

The Trend Of “De-Risking” In International Finance and Its Impact on Small Island Developing States

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Question

What challenges do the loss of correspondent banking relationships or “de-risking” create for the post-COVID-19 economies of Small Island Developing States (SIDS)? Also, give a brief overview what can be done about it by governments and development agencies?

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1. Summary

This rapid review synthesises the literature from academic sources, knowledge institutions, non-governmental organisations (NGOs), and trusted independent media outlets on the challenges small island development states (SIDS) face when they lose correspondent banking relationships (CBRs). The rapid review concludes that, although the loss of CBRs is a global phenomenon, **regions with SIDS, such as the Pacific and Caribbean, have seen the highest rates of withdrawals.** During the last decade, local and regional banks in SIDS have lost and continue to lose bank accounts at large global banks to a critical level, sometimes having only one or none CBRs with banks in major economies, such as the United States, the United Kingdom, the European Union or Australia. **This means that local banks have reduced access to financial services related to cross-border financial transactions, impacting on remittances and trade finance.**

SIDS were amongst the countries that suffered the most from the Covid-19 pandemic, mainly due to their dependence on the tourism industry. For their recovery, they need access to the international financial system. For example, during the pandemic households in SIDS relied heavily on remittances, while local businesses need access to credits and trade finance to scale up, increase productivity, or enter new markets. However, **with the loss of CBRs, recovery of essential economic sectors in SIDS and receiving remittances becomes more complex and more expensive.**

This is what the literature calls “de-risking” by global financial banks. International financial institutions have significantly reduced the number of CBRs by withdrawing from entire regions, jurisdictions, or categories of clients **without due consideration of individual customers’ risk profiles, avoiding compliance and regulatory risks rather than managing risks.** This means that international banks make blanket risk decisions without considering the implications of such decisions for local banks, local money transfer operators (MTOs), or businesses in SIDS.

There are many drivers that could explain de-risking decisions. Increased anti-money laundering and combating the finance of terrorism (AML/CFT) regulations, regulations that increase tax transparency, and international and regional economic and trade sanctions, have made the provision of correspondent banking services a less financially attractive business proposition. As such, high-volume, low-return businesses, such as correspondent banking, have become less attractive for correspondent banks. The reduced appetite for CBRs is not purely cost related, but also is driven by fear of reputational risks. Furthermore, correspondents lack knowledge and expertise of specific customers’ business models, which has led to some businesses and institutions being refused to enter into or maintain a business relationship, such as MTOs and non-profit organisations. Another factor is that smaller local banks and MTOs have less capacity and knowledge to scrutinise their clients and comply with AML/CFT regulations.

The result is that correspondent banks withdraw CBRs with local banks in what they believe are higher-risk countries with higher compliance costs and lower profit margins. However, this has affected many SIDS. **SIDS have characteristics that exaggerate de-risking decisions,** such as small internal economies, low capacities for specific tasks (e.g. complex risk assessments), and persistent perceived high risk levels due to their reliance on cash-transfers and remittances, while some SIDS are linked with drug smuggle and money laundering activities due to their status as global financial hubs with less transparency.

For SIDS the implications of the reduction in CBRs are severe. First, they rely heavily on remittances. By making remittance transfers more expansive and excluding many MTOs from the international financial system, a small decline in remittance inflow can have a huge impact on household incomes and potentially on economic growth. This is particularly true after a shock (e.g. natural disaster, health or economic crisis) for which SIDS are more vulnerable. For recovery, they need access to remittances and other timely financial services through CBRs. There is even evidence that the loss of CBRs affect humanitarian responses. **There is emerging evidence that remittances and other financial transactions are being diverted to less transparent, informal hand-carry of cash across borders or to costlier remaining banking channels.** This means that seeking more transparency and compliance to AML/CFT regulations has resulted in the opposite, pushing smaller, often poorer clients out of the formal financial system, and reducing progress made towards financial inclusion.

The literature also mentions that when governments struggle to access the US dollar or other Western currencies, they seek alternatives, for example by establishing CBRs with Chinese banks who are less reluctant to do so. Furthermore, **losing CBRs could have implications for the tourism sector on which SIDS depend heavily for their economic growth and for receive foreign currencies.** The absence of the credit card services or higher costs for such services could negatively impact the viability and competitiveness of the tourism sectors of SIDS. Overall, the loss of CBRs has the potential to constraint these investment inflows and make it difficult for the repatriation of reinvested earnings. Hence, for a sustainable recovery and to fight climate change, SIDS need better access to the global financial system. However, continued loss of CBRs do the opposite. **Without corrective policy actions, the consequences of continued withdrawal of CBRs could undermine the functioning of the financial system, weaken growth prospects, and reduce resilience to shocks.**

Fortunately, the issue has been raised at high-level dialogues and international institutions such as the International Monetary Fund in cooperation with several central banks and governments are looking for solutions and actions. Policy recommendations mentioned in cited reports show that policy responses seek **improve the capacities of local banks** to comply and respond to changes in regulations. **Local authorities need to improve regulatory and supervisory frameworks, removing legal and practical impediments to information sharing, and establish intermediary (regional) banks.** To do so, technical assistance and trainings need to be provided.

Furthermore, **guidance is needed to correspondent banks to clarify the interaction between AML/CFT obligations and the access to the financial system as a fundamental aspect for development and participation.** Central banks in correspondent bank countries could initiate projects to reduce the costs of remittances to SIDS while improving the compliance processes. A scalable, risk-based application of AML/CFT regulation should be designed to ensure stringent regulation is not imposed on the smallest remittance providers. While on the longer-term SIDS need to reduce cash payments and incentivise electronical payments, for which investments and support is needed.

Finally, the literature mentions **that technological solutions could help SIDS against de-risking.** For example, developing Know Your Customer (KYC) technology and processes for customer due diligence and information sharing between banks and between banks and regulators, national or regional KYC registry, and blockchain technology/distributed ledgers to

reduce the reliance on the banking system for the clearing and settlement of financial transactions.

