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DE-RISKING IN THE CARIBBEAN: THE UNINTENDED CONSEQUENCES OF INTERNATIONAL FINANCIAL REFORM

BY

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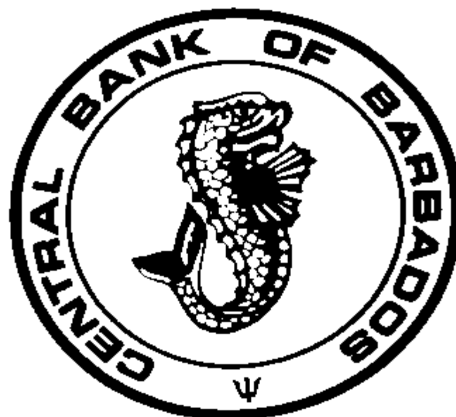

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"De-risking in the Caribbean: The Unintended Consequences of International Financial Reform"

ABSTRACT

This paper analyses the potential causes and consequences on the Caribbean of de-risking strategies adopted by international banks in response to recent changes in bank regulation, reporting requirements and judicial pursuits. These include the initiatives adopted by the Basel Committee, the Financial Action Task Force, the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes, the US FATCA, and the increasing judicial scrutiny faced by international banks. The impact to date has been felt in the Caribbean across-the-board, including in jurisdictions with competitive, well regulated and transparent international financial centres, which provide high quality financial services. Some small Caribbean jurisdictions have suffered disruptions in their external payments system, as money transfer and other services that are presumed to be high risk, have had their operations curtailed. The de-risking strategies that produce these results are adopted very reluctantly by a number of international banks, which see no other way to protect their franchise value in the face of costly procedures required for transactions in small markets and international financial centres. This paper contributes to the ongoing research on a global phenomenon of troubling proportions, one which is still intensifying and not widely understood.

Keywords: De-risking; international banking; bank regulation; Caribbean

JEL codes: G21; F36.

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1. INTRODUCTION

The understandable preoccupation with international regulatory reform in the wake of the 2008 global financial crisis has motivated international banks to adopt strategies designed to reduce their risk exposures, as was the intention of the reforms. However, it is becoming evident that these strategies have consequences which are troublesome. In this paper we discuss: 1) policies that have the potential to be inequitable among income groups; 2) policies that amount to non-tariff barriers; and 3) policies that limit global competitiveness and efficiency. We investigate the consequences for the Caribbean of the de-risking strategies adopted by banks in response to these initiatives.

The de-risking strategies of concern include strategic repositioning by international banks, involving withdrawal from selected countries, regions, and lines of activity. Also, many banks have become selective in their clientele, using criteria which result in practices that might be considered discriminatory and inequitable. Much attention has focussed on those international banks that have terminated correspondent relationships with banks in Emerging Market and Developing Economies (EMDEs), and this is another important dimension of the problem.

The reasons for de-risking strategies are varied, but they all have to do with regulatory reforms introduced since 2008. Firstly, there is now a substantial additional capital cost for banks which are designated as systemically important financial institutions (SIFI's), and this creates an incentive for banks to divest themselves of less profitable business in order to remain below this threshold. Secondly, anti-money laundering guidelines (AML) have come under greater scrutiny, and all financial institutions have invested heavily in systems to ensure that they are in compliance. Compliance costs have driven the average costs of providing banking services to a level so high that some, especially small and less developed markets, can no longer access those services. Thirdly, there are the additional costs of installing data systems to collect information on individual clients' tax status. These information requirements are country specific, with different requirements imposed by the US, the EU, Canada and others. Fourthly, banks must ensure that their clients are not involved in activities that violate the sanctions regimes that have been imposed on some countries by the UN, the US and other countries. And finally,

there are potentially costly market conduct risks which may be elevated in certain markets and types of activity.

The cost of failure to comply with any aspect of this complex web of regulations is very high. Fines and penalties imposed by courts in the advanced economies have had a significant impact on bank profitability. Perhaps even more important has been the damage to banks' image and credibility. A number of financial institutions have lost credibility even in cases where they maintain that they are without blame; the mere announcement of an investigation has triggered losses in share prices and franchise value. In these circumstances there is nothing to be gained by contesting the charges in court, which involves great expense and a lengthy process, by the end of which the lost franchise value cannot be redeemed, even if the bank is vindicated.

Uncertainty, misperception and discrimination heighten the challenges facing international banks. There is no clear guidance on the information requirements that would be internationally acceptable, and no over-arching body that is mandated to provide guidelines that would jointly satisfy the requirements of AML, tax information, market integrity and sanctions compliance. Small markets and developing economies are being held to higher standards of information and risk protection than larger countries, for risks that are identical. As a result, it becomes disproportionally more costly and less attractive to do banking business in small international financial centres, even those that have stronger regulatory requirements than particular OECD countries, and that are able to provide services of comparable quality at more competitive prices.

