if Australian and New Zealand banks withdraw their services from the Pacific before the Pacific Remittance Project's work is completed.

Whakakapinga | Conclusions

The global retreat of correspondent banking relationships particularly affects Pacific island nations. Both the pace of the retreat and the potential impact are heightened relative to global peers, and early indications are that the problem continues to worsen.

While we are yet to observe direct negative consequences for customers, domestic Pacific banks and money remittance providers are already struggling to secure a sufficient network of correspondent banking relationships. If the problem progresses unchecked, it is possible that more serious negative consequences will emerge at a systemic level.

The underlying drivers are global in nature, and therefore will require global coordination to address. In February 2021, the Financial Action Task Force (FATF) launched a new project to study and mitigate the unintended consequences of the FATF Standards.[18] It is hoped that this work will become part of a wider conversation about managing the downstream consequences of AML/CFT risk management and compliance.

At the same time, a number of regional challenges can be addressed, namely, better data and monitoring, increasing the compliance capabilities of Pacific focused financial institutions, and changing regulatory conditions in correspondent jurisdictions like Australia and New Zealand. The Reserve Bank's Pacific Remittances Project may help address some of these key issues. Despite these interventions, there is a risk that our efforts could be undermined if

[15] International Monetary Fund (2017) Challenges in Correspondent Banking in the Small States of the Pacific
[16] World Bank (2018) The Decline in Access to Correspondent Banking Services in Emerging Markets : Trends, Impacts, and Solutions
[17] Reserve Bank of Australia (2018) Developments in Correspondent Banking in the South Pacific
[18] FATF (n.d.) Mitigating the Unintended Consequences of the FATF Standards

Australian and New Zealand banks withdraw their services from the Pacific before the Pacific Remittance Project's work is completed.