2. Framing the issue

Correspondent Banking Relationships (CBRs) are essential for the international financial system with international payments depending on them (World Bank Group, 2018).

Correspondent banking involves a financial institution (the correspondent) providing a deposit account or other service to another financial institution (the respondent) for the purposes of currency exchange, handling trade-related documentation and cross-border money transfers (Boulton & Winton, 2018). As such, the correspondent bank executes payments on behalf of the respondent bank and its customers.

Since the global financial crisis in 2008, international financial institutions have significantly reduced the number of CBRs by withdrawing from entire regions, jurisdictions, or categories of clients without due consideration of individual customers' risk profiles; avoiding compliance and regulatory risks rather than managing risks (EBA, 2022; IFAD & World Bank, 2021; World Bank Group, 2018; Erbenová et al., 2016). This process is often referred to as "de-risking". Global financial institutions increasingly restrict account services to regional and local banks and money service businesses, such as money transfer operators (MTOs), which reduces their access to the international financial system or in some cases are completely shut out of it (World Bank Group, 2015).

Haley (2017) mentioned **three forms of de-risking** (this rapid review focusses primarily on the last two):

- Banks closing bank accounts or not opening new ones for certain individuals or businesses.
- Banks withdrawing financial services from money service businesses, such as MTOs.
- Loss of CBRs, large international banks closing bank accounts of local banks.

Low- and middle-income countries (LMICs), particularly the more fragile and smaller ones, depend on well-established CBRs to give local businesses the ability to engage in international trade and households to access financial services (e.g. receiving remittances). However, their local banks are often too small or do not have offices abroad to offer cross-border payment services themselves (Boulton & Winton 2018). Importantly, it is these countries that also depend on humanitarian and development aid (for example, after a natural disaster), but de-risking increasingly restricts and complicates humanitarian and developmental financial flows among countries (World Bank Group, 2018).

What does the data show? **Most of the literature that measures the decline of CBRs used surveys with financial institutions.** The first of this kind, and often cited, was done by the World Bank Group (2015). The survey showed that the Caribbean and the Pacific seem to be the most severely affected regions (World Bank Group, 2015). The World Bank Group (2015) study found that jurisdictions that have faced a sharp decline, include:

- Small jurisdictions with low volumes of business and transactions, particularly in Eastern Europe and Central Asia, the Caribbean, and Africa.

- Small jurisdictions with significant offshore banking activities are particularly affected by the decline of CBRs, particularly the Caribbean.
- Jurisdictions perceived as high risk for money laundering and financing terrorism or those subject to international sanctions, and jurisdictions affected by sanctions by the US Office of Foreign Assets Control (OFAC).
- Economies which are among the top remittance recipient countries (in terms of the share of the total value of remittances compared with Gross Domestic Product - GDP).

Another methodology uses data from the Society for Worldwide Interbank Financial Telecommunication (SWIFT).¹ The Reserve Bank of New Zealand (2021) mentioned that using this data, globally, in the period from 2011-2019, the number of active cross-border CBRs fell by 22%, with significant declines across all major regions. While it is a global phenomenon, the data showed that small economies are among the most affected by CBR withdrawal, losing nearly a third of their CBRs (FSB, 2017; 2018). One of the most affected regions is the Pacific. For the period from 2011 to 2019, CBRs fell 48% in Melanesia and 44% in Polynesia (Reserve Bank of New Zealand, 2021). The Caribbean was also among the hardest hit regions in terms of US-dollar correspondents, with a contraction of about 42% overall from 2011 to 2020 (Atlantic Council, 2022). The analysis also showed that globally the volume and value of cross-border transactions increased in the same period, suggesting a concentration of international transactions using fewer CBRs. These findings are in line with other studies (e.g. Collin, Cook & Soramaki, 2016).

Overall, the findings are clear. On average, small island development states (SIDS) are among the countries that have seen the highest decline in CBRs in the last decade.

Importantly, while the rate of retreat of CBRs appears to have slowed down in many parts of the world, this is not the case for SIDS in the Pacific and Caribbean. For example, in 2019, the number of active cross-border correspondents fell by 11% in Melanesia and 9% in Polynesia, compared to a global decline of 3% (PIFS, 2021). This does not mean that all small island economies are affected similarly. Alwazir et al. (2017) show for the Pacific that the loss of CBRs is largest in Papua New Guinea, the Solomon Islands, and Tuvalu, with smaller losses in Fiji, Tonga, and Vanuatu (Alwazir et al. 2017).

The same for the Caribbean, where Belize (51% decline in CBRs) was mostly affected in the period 2011-2020, followed by St Vincent and the Grenadines (45%) and Dominica (42%) (Atlantic Council, 2022), while another study showed that for example Montserrat was hardly affected (Wright, Kellman & Kallicharan, 2018). Importantly, the three most affected Caribbean islands also show a decline in the total volume of transactions and the total value of the transactions during the same period, while most other Caribbean countries with declining CBRs did increase the volume and value of transactions (Atlantic Council, 2022). For example, Jamaica

¹ However, using SWIFT to measure trends in CBRs have been criticised given that the data are based on transactions reported on SWIFT network, while financial institutions have other means to exchange information about their financial transactions. Also, the value of transactions partly reflects changes in the US dollar exchange rate (FSB, 2017; 2018). As such, most studies mention along the value of transactions also their volume, while using survey data to back up their findings and give further insights on factors that can explain the trends.

saw both volumes and values increase, despite a considerable decline in CBR relationships over the same period.

Although no data could be found from the Covid-19 period, the report by the Reserve Bank of New Zealand (2021: 2) mentioned that “emerging reports indicate that the retreat of correspondent banking relationships has continued, and even accelerated in some parts of the Pacific”. The same report cited that the IMF warned that the National Bank of Tuvalu is at risk of losing its only CBR with an Australian bank, concluding that the contraction in the international banking 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” (Reserve Bank of New Zealand, 2021: 2).

The reasons why some SIDSs are more affected than others will be discussed later in this rapid review, but first this review investigates the global drivers of de-risking and the general implications of de-risking on the micro-level (stakeholders) and macro-level (economic development).