The manifestations of de-risking strategies continue to evolve and expand, sometimes in response to efforts to find a way around initial difficulties caused by de-risking. Regulatory guidance also continues to evolve, on several uncoordinated tracks. The adverse consequences of de-risking are an expanding global problem, and their full depth and dimensions are not yet apparent.

The present study aims to explore all aspects of the de-risking strategies adopted by international banks, using the Caribbean as a case study. The Caribbean is a good laboratory for this purpose, because it features a modern sophisticated financial sector, with the active participation of international banks offering

correspondent services as well as financial services for local populations, and the region includes important well-connected international financial centres. The Caribbean therefore offers examples of the potential range of effects that de-risking strategies can have, and evidence of the motives that underlie those strategies.

The remainder of the paper is as follows. The next section reviews the literature on the role of international financial centres in the global economy, showing how these centres can contribute to the efficiency of international financial markets. We also provide a brief overview of the international regulatory landscape and factors which are material to the analysis of de-risking. Our third section surveys the current international regulatory landscape and documents the status of the Caribbean, in terms of compliance with regulatory guidelines. To provide context, the Caribbean is compared with other international financial centres and selected OECD countries. Section 4 considers other drivers of de-risking strategies, while section 5 discusses other material considerations affecting the observed changes. Section 6 considers the evidence of de-risking to date. We conclude with suggestions for the way forward, in a continuing process of investigation and international cooperation, working towards a comprehensive, coordinated framework for international financial regulation, implementation and monitoring.

2. BACKGROUND

OFCs are efficient global transmitters of short term capital, providing lower explicit costs of investing and consequently a lower required rate of return on capital (Naitram, 2014). Stagnation of this activity implies not only a loss of income for Caribbean IFCs, but also a fall in the efficiency of global financial transactions (Hejazi, 2015). In addition, the region's vested interest in trade, tourism and external investment heavily depends on functioning CBRs (Hopper, 2016). Hejazi (2015) provides evidence of the mutually beneficial relationship between Canada and Barbados in terms of the generation and diversification of income and the creation of employment in the two countries.

Canada has also benefitted from several Double Taxation Agreements and Bilateral Investment Treaties signed by Barbados with other countries, in combination with the Tax Information Exchange Agreement between the two

countries. Barbados' competitive strengths include, inter alia, a high quality of education and health services, low levels of crime, a sound legal system and good infrastructure (Worrell, 2015). Further, the Caribbean has other comparative advantages such as political and economic stability, a strong system of property rights, close proximity to the US, Canada and Latin America, and a labour market with a pool of high quality professional services at prices which are considerably below comparable rates in major IFCs such as New York and London (Worrell & Lowe, 2011).

The international regulatory framework has gradually evolved in response to several changes in the financial environment via regulatory bodies such as the Financial Stability Board (FSB) and the Financial Action Task Force (FATF). Established in 2009, the FSB promotes global financial stability via the coordination of the development of regulatory, supervisory and other financial sector policies in addition to conducting outreach to non-member countries. Moral suasion and peer pressure is used to achieve the Board's objectives as its policies are not legally binding. To identify any systemic risk in the financial sector, a three-stage process inclusive of a vulnerabilities assessment, policy development and coordination as well as implementation monitoring is carried out.

The FATF is an inter-governmental body whose objectives are to set standards and promote effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats to the integrity of the international financial system. Beginning in 1996, the FATF has produced a series of recommendations which are now the international standard for combating money laundering and the financing of terrorism. Subsequently, the recommendations have been updated in 2001, 2003 and 2012. To ensure international compliance, the FATF conducts regular peer reviews on countries thus providing an in-depth analysis of each country's system for preventing criminal abuse of the financial system.

Arguably the most in depth review of a jurisdiction's financial sector, the Financial Sector Assessment Programme (FSAP) is a joint undertaking between the IMF and World Bank that produces a comprehensive analysis of a country's financial sector with an aim of gauging the sector's stability and soundness as well as assessing its

potential contribution to growth and development. This is done by identifying the main vulnerabilities that could trigger a financial crisis while keeping in mind financial stability dimensions. The stability assessment conducted by the IMF includes stress testing, analysing systemic risks and reviewing the quality of supervision while the World Bank's appraisal of the development aspects includes examining the development needs in terms of institutions, markets, infrastructure, and inclusiveness and the quality of the legal framework. As a result of the global financial crisis, the FSAP was updated to include a clear definition of the components of stability assessments, risk assessment matrices, and the possibility of modular FSAPs conducted separately by the IMF or the World Bank, focusing on each institution's chief responsibility.

