COMPLIANCE/REGULATORY RISK IN FINANCIAL ACTIVITY (*DE-RISKING*) IN THE AMERICAS

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I. INTRODUCTION

The post financial crisis scenario in 2008, is a banking industry facing lower interest rates and margins; new regulations that represent higher compliance costs and; the emergence of new and dynamic competitors who represent a threat to traditional financial institutions.[1]

Regarding compliance costs, personnel expenses in compliance functions would be reaching a maximum of 10% of the total expenditure on staff.[2] In addition, about 85% of professionals in the financial services industry considers that regulatory compliance costs will increase during 2016.[3] The response of financial institutions before the mentioned scenario has been redirecting their business models.

One of the actions aimed at changing the business strategy is the "De-risking". A process motivated by a lower risk appetite of financial institutions when facing high-risk situations.[4] Through this process, financial institutions abandon or significantly reduce activity in business lines in order to avoid compliance and/or regulatory risk. Although the de-risking is mostly associated with the risk of money laundering and terrorist financing (ML/FT), the Financial Action Task Force (FATF) indicates that this process goes far beyond prevention of ML/FT[5].

Before the financial crisis, it is estimated that big banks like BNP Paribas, Citigroup, HSBC and ING earmarked 14 trillion dollars to trade finance; however, the establishment of new regulation and penalties have reduced the participation of banks in this market,[6] leading to the entrance of new players who are attracted by the low risk of such financing, which is collateralized by its traded merchandise.

In another line of business, when financial entities act as correspondents, they trust in their local counterparts to develop systems that mitigate the risk of transfer of illicit funds; however, sometimes these systems have failed, leading to the imposition of fines. Given this situation, some banks have chosen to withdraw from the activity of correspondent banking, affecting emerging economies because of the limitation of their agents to transfer and receive money,[7] having implications on financial inclusion and sustainable growth.[8]

In this regard, regulators should not be aside of this problem, given that its mandate is to contribute to the stability of the financial system. Furthermore, if the regulated financial sector cannot provide the

[1] Wall Street Journal. "After Crisis, Banks´ Model Faces Disruption". January 19, 2016.
[2] Wall Street Journal "Culture of Compliance – Experts Weigh in How It´s Changed". February 9, 2016
[3] Duff & Phelps "Global Regulatory Outlook 2016"
[4] Alliance for Finance Inclusion. "G-24–AFI Roundtable in Peru: Central Bankers Must Act to Stem the Tide of De-Risking". October 2015.
[5] Financial Action Task Force "Drivers for "de-risking" go beyond anti-money laundering / terrorist financing"
[6] The Economist. "Commodity Trade Finance". September 26, 2015.
[7] Financial Stability Board "Keep finance safe but do not shut out the vulnerable" Mark Carney and Bertrand Badré. June 2015.
[8] Huffington Post "De-Risking Is De-linking Small States from Global Finance". October 22, 2015.

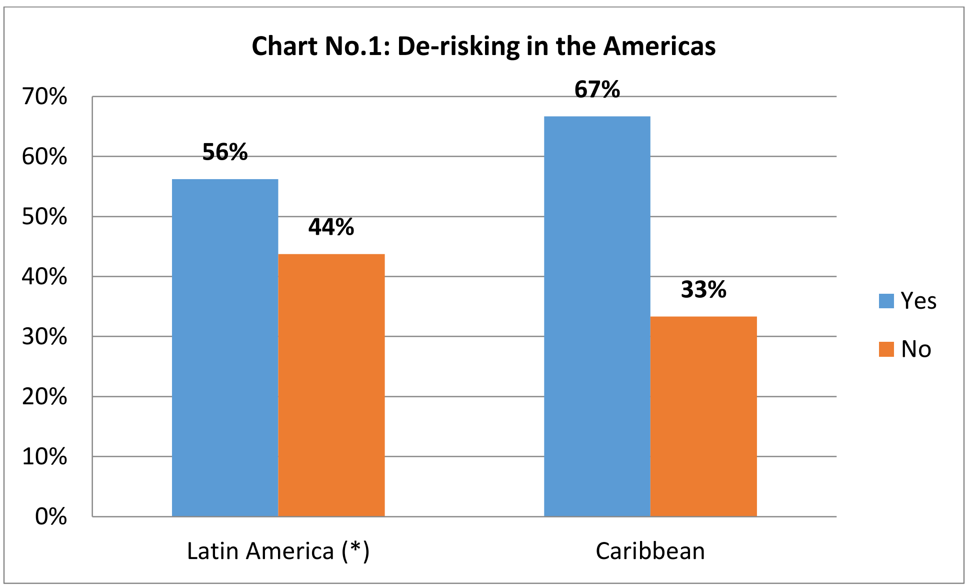
services demanded by the economy, funds maybe be allocated through unregulated systems ("shadow banking") increasing the risk of illicit activities and arbitration.