3. The drivers behind the trend of “de-risking”

Where the factors which may constitute key elements behind the de-risking decision include size of the economy and aggregate cross border flows, other factors relate to country and financial institution risk profile, and the structure of the financial system (Wright et al., 2018). These factors can be linked with key, interrelated drivers, which have been categorised differently in studies. For an extensive overview of the drivers of de-risking see also Grima et al. (2020). This rapid review categorises three drivers: regulatory and risk-related drivers, business-related drivers, and capacity-related drivers.

Regulatory & Risk-related Drivers:

One of the most mentioned drivers in the literature is **increased anti-money laundering and combating the finance of terrorism (AML/CFT) regulations, regulations that increase tax transparency, and international and regional economic and trade sanctions** (Erbenová et al., 2016). New AML/CFT regulations (e.g. US Dodd-Frank Act in 2010) and related initiatives have created lists of countries that present strategic deficiencies in their AML/CFT regimes, like within the European Union or the grey and black lists of countries with significant deficiencies by the Financial Action Task Force (EBA, 2022). This reduces CBRs between international correspondent and respondent banks in these countries.

However, these regulations cannot account for the continuing trend of de-risking. **What is more at play is that risks related to AML/CFT regulations has exceeded financial institutions' risk appetite.** Data from Boston Consulting Group (BCG) indicate that globally, banks have paid US\$321 billion in fines since 2008 for an abundance of regulatory failings from money laundering to market manipulation and terrorist financing (cited in the ECLAC report authored by McLean et al., 2018). This made internationally operating banks reconsider risks involved with individual cross-border transactions, with many concluding that it was easier and cheaper to reduce certain CBRs entirely for groups of jurisdictions, institutions and clients than individually assess their risks. This particularly relates to the AML/CFT regime call for financial institutions to enhance their systems to identify and verify customers to meet ‘know your customer’ (KYC) requirements,

which also must be kept updated. As a result, the KYC due diligence process has been described as “complex, costly, time-consuming and labour intensive” (Boulton & Winton, 2018). Moreover, higher capital requirements and higher liquidity thresholds appear to have led institutions to adapt their customers’ acceptance policies, and to assess carefully the cost of compliance against profitability (EBA 2022).

A blog post by TenureX (2022) mentions, for example **the impact of the war in Ukraine for an acceleration of CBR terminations, because the financial sanctions against influential Russians have increased the call for more financial transparency and compliance with AML/CFT regulations**. To cite TenureX (2022: N/A): “The requirements to adhere to the new sanctions will undoubtedly add pressure to a segment already under high pressure of concentration and consolidation. Again, the smaller financial institutions and higher-risk jurisdictions would be affected and cut off from the traditional cross-border chain as they would not be able to evidence product control over compliance requirements.”

As such, **stringent AML/CFT regulations and international sanctions regimes make the provision of correspondent banking services a less financially attractive business proposition**. All bankers at large international banks interviewed for a World Bank Group (2018) survey acknowledged that correspondent accounts cost much more to maintain, thus requiring larger transaction volume and fees to remain a viable activity. Larger transaction volumes and higher fees are a problem, particularly for smaller and poorer countries, including many SIDS.

Business-related drivers:

The small scale and low profitability of doing business in many small and poorer economies, combined with higher compliance costs in light of shifting regulatory requirements, has led to a re-assessment by correspondent banks of their business model for providing corresponding banking services in specific areas groups of countries or regions. **High-volume, low-return businesses, such as correspondent banking, have become less attractive**. For example, many correspondent banks have found that profits from remittance transactions do not compensate for their high compliance costs and the risks of non-compliance. By de-risking and ceasing to transact with respondent banks, these financial institutions have reduced their exposure to fines and penalties, decreased compliance costs, and minimised reputational risk (Schou-Zibell, 2021).

MTOs are often very small and operate in partnership with other small or single operators in different countries, making risk assessments difficult. Furthermore, MTOs accumulate many two-way transfers (each transfer is very low in value) that are then netted out. For example, in Samoa, MTOs handle just over half a million inward money transfers a year, with an average size of just US\$270 (Alwazir et al., 2017). As an MTO uses its bank accounts for bank-to-bank cross-border transfers of the net amounts, this bundling of cross-border transfers into a single transaction complicates monitoring for international banks. But in applying the risk-based approach, and with uncertainty about the strength of an MTO’s systems, a given bank may be concerned about its ability to respond to requests for information. Banks have argued that KYCC is, for all intents and purposes, a requirement (Alwazir et al., 2017).

The reduced appetite for CBRs is not purely cost related, but also is driven by fear of reputational risks. In those situations, “institutions appear to adopt a conservative approach and may de-risk such customers with common characteristics (e.g. those in higher-risk jurisdictions,

including those operating in jurisdictions with weaker AML/CFT supervisory and regulatory frameworks), irrespective of mitigating factors” (EBA, 2022). For the same reason, regional or local banks fear losing their CBRs for having a reputation of dealing with many smaller MTOs and less transparent cash transfer providers (Grima et al., 2020) and as such take steps to lower their risk profiles by turning down or closing business relationships (EBA, 2022).

Capacity-related drivers:

Some correspondents lack knowledge and expertise of specific customers’ business models, which has led to some businesses and institutions being refused to enter into or maintain a business relationship. The EBA (2022) survey shows that a combination of lack of such understanding and limited assessment time makes it difficult to determine whose identity should be established and verified, and where the AML/CFT risks lie. The most common groups that are de-risked for such reasons are NPOs, MTOs, gaming operators, and FinTech firms (EBA 2022; World Bank, 2015).

Another argument is that smaller local banks and MTOs have less capacity and knowledge to scrutinise their clients. For example, a large MTO such as Western Union, spends over US\$200 million a year on risk and compliance, with 20% of its employee base dedicated solely to this function (Schou-Zibell, 2021), which is impossible for smaller ones to do. As such, they are seen as riskier institutions while more checks and therefore higher costs are needed to deal with such banks.