The OECD's Global Forum on Transparency and Exchange of Information for Tax Purposes addresses the risks to tax compliance posed by non-cooperative jurisdictions. The Global Forum employs the use of a two-phased Peer Review process which evaluates a jurisdiction's compliance to the international standard of transparency and exchange of information. Phase 1 examines the legal and regulatory framework for transparency and the exchange of information for tax purposes while Phase 2 delves into the implementation of the standard in practice. As at 2013, a rating is allotted to both phases in addition to an overall score for each jurisdiction. Recently, provisions have begun to be implemented to allow for the Automatic Exchange of Information as a new global standard. It allows for the exchange of non-resident financial account information with the tax authorities in the account holders' country of residence with a view to enabling governments to recover tax revenue lost to non-compliant taxpayers as well as further strengthening international efforts to increase transparency, cooperation, and accountability among financial institutions and tax administrations.

Several measures have also been introduced to ensure that individuals and companies contribute to the efficiency of the financial system. The Base Erosion and Profit Shifting (BEPS) initiative is intended to inhibit tax planning strategies that profit from gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations. Most BEPS strategies used are legal and to the extent that leading international companies use them to avoid paying reasonable rates of tax, the fairness and integrity of tax systems are called into question. To address this, the

OECD produced 15 actions that aim to create consensus on international tax rules to protect tax bases, to offer some predictability to taxpayers and to arm governments with domestic and international instruments to address tax avoidance.

The Foreign Account Tax Compliance Act (FATCA) is a means by which the Internal Revenue Service (IRS) can target non-compliant US taxpayers using foreign accounts. It requires foreign financial institutions (FFIs) to report information about financial accounts held by US taxpayers or by foreign entities in which US taxpayers hold a substantial ownership interest. FFIs may report information to their own governmental agencies, to be forwarded to tlhe IRS, or they may report information directly to the IRS.

3. THE INTERNATIONAL REGULATORY LANDSCAPE AND THE STATUS OF THE CARIBBEAN

Over the years the international financial community has established institutional arrangements to address concerns about safety and soundness. The Basel Committees on Banking Supervision and on Payments are the longest established, and the Financial Action Task Force on anti-money laundering and the Global Forum on the Exchange of Tax Information have been added more recently. There are established procedures for assessing countries' engagement with these processes, and their compliance with the guidelines set out by each of the agencies set up to oversee and review the regulatory frameworks. In this section we examine how Caribbean countries compare with some other international financial centres, and with the US, the UK and Canada, according to the agreed criteria.

The most comprehensive assessment of countries' financial sector is undertaken jointly by the World Bank and the International Monetary Fund. The Financial Sector Assessment programme (FSAP), which is subscribed to by all members of the Fund and Bank, involves teams of financial experts who undertake a comprehensive, in-depth analysis of the vulnerabilities and strengths of each country's financial sector. We therefore begin our comparisons with countries' assessment under the FSAP.

The Financial Action Task Force (FATF) is the second international institution which conducts assessments of countries risk exposures. Their remit is anti-money

laundering and the financing of terrorism (AML/CFT). Their assessment methodology is through mutual evaluation, where a team of assessors, drawn from countries subscribing to FATF, conduct reviews of other countries, using a list of guidelines to assess compliance.

The third international body to which many countries subscribe is the Global Forum for the Exchange of Tax Information. Their assessments are also done through a process of peer reviews, where experts from some member countries visit others to conduct the reviews. The reviews explore the legal and operational arrangements that exist to facilitate the exchange of information in a timely manner.

The FSAP process conducted jointly by the IMF and World Bank evaluates a country's financial stability and the development needs of its institutions, markets and infrastructure. The assessment covers three broad areas:

- The soundness of the financial system and its vulnerabilities that increase the risk of a financial crises.
- The country's developmental needs in terms of infrastructure, institutions and markets.
- the country's compliance with the observance of selected financial sector standards and codes set out by the Basel Committee on Banking Supervision.

The Basel Core Principles for effective banking supervision identify minimum characteristics and infrastructure required for the effectiveness of the supervisory regime

The recommendations developed by the FATF serve as the global standard for legal infrastructure and regulatory oversight necessary to support an effective approach of anti-money laundering and combatting the financing of terrorism. The FATF monitors the adoption of AML/CFT best practices, through countries' periodic assessment of their AML/CFT framework.