Although this process is at an early stage, the Association of Supervisors of Banks of the Americas (ASBA) is interested in the potential impact that the process of de-risking may be having in ASBA's Associate Members (MAS). For this reason, a survey was distributed, obtaining responses from 25 MAS.[9] The main findings of the consultation are detailed below.

II. MAIN FINDINGS

1) De-risking in the Americas

The de-risking is becoming a global issue and the Americas is not aside of it. Most of MAS (60%) consider that a process of de-risking is occurring in their jurisdiction, in other words, the activity of some financial product, service or channel (PSC) has been reduced due to the compliance/regulatory risk. This situation occurring mostly in the Caribbean region.



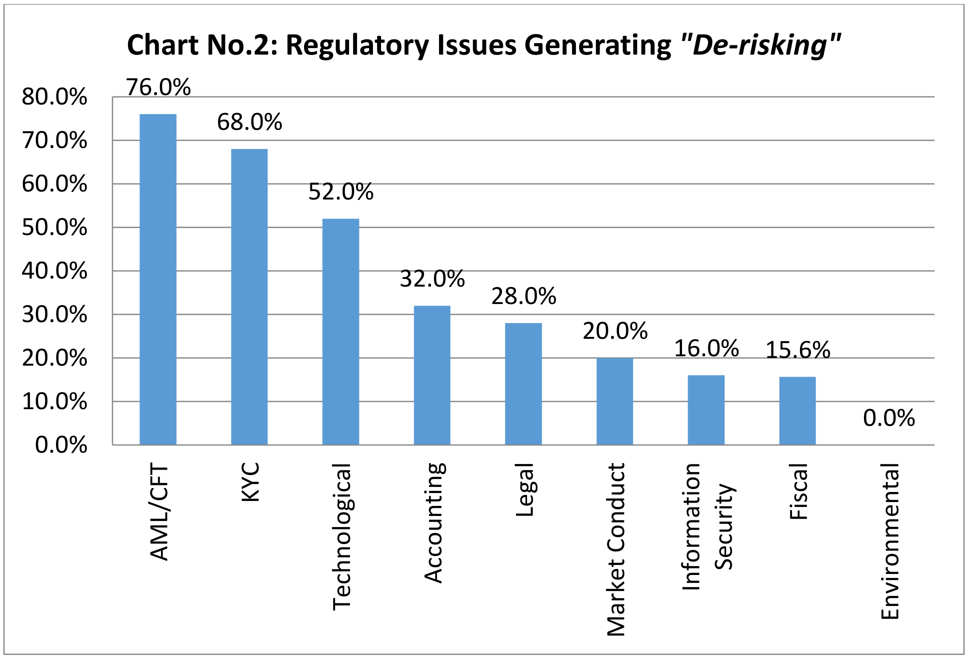
(*) Latin America and Spain

Additionally, several institutions have decided to limit or suspend some business lines, because of stricter regulation in accordance to international standards, as well as policies of foreign correspondent banks which operate with local financial institutions.

[9] Associate Members which responded the survey: Bahamas, Barbados, Belize, Bolivia, Brazil, Chile, Costa Rica, Ecuador, El Salvador (Central Bank and Superintendency of Financial System), Guatemala, Haiti, Honduras, Cayman Islands, Jamaica, Mexico, Panama, Paraguay, Peru, Dominican Republic, Spain, Suriname, Trinidad and Tobago, Turks and Caicos and Uruguay.