Overall, **the three drivers are interrelated:** higher risk can result in greater cost and more capacities are needed to deal with complex rules and business models, while operating in a low profit financial service. The World Bank (2015) study showed that while local/regional banks put more of an emphasis on the economic/business rationale for the decline, banking authorities and large banks emphasised both regulatory AML/CFT and business-related concerns (World Bank 2015).

Wright et al. (2018) asked why respondent banks did not alter the pricing structure to bring into balance the risk/return relationship, and why was the relationship terminated completely without looking into viable alternatives? One answer to these questions is not possible, but Wright et al. (2018) show that it has to do with the structure of the financial system. Large international banks do not suffer from losing CBRs, but local smaller banks and MTOs do suffer (see next section). As such, **the concentration in CBRs makes it easier for larger banks to do business and increase to some extent control, and as such the issue is not purely the price.** Finally, eventually, higher fees will push most clients to look for alternative often informal ways to transfer money.

4. Implications of “de-risking”

Implications for specific stakeholders (micro-level)

The World Bank (2015) survey showed that products and services identified as being most affected by the withdrawal of CBRs: check clearing, clearing and settlement, cash-management services, international wire transfers and banking authorities and local/regional banks also trade finance. Over 69% of the banking authorities responding to the survey indicated that MTOs and

other remittance companies are most impacted, followed by smaller local banks (44%), while also business clients, mainly small and medium exporters (26%), were identified as negatively impacted (World Bank 2015). Furthermore, **the trend toward a concentration of correspondent banking services with fewer institutions handling larger volumes, has been linked with higher counterparty risks and the prospect of systemic risks in a few jurisdictions** (World Bank, 2018).

Respondent banks:

Impacts for respondent banks include, among other things (World Bank, 2018):

- The loss of significant numbers of customers, mostly corporate companies and exporters.
- A significant drop in remittance volumes.
- The loss of highly profitable businesses, such as the supply of the United States dollar to certain countries.
- Adverse effects on banks' ratings.

A decision to end an existing relationship often by only giving them two- or three-months notification time, makes it difficult to find alternatives, particularly for smaller respondent banks that heavily rely on one CBR, resulting in disruptions in the business continuity, such as account closures, loss of customers and, ultimately, closure of business (EBA, 2022). When local respondent banks are losing CBRs, they seek alternative ways often with less reputable institutions (World Bank, 2018). Only the respondent banks that rely on more than one CBR are able to maintain their operations but have to review their pricing fees for their customers in a competitive market (EBA 2022).

Money Transfer Organisations:

The literature is clear that respondent banks receive instructions from their correspondent banks to limit or stop providing services to small MTOs and other cash-intensive businesses such as foreign exchange traders. However, such financial services are the most common cross-border financial services in LMICs. As such, MTOs and foreign exchange traders have been particularly affected by account closures (World Bank 2018). Not being able to deposit the clients' money on accounts with banks, forces MTOs or other payment institutions to store and secure large amounts of cash on their own premises, including more expensive and risky cash collection processes. Very few alternatives to access financial services were possible once they were de-risked with seeking new banking relationships with alternative partners often coming at a much higher price (EBA, 2022).

To remain in business, MTOs and other cash-intensive financial businesses are pushed to look for alternative ways, sometimes using personal bank accounts to channel money or the use of commercial couriers to carry cash between sending and receiving countries. As such, de-risking has been linked with the rise of new, informal channels through which money is now flowing, undermining the AML/CFT objectives by driving financial transactions outside of regulated channels (World Bank 2018).

Businesses:

McLean et al. (2018) mention that **businesses could face increased pecuniary and non-pecuniary costs of doing business**. An example of the former is an increase in fees while the latter includes additional documentation requirements, delays in executing transactions and longer time periods for transferring funds. Furthermore, access to credit by enterprises rely on credit unions and local banks with stable connections to large international banks. Without such relationships, access to credit will be particularly become more difficult for smaller businesses (McLean et al., 2018). In general, Artingstall et al. (2016) mentioned that **small- and medium-sized enterprises are more likely to be de-risked in many cases than larger firms in the same sector**, which makes it for them more difficult to find investments for upscaling, restricts import and export opportunities, and hamper to enter new markets - often because banks use size as a proxy for compliance effectiveness.

Non-profit organisations:

The literature also has indicated that humanitarian organisations face problems due to reduced CBRs, particularly in the countries in which they work. For example, they are denied opening new bank accounts, and for existing accounts, they face excessive delays in cash transfers in certain jurisdictions where they are conducting their humanitarian interventions, and in some cases see their accounts being frozen, and in extreme cases closed by exiting a customer relationship (e.g. Artingstall et al, 2016). Overall, they spend much more time getting transactions processed, while being unaware of the systemic drivers behind the decisions made by institutions to delay these transactions.

The EBA (2022) survey mentioned that **this could result in a significant delay in programme delivery, rise in costs of such operations, or even programme closers**. Wolf (2020) mentioned in an article on the website of Thomson Reuters some recent cases of charities having problems delivering aid during the Covid-19 pandemic. The article also highlighted an example of a “winterisation programme” in Afghanistan that received the money when the winter was already over, due to delayed wire transfers. Alternatives that were found included carrying cash across borders into conflict areas, using personal bank accounts for transferring and receiving funds, or resorting to the services of MTOs, but these services are increasingly limited in these countries as well (EBA 2022).

Implications on economic development (macro-level)

Most of the studies included in this rapid review highlight that the macroeconomic impact of de-risking generally seems to be limited. In most countries, banks have been able to cope with the situation by dealing with fewer correspondent banks or establishing new ones, so businesses and households do not necessarily feel many changes regarding cross-border financial services. Overall, it is extremely difficult to measure and isolate the impacts (and causality) of financial de-risking on economic growth.

With the lack of hard evidence, assumptions have been made. The main issue is that CBRs are essential to enable trade, foreign investment, and remittances. When countries face a critical reduction of CBRs, the assumption is that this should reflect on all three. For example, as local banks rely on correspondent banks to offer clients a broader range of services, a loss of CBRs leaves local business without access to some types of financial services, such as trade finance, which could affect them to do business abroad and enter new markets. Furthermore, in countries with a small number of banks, pressure on CBRs can become systemic in nature if unaddressed,

as the losses of CBRs or closure of MTO bank accounts can quickly create a systemic risk with services becoming concentrated in a single entity.

Overall, the literature names the following **key impacts areas** regarding countries' economic development:

- **A more fragile and more expensive remittance sector:** Closures of MTOs' bank accounts and ultimately of MTOs could reduce the resilience of the remittance sector as the ability of MTOs to offer reliable services has declined. Although remittances can still be sent by banks or remaining and larger MTOs, concentration comes with a higher price (EBA, 2022). Weaker competition in the remitter market could raise the already-high cost of remittances to higher risk and smaller countries. Closure of remaining MTOs bank accounts limits their ability to find the lowest transfer cost, which pushes up their average cost (EBA, 2022). Furthermore, a shift in remittance flows into the banks will further boost average costs, because account-to-account services are the most expensive means of transferring money (Alwazir et al., 2017). As LMICs depend for a large part on remittance inflows, higher costs could see a shift towards more non-regulated remittance channels, which could reduce transparency and the authorities' ability to monitor and investigate transactions. For households who rely on remittances for their livelihoods, both higher costs of regulated channels and riskier methods of non-regulated channels are undesirable options.
- **Negative consequences for financial inclusion:** Enhancing financial inclusion to support growth is a key policy priority for LMICs. These economies rely largely on cash, and the closure or curtailment MTOs or other cash-related financial businesses could significantly impact the financial inclusion of riskier and poorer groups, such micro- and small businesses, and women (Langthaler & López Nino, 2017). Closing CBRs might not directly impact on the poorest, but already struggling to access finance, with pressure on local banks to reduce some lucrative finance businesses and reducing services to riskier groups, it is the high-risk and poor populations that need to find substitutes to get financial services, distancing vulnerable communities, such as women, even further away from the formal financial sector (Schou-Zibell, 2021).
- **Negative consequences on international trade:** Finance services from correspondent banks play a major role in cross-border trade. Banks provide trade finance services such as, export/import letters of credit, standby and back-to-back letters of credit, discounting, contract guarantees, etc. (Langthaler & López Nino, 2017). Without these services, small to medium exporters are less able to participate in trade. Reductions in the availability of trade finance have been found to affect trade. It is estimated that credit shocks related both to working capital and trade finance accounted for between 15 and 20% of the decline in trade during the 2008 crisis (Starnes, Kurdyla & Alexander, 2016). In many cases, the terms and conditions of newly established CBRs are significantly more unfavourable than under previous relationships, with some services facing increasing fees (World Bank 2018). This affects many countries' balance-of-payments. Also, small exporters will potentially move to already saturated working markets or even enter in criminal activities, which will be a constraint on economic development.
- **Creating a non-transparent shadow banking system:** Alternative channels, such as FinTech, might be low cost and can be accessed easier, as they are less regulated and therefore riskier for local banks, MTOs, traders, and households. Overall, when

alternatives result in increased financial system risk, particularly given that basic risk management, legal certainty, or consumer protection are not provided in unregulated financial channels, this risks economic and security implications. As such, this has created a regulatory paradox. “The higher compliance and regulation requirements aimed at reducing and preventing money laundering and terrorism financing activities are provoking de-risking, which, in turn, pushes operations to less regulated and monitored markets” (Langthaler & López Nino, 2017).

Hence, the continuing **decline in CBRs has the potential to harm all efforts made to improve financial integration, financial inclusion, financial transparency**, and thus economic growth and poverty reduction (Schou-Zibell, 2021).

5. Vulnerabilities and challenges for SIDS

Characteristics

In small islands states, the impact of the decline in CBRs has been acute (World Bank 2018), even with studies emphasising that AML/CFT risk levels in the Caribbean and Pacific region (where most of the SIDS are located) are not close to the highest threat level compared to some other developing countries (Basel Institute on Governance, 2017). So, the question is why these countries face declines as high as high-risk countries?

Small Island Developing States (SIDS) are a distinct group of developing countries facing specific social, economic, and environmental vulnerabilities (UNCTAD, 2021). **The literature mostly refers to the small internal markets of SIDS, which precludes economies of scale and, along with a narrow resource base, forces undue specialisation and openness to trade**, exposing SIDS to external shocks and accentuating their inherent vulnerability (IMF, 2013). SIDS' trade openness averaged 95% for the period from 2005 to 2019 (UNCTAD, 2021). The OECD (2018) shows that SIDS are on average the most vulnerable among developing countries by using the economic vulnerability index. For example, upper-middle-income SIDS are 73% more vulnerable than other upper-middle-income countries, due to their open economies and low diversification levels.

Small island economies, therefore, can be heavily linked with the business-related drivers of de-risking. Compliance costs are high while profit margins are extremely small; the total value of transactions to these countries is small, while all transactions still need to be assessed according to international regulations. As such, the small, low-income markets of many SIDS provide challenging commercial conditions for correspondent banks. To cite the Reserve Bank of New Zealand (2021: 4): “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”.

Having said that, **some island economies have to some extent, increased risks according to the metrics used to identify these risks.** This links with the regulation-related driver for de-risking. SIDS are associated with large volumes of low-value remittances payments, which can create risk of money laundering and terrorism financing, and therefore require careful risk management by correspondent banks (Reserve Bank of New Zealand, 2021). Paradoxically, some SIDS are very much integrated within the global financial system as they have established

global financial services as a popular avenue for economic diversification and a viable pillar to support the economic growth and development agenda, particularly in the Caribbean region, such as the Bahamas, Barbados, the British Virgin Islands, and the Cayman Islands (Wright et al., 2018). However, these financial services are increasingly scrutinised for having relaxed regulatory regimes, and the legal structures established in these jurisdictions are increasingly labelled as vehicles for corporations and wealthy individuals to conceal wealth and avoid taxation (Wright et al., 2018).