2) Regulatory Requirements and De-risking: Beyond AML/CFT

The FATF notes that although de-risking is mostly associated with the risk ML/FT, this is an issue that goes beyond that risk and could be associated with other factors.[10] The foregoing is confirmed in the responses of supervisory agencies, which note that the main issues that generate de-risk are the Anti-money Laundering / and Counter Terrorist Financing (AML/CFT) regulatory requirements and Know your Customer (KYC) policies, 76% and 68% respectively; however, there are other important issues to be considered such as the technological aspects (52%), accounting (32%) and legal issues (28%).

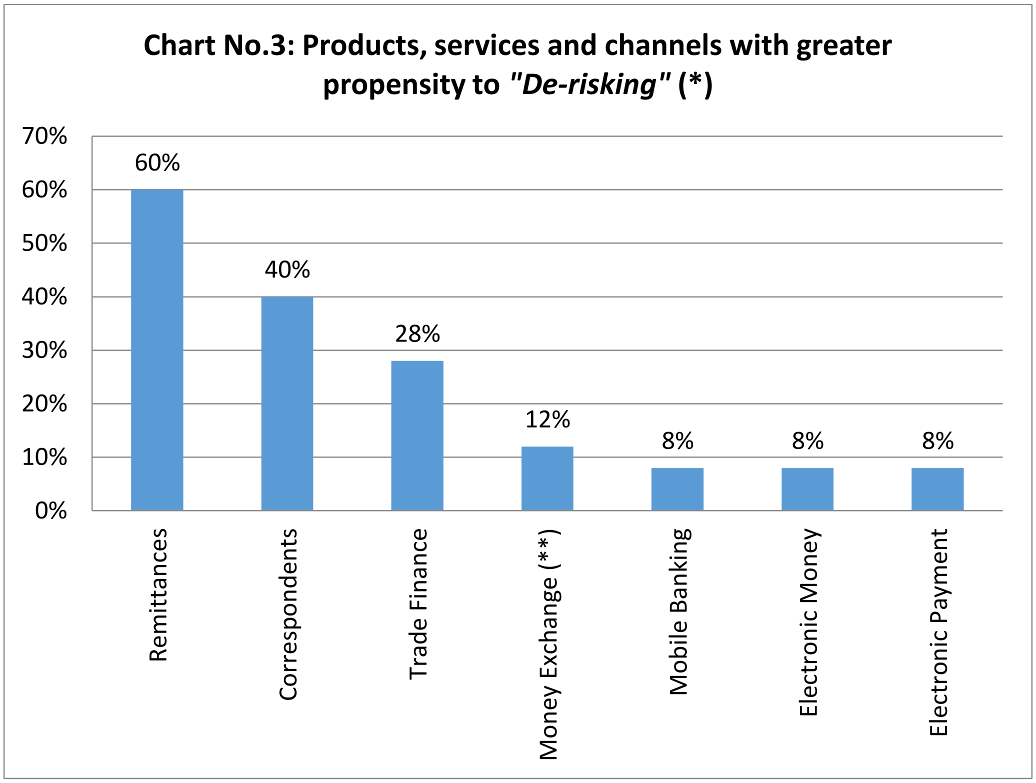


3) Business Lines Most Affected by De-risking

Each financial activity, by its nature and risks involved, is associated with certain regulatory requirements. It has been identified that the regulatory aspects that have greater impact on the de-risking are mainly associated with AML/CFT, in that sense, the activities most affected are those exposed to that risk.

According to supervisors of the region, PSC that have a higher propensity to de-risking are remittances (60%), followed by correspondents (50%), trade finance (28%) and currency exchange (12%), which are activities that are highly exposed to the risk of ML/FT.

[10] Financial Action Task Force "Drivers for "de-risking" go beyond anti-money laundering / terrorist financing".



(*) In the survey question, it was the option of marking all product alternatives that are considered prone to de-risk. The percentages refer to the proportion of countries to the total (25) considered in every alternative.

(**) Not considered in the alternatives proposed in the survey.

Moreover, PSC such as mobile banking, electronic money and payments, each with 8%, are associated with the risk of ML/FT, as well as to technological regulatory requirements.

Other PCS that are prone to de-risking are deposits of high-risk customers, ATMs, physical transportation of cash, fiduciary activities. However, it is considered as a process that affects customer groups and not specific products.

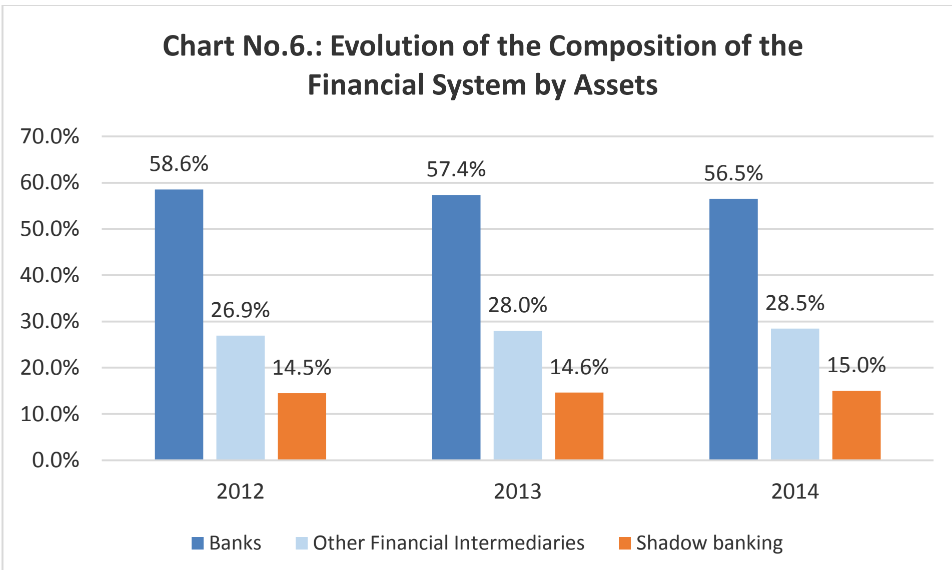
Other identified activities that may be affected by de-risking, range from specific, such as casinos, arms and explosives, to more general segments as small businesses.

4) Impact of the De-risking Process of Developed Markets on Emerging Markets

There is consensus that a process of de-risking in developed financial markets will have a direct impact on emerging markets. The impact maybe given in two ways. Firstly, through foreign banks operating in the region. Given regulatory requirements, the headquarters may decide to increase the costs of their services or withdraw from some countries or business lines that have a high risk relative to the profitability it generates. Secondly, the impact would not only be given through foreign parent banks operating in the region, but through foreign banks that provide correspondent services, remittances, foreign exchange operations and trade financing, which by a decision to de-risk may choose not to continue providing these services in the Americas.

For example, due to regulatory risks, it is estimated that in the Caribbean, more than ten banks in at least five countries have seen significantly affected their relationship with correspondent banks.[11] Also, some banks in the United States (US) would be cutting operations with correspondent banks in Mexico, situation that significantly impacts the financial activities, since Mexico is the fourth largest global recipient of remittances from the US, USD 24 billion in 2014 according to the World Bank.[12]

This situation would lead to an increase in operating costs and/or loss of market access of operators in the region; leading to the increase of shadow banking, such as Fintech or unregulated investment funds, which will become potential suppliers of services to the underserved agents. According to the Financial Stability Board (FSB),[13] shadow banking participation has been growing as seen in the chart below.



Source: Financial Stability Board.

5) <u>Quantification of the De-risking in the Region</u>

In general, countries in the region did not indicate having quantification mechanisms of de-risk, however some stated that as part of regular monitoring, could identify situations related with this process or have periodic statistical reports that allows them to monitor it.

In the region there are two agencies which have specific supervisory practices for de-risking. These actions are questionnaires to consult supervised entities if the provision of a financial services has been affected by regulatory/compliance risk.