On top of that, in 2021, the US Department of State's International Narcotics Control Strategy (INCS) report on drug and chemical control and money laundering classified thirteen Caribbean countries as major money-laundering jurisdictions,² and considered four Caribbean countries as major drug transit countries³ (Atlantic Council, 2022). MacDonald (2019: 5) pointed to an **increasing friction between the Caribbean region and Western countries** because “the United States and others, which control the Organization for Economic Cooperation and Development (OECD), FATF, Financial Stability Board, and other international organisations, use the policymaking process to constantly impose new standards and then penalise small countries for not meeting the standards”. He refers that many of the OECD countries, including the United States and the United Kingdom, “do not meet all of the new FATF standards, especially when it comes to better transparency and disclosure on ultimate beneficial owners of shell corporation” (MacDonald, 2019: 5).

Finally, **low levels of overall regulatory compliance capabilities amongst banks and other financial institutions, such as MTOs, relate to the capacity-related drivers for de-risking.** Shortage of specific capacities needed for financial risk assessments and immature regulatory compliance can make international banks decide to reduce or terminate CBRs with that country (PIFS, 2021; Liu & Fernando, 2020). Also, Haley (2018) mentioned that international banks argue they cannot carry out adequate due diligence of their foreign respondent banks given prohibitions in local regulations to sharing information among financial institutions. However, the CFATF (2019) report mentioned another factor, which they called the informational driver, because of the perception that many SIDS, such as those in the Caribbean region, are inherently high-risk despite best efforts to meet the international AML/CFT standards set out by the FATF.

Evidence of the specific challenges faced by SIDS

Importantly, SIDS have many characteristics that influence the severity of de-risking. **One of the most important challenges they face due to de-risking is their high dependence on remittances for their national income.** Owing to large diasporas, remittances represent the largest flow of external finance for SIDS: 54% in 2012-15, compared to 27% in other developing countries (OECD, 2018). Remittances average around 10% of GDP in the Pacific Islands compared with 5% in other developing regions (Boulton & Winton, 2018). However, the difference between countries in the Pacific is large. Before the Covid-19 pandemic, remittances were the equivalent of just over 30% of GDP for Tonga and nearly 20% for Samoa,

² Antigua and Barbuda, The Bahamas, Barbados, Belize, Dominica, Guyana, Jamaica, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, Suriname, and Trinidad and Tobago.

³ The Bahamas, Belize, Haiti, and Jamaica.

while also Kiribati, the Marshall Islands, and Tuvalu have percentages well above the regional average (Boulton & Winton, 2018). In the Caribbean, countries such as Jamaica (22% of GDP) and Haiti (21%) also rely highly on remittances (Atlantic Council, 2022). The impacts of the pandemic exacerbated the relative importance of remittances for these island states because of the impact it had on trade and tourism (World Bank, 2020). Any decline in future remittances due to de-risking could significantly impact the GDP of these island economies.

One of the underlying reasons is the persistent slow growth in most SIDS which points to a brain drain-induced decline in productivity and generally weak competitiveness (IMF, 2013). The result of slow economic growth (or high variable growth rates) and the inherent constraints to the development of the private sector (lack of economies of scale) mean that few employment opportunities exist, with SIDS often exceeding 10% unemployment rates, particularly in the Caribbean region, stimulating migration and increasing the dependence on remittances for households' income.

Another factor that makes SIDS particularly vulnerable to the impact of de-risking is that a significant share of remittances to these countries is transferred through MTOs (Boulton & Winton, 2018). For example, MTOs handle some 80% of the remittance flows to the Pacific, with the average value of remittance transactions of less than US\$500. Many of these MTOs are small and far more mobile as they travel to remote areas and small villages which are otherwise not serviced by banks or global MTOs (Boulton & Winton, 2018). Losing CBRs and de-risking MTOs, particularly smaller ones, will affect such localised financial services. Furthermore, the cost of sending remittances via an MTO is around 40% lower, both in terms of the outright fee and the margin on the exchange rate to the Pacific, while the banks are mostly based in the capital, making them less accessible for remote communities (Boulton & Winton, 2018).

On average the inflow of remittances into SIDS did not fall, assuming that alternatives were available, for example using larger, global MTOs and banks to transfer remittances, but often for a higher price. The average cost for sending remittances to Pacific Island countries from Australia has been about 12–13%, and from New Zealand, 10–11%, which is well above the G20 target of 5% by 2020 and is much higher relative to other developing countries (Alwazir et al., 2017). Alwazir et al. (2017) show that bilateral surveillance suggests that the high price is due largely to the closure of MTO bank accounts in both home and host countries. In Tonga, the authorities report that most bank accounts of MTOs in Australia and New Zealand have been closed, necessitating the use of other avenues. Similarly in Samoa, the authorities report major challenges facing MTOs in maintaining bank accounts. Most rely on one bank account, compared with several across many banks previously. Moreover, a few MTOs without a business bank account were using personal accounts (Alwazi et al., 2017).

As such, specific implications have occurred for specific countries. Smaller countries with typically a small number of banks and MTOs in the domestic banking sectors, will face more implications on financial service provisions even with the withdrawal of a small number of CBRs than countries with more banks and MTOs (Alwazir et al., 2017). Wright et al. (2018) study in the Caribbean showed that **smaller, more isolated local banks appear the most susceptible to loss of CBRs**. The severity of CBR terminations appeared to be much worse in a country such as Belize, with more than 75% of the commercial banking sector impacted by CBR terminations. Wright et al. (2018) argued that when countries rely on a small commercial banking sector characterised by low asset base and dominated by local banks with few or no affiliations to larger

(foreign) banking groups, the provision of correspondent banking services appears likely to have been unattractive to correspondent banks.

As such the impact depends on the remittance channels used. For example, in the Marshall Islands, where remittances are sent mainly through the domestic bank, its CBR relationships with global banks are under pressure. In other countries such as Fiji and Samoa, where MTOs are important for remittances, MTO bank accounts are facing closure both in the domestic economy and in remittance-source countries, mostly Australia and New Zealand (Alwazir et al., 2017). **KYC compliance is also hampered by the lack of formal means of identification in many small states that do not issue national IDs and many individuals do not have driver's licenses or passports** (Alwazir et al., 2017).

With continued de-risking in SIDS and particularly in the Pacific region, MTOs could cease operating entirely or shift operations outside formal banking channels: indeed, **remittances are already being diverted to less transparent hand-carry of cash across borders or to costlier banking channels** (Alwazir et al., 2017). A study in Jamaica on the impact of CBR withdrawal on local money service businesses, including MTOs but also small money exchange traders, showed significant negative spill-over effects in their ability to transact in foreign currency with local commercial banks; the scale of this impact is greater and costlier for smaller entities (Gordon, 2019). Gordon (2019) mentioned that such businesses are important for the poor, but that the link with the cash economy has labelled these businesses as riskier, with domestic banks incentivised not to provide financial services to these businesses due to the threat of losing CBRs. This threatens any progress made in inclusive finance.

As many studies show, the overall implications are not yet catastrophic. Although only a small number of certain SIDS are not far from such a situation, there should still be concerns that many SIDS (and other smaller developing countries) are in a sufficiently precarious situation as they rely on foreign currencies, like the US dollar, but “should start looking for alternative solutions for global correspondent banking immediately” (Jimenez & Labeaga Azcona, 2021: 1). **Without corrective policy actions, the consequences of continued withdrawal of CBRs could undermine the functioning of the financial system, weaken growth prospects, and reduce resilience to shocks** (Alwazir et al 2017).

However, being vulnerable for shocks is already one of the main issues for SIDS. SIDS have a high exposure and vulnerability to natural hazards which have imposed tremendous costs in terms of loss of human lives, productive assets, physical infrastructure, output supply and product demand especially in agriculture and tourism. At 17% SIDS have the largest losses due to natural hazards as a percentage of national output (OECD, 2018). The development challenges posed by natural hazards are compounded by climate change, which has increased the frequency and force of hurricanes and caused sea level rise, which threatens coastal infrastructure, beaches, housing settlements, fresh water supplies, and marine life and coastal fisheries (Bourne, 2015). **Proportionately high climate and disaster impacts ask for a swift financial responses combined with humanitarian aid and also necessary for recovery, which will be negatively impacted by de-risking. Importantly, access to remittances by communities in the aftermath of a disaster cannot be underestimated** (Alwazir et al., 2017).

Entrepreneurial activities could decrease due to less access to funds, and that for enterprises that already struggle to scale up or become more productive due to the specific economic constraints of small island states. As Branch and McIntosh (2017) mention, the Caribbean is

heavily dependent on foreign direct investment (FDI), but **the loss of CBRs has the potential to constraint these investment inflows and make it difficult for the repatriation of reinvested earnings**. The lower access to foreign currencies also plays a role in the tourism industry on which SIDS economies rely heavily on. For example, if access to foreign exchange services or wire transfers diminishes then tourism flows and investments in this sector and other related activities also could diminish. Given that most transactions in the tourism sector are processed through credit card with correspondent banks, in turn, executing these transactions, the absence of these credit card services could negatively impact the viability and competitiveness of the tourism sectors of Caribbean countries (McLean et al., 2018).

There is evidence in some countries in the Caribbean region of the re-emergence and growth of informal markets for foreign exchange and trade and of the use of less transparent mechanisms (McLean et al., 2018). As McLean et al. (2018) mention, these impulses threaten the transparency and the formal sectors of the affected countries in the long-term. The Atlantic Council (2022: 7) comes to the same conclusions, acknowledging that CBR withdrawal in the Caribbean and the critical financial functions they facilitate have set “the conditions to instability and shadow banking rise”. The report highlighted that the risk of increasing shadow banking activities can fuel illicit activities for transnational criminal organisations. Interestingly, the Atlantic Council (2022) also referred that it is mainly the Western banking system that is the culprit to the loss of CBRs, pushing SIDS towards establishing CBRs with Chinese banks. For example, this has led to an increase in Chinese-Caribbean cooperation with increased use of Chinese renminbi as Caribbean governments struggle to access the US dollar (Atlantic Council, 2022).

These implications come on top of already higher costs of public services, low tax revenues and high fiscal volatility, which have resulted in high debt levels in SIDS: on average, the debt over GNI of SIDS (57%) is significantly higher than for other developing countries (47%) (OECD, 2018). SIDS are among the most indebted developing countries in the world. In 2019, external debt accounted for 62% of their GDP, a record high, mostly driven by increases in short-term debt and private debt (UNCTAD, 2021). **High debt makes them vulnerable and high need to repay debts need economic growth and investments in diversification, which is at risk with lower integration in financial systems.**

The Covid-19 pandemic have shown these vulnerabilities for SIDS. In the wake of the pandemic, SIDS experienced an estimated fall in GDP of 9% in 2020, compared with a 3.3% decline in other developing countries based on IMF projections data (UNCTAD, 2021). Covid-19 has severely hit SIDS’ services exports, which is heavily reliant on tourism. In the wake of the COVID-19 pandemic, SIDS suffered an estimated 70% drop in travel receipts in 2020. The UN World Tourism Organisation estimates that it could take up to four years for international tourism, an essential source of jobs and livelihoods, to recover to levels observed in 2019 (UNCTAD, 2021).

Hence, **for a sustainable recovery and to fight climate change and other global threats, SIDS need better access to the global financial system. However, continued loss of CBRs do the opposite.** This has led to an increasing number of critical voices by SIDS policymakers and international organisations. For example, during the International Chamber of Commerce

(ICC) 2019 high-level dialogue on correspondent banking, where the ICC Secretary General John W.H. Denton said:⁴

“The decline in correspondent banking services drives up the cost of remittances – a critical lifeline to development for many nations; it puts crucial trade finance out of reach for importers; and it threatens to cut off whole economies from the international financial system.”

And the Commonwealth Secretary-General Patricia Scotland said at the same event:

“There is now a question as to whether small states can survive, at all. Because if they are going to be subject to the rigors, the exigencies of climate change – that existential threat – and have no correspondent banking, what is the future?”