[11] "Correspondent Banking Challenges in the Caribbean", presentation by Charles Enoch y Jacques Bouhga Hagbe in "2015 High Level Caribbean Forum". September 2015. St. Kitts and Nevis.

[12] Wall Street Journal. "U.S. Banks Cut Off Mexican Clients, as Regulatory Pressure Increases". January 22, 2016.

[13] Financial Stability Institute. "Global Shadow Banking Monitoring Report 2015". November 2015.

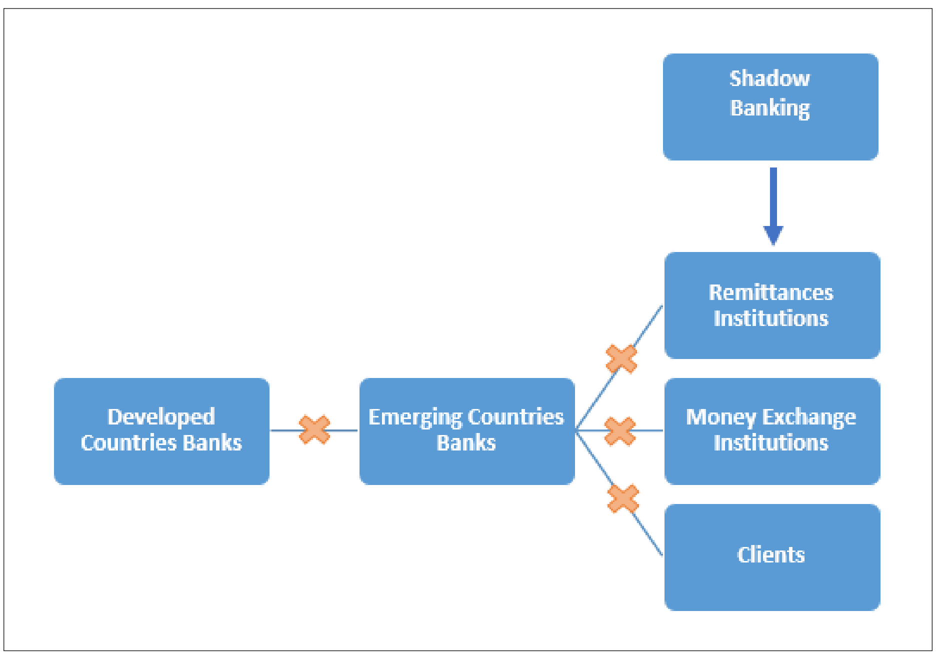
III. CONCLUSSIONS

According to supervisors, a process of de-risking is occurring in the region, mainly due to regulatory requirements for AML/CFT and KYC policies. Business lines, such as remittances, trade finance and correspondent banking, where the ML risk is present, are the most affected.

There is also consensus that the de-risking process that is occurring in developed financial markets would impact on emerging markets. This is due to de-risking decisions of foreign parent banks operating in the region as well as foreign entities that stop providing to the region remittance services or correspondent banking among others.

In this regard, because of compliance risk, parent banks in developed countries choose to halt their operations with banks in emerging countries, what is known as "blanket solution".[14] The latter in turn, choose to cut their operations with remittance and money exchange companies because of regulatory requirements. In this process, operators loss market access leading to the increase of shadow banking in the region.

Chart No.7: De-risking Process



Given this situation, the FATF recommends that financial institutions implement a risk-based approach for AML/CFT and not to abandon a business line without first having made the effort of identifying and mitigating the individual risk[15]. Additionally, a de-risking process could generate the opportunity for the develop of new unregulated players (shadow banking); therefore it is important to level the playing field through establishing similar conditions as those for the regulated participants.

[14] Refers to the decision to completely abandon a business line, instead of a case-by-case risk assessing.

[15] Huffington Post. "De-Risking Is De-linking Small States from Global Finance". October 22, 2015.

Moreover, since de-risking affect the provision of financial services and competition, it is important for supervisors to establish an appropriate balance between regulatory requirements and the viability of the financial market as well as a proportional supervision to risks of operations. Finally, it is also important that the supervisor identifies if a de-risking process is being used as a strategy to exert pressure from the industry to the supervisor.