6. Responses and best practices

Most of the cited reports in this rapid review give various recommendations how governments and financial institutions have to respond to turn the de-risking trend, particularly regarding smaller, lower income states, such as SIDS. However, **given the multitude of drivers and the specific implications of de-risking for countries, there is no silver bullet to address CBR pressures, and solutions need to be tailored to the circumstances of an affected country or region** (Liu & Fernando, 2020). This section will give an overview of policy recommendations targeted at governments in the countries of respondent and correspondent banks.

One of the first recommendations for policy responses came from the FSB (2015), which adopted a **four-point action plan** to tackle the decline in CBRs:

- Examining the dimensions and implications of the issue.
- Clarifying regulatory expectations.
- Strengthening domestic capacity building in jurisdictions with affected respondent banks.
- Enhancing tools for due diligence by correspondent banks.

Most of the recommendations in reports that were published after the FSB (2015) report echo the same responses. Recently Liu and Fernando (2020) **summarised the recommended actions** as follow:

- Enhance communication among banks to build trust.
- Strengthen respondent banks' capacity to manage risks.
- Improve legal and regulatory frameworks and implementation in affected jurisdictions.
- Clarify international standards by FATF and regulatory expectations by home regulators of global banks.
- Harmonize regional regulatory frameworks.

⁴ Information and citations retrieved from ICC website (May 2022): [De-risking: the hidden issue hindering SDG progress and threatening survival of small island states - ICC - International Chamber of Commerce \(iccwbo.org\)](https://www.iccwbo.org/news/press-releases/2022/05/2022-05-10-de-risking-the-hidden-issue-hindering-sdg-progress-and-threatening-survival-of-small-island-states/)

- Remove impediments to information sharing.
- Use KYC utilities and Legal Entity Identifier.
- Improve payment messages and Fintech solutions to improve the quality of information and facilitate due diligence processes.
- Bundle banking products and set volume or risk-based pricing to reduce compliance costs and increase profit margins.
- Consolidate transactional traffic by channelling the transactions of several banks through an intermediary bank.

International donors and governments can look at technical assistance and training measures to improve the capacity of local banks and local financial authorities or seek other support towards key stakeholders.

- **Technical assistance and training for local banks should target the capacities to undertake risk assessment and management**, improving compliance with the FATF standards and improving performance in FATF assessments. However, this will not reduce the issue of small size. Therefore, Wright et al. (2018) recommended to support and incentivise small local banks to merge and create “indigenous banking groups” capable of competing regionally and capturing enough cross-border flows to be attractive to correspondent banks.
- **Technical assistance and training should also be targeted at local (financial) authorities to improve regulatory and supervisory frameworks**, as these are crucial to correspondent banks’ decisions on maintaining or terminating a CBR (Liu & Fernando, 2020).
 - Governments in SIDS can be supported in **removing legal and practical impediments to information sharing**, which helps to ensure provision of timely, accurate, and adequate information by respondent banks on transactions, their originators, and beneficiaries to correspondent banks. This helps correspondent banks to meet their customer due diligence requirements (Liu & Fernando, 2020).
 - Support and capacities need to be built to **establish intermediary banks in regions** (a solution that is gaining traction in the Caribbean, Pacific and Africa) as they need robust control and risk management system and make efforts to ensure full transparency throughout the relationship chain to give correspondent banks confidence in the CBRs. However, as Liu and Fernando (2020) highlighted, intermediary (regional) banks could entail higher costs and leads to concentration risks, as well as raises issues of market competitiveness.
- **Guidance is needed to correspondent banks to clarify the interaction between AML/CFT obligations and the access to the financial system as a fundamental aspect for development and participation** (EBA, 2022). As an example, 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 (Reserve Bank of New Zealand, 2021).
- Central Banks in correspondent bank countries could **initiate projects to reduce the costs of remittances to SIDS while improving the compliance processes**. For example, the Reserve Bank of New Zealand (2021) mention their Pacific Remittance Project which aims of enhancing access to, and reducing the costs of remittances to the

Pacific, with a range of initiatives including ongoing information gathering exercises, policy/legislative changes and the development of a regional electronic KYC facilities.

- **A scalable, risk-based application of AML/CFT regulation should be designed to ensure stringent regulation is not imposed on the smallest remittance providers.** Such approach will minimise compliance costs and boost flexibility to respond to emerging risks (Schou-Zibell, 2021).
- Wright et al. (2018) mention a longer-term solution to support SIDS **to reduce cash payments and incentivise electronic payments.** For this governments, regional financial institutions, and the private sector must work together to encourage the use of electronic payment systems. As clients are incentivised to migrate towards electronic means of payment, this will reduce the level of anonymous cash transactions at businesses serviced by local banks; thus, their risk-levels may decrease over time.

Technological solutions have also widely been discussed:

- Support is needed to **harmonise process of identification of payers and payees in a transaction by developing KYC technology and processes for customer due diligence and information sharing between banks and between banks and regulators** (Wandhofer & Casu, 2018). Schou-Zibell (2021) mentioned that the Central Bank of Samoa, with ADB support, has developed a web-based platform to verify the identity of remittance senders and receivers. It checks against sanctions, politically exposed persons lists, and other due diligence measures.
- As Wandhofer and Casu (2018) mentioned information could be stored and updated regularly in a **national or regional KYC registry**. Various types of registry solutions have emerged, such as SWIFT registry and Nordic banks registry.
- Biometrics, blockchain, artificial intelligence, machine learning, and big data offer potential solutions to create digital legal identities, deliver trust, security, and privacy. For example, Alwazir et al. (2017) mentioned that **platforms for the transfer of funds using blockchain technology/distributed ledgers have the potential to reduce the reliance on the banking system for the clearing and settlement of financial transactions.** As such, blockchain technology Fintech applications promise to reduce the time, cost, and complexity of financial transactions—including cross-border money transfers. This could increase the use of mobile money facilities as an accessible alternative to conventional cross-border money transfers (Boulton & Winton, 2018). More details about the potential of blockchain to improve remittances and trade finance in the context of de-risking, see Ramachandran and Rehermann (2017).

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