All the Caribbean countries listed in Table 1 are fully engaged with the FSAP process. Most have had two assessments done under the programme, and Barbados has been assessed on three occasions. Each successive evaluation has recorded progress in the level of compliance with the Basel Core Principles. In contrast, the US had its first and only FSAP so far in 2015.

Levels of compliance among the countries in Table 1 are graphically represented in Figure 1. (There are 29 Core Principles.) It may be seen that compliance is comparable among all the countries listed, and there is no country with levels of noncompliance sufficient to suggest that the country has not fully accepted the Core Principles. The principles on which countries are "materially non-compliant" are few, and where they occur they are on countries' agendas for reform.

Table 2 presents a similar comparison among the countries, based on reports of mutual evaluations conducted under the FATF framework. Once again the record shows that Caribbean international financial centres (IFC's) are fully engaged with the process. All the Caribbean countries in the table have completed reviews of their legal frameworks, and are in the process of addressing gaps that have been identified. Barbados and some other Caribbean IFC's are undergoing reviews of their operational procedures, which is the next stage of the mutual evaluation process.

As may be seen from Figure 2, levels of compliance with the FATF guidelines are lower in all countries than for compliance with Basel Core Principles. However, the conclusion with respect to the Caribbean is similar to the pattern we saw for the FSAP: Caribbean performance is on par with other IFC's, and also on par with the US, Canada and the UK.

The picture that emerges from Table 3, which gives a summary of compliance with the guidelines of the Global Forum on tax information exchange, is very similar to what we have seen so far. All Caribbean countries are largely compliant, except for Barbados, which is partially compliant. The comparitor countries are all largely or fully compliant, except for Panama, which has not yet been rated.

Table 1: Caribbean IFC and their international counterparts

The table provides a comparison of International Financial Centres showing their degree of conformance with international best practices as attested by various international certification processes including the IMF's FSAPs and the FATF's mutual evaluations. It considers either 25 or 29 core principles dependent upon the date of the FSAP review, while the FATF compliance measure considers 49 core principles.
For example, C-14 reads as compliant in 14 of the relevant Basel Core Principles.

IMF/WB FSAP Ratings: C - Compliant, LC - Largely Compliant, MNC – Materially Non-Compliant, NA – Not Applicable.

	Country	Basel Capital Adequacy Implementation	Last FSAP Conducted	Compliance with Basel Core Principles for Effective Banking Supervision
Caribbean IFCs	Barbados	Partial Implementation of Basel II	2014	C – 14, LC – 14, MNC – 1
	Bahamas	Partial Implementation of Basel II	2013	N/A
	BVI	Partial Implementation of Basel II	2010	C – 20, LC – 4, NA – 1
	Bermuda	Partial Implementation of Basel II	2008	C – 18, LC – 11, NA – 1
	Cayman Islands	Partial Implementation of Basel II	2009	C – 15, LC – 10)
IFCs	Jersey	Basel II	2009	C - 26, LC -5
	Hong Kong	Basel II	2014	C – 26, LC – 3
	Luxembourg	Basel II and elements of Basel III	2011	N/A
	Panama[1]	Basel II and elements of Basel III	2014	C – 15, LC – 9, MNC – 1
	Switzerland	Basel II and elements of Basel III	2014	C – 19, LC – 8, MNC – 2
	Isle of Man	Basel II and elements of Basel III	2009	C – 18, LC – 7
OECD/G-10	USA	Basel II and elements of Basel III	2015	C – 18, LC – 11
	Canada	Basel II and elements of Basel III	2014	C – 22, LC – 7
	UK	Basel II and elements of Basel III	2016	C – 20, LC – 9

[1] Detailed Assessment Report – FATF Recommendations for Anti-Money Laundering and Combating the Financing of Terrorist Report conducted by the IMF as at January 2014

Table 2: FATF EVALUATION ASSESSMENTS

FATF Ratings C – Compliant, LC – Largely Compliant, PC – Partially Compliant, NC – Non Compliant,

	Country	FATF Mutual Evaluation Assessments (3rd Round)
Caribbean IFCs	Barbados	C – 9 , LC - 13, PC - 21 , NC - 6
	Bahamas	C - 13, LC – 8, PC – 24, NC - 3
	BVI	C – 18, LC – 15, PC – 15, NC - 1
	Bermuda	C – 9, LC – 10, PC – 16, NC - 14
	Cayman Islands	C – 14, LC – 24, PC – 10 , NC - 1
IFCs	Jersey	C – 16, LC – 32, PC – 1
	Hong Kong	C – 10, LC – 20, PC – 15, NC - 4
	Luxembourg	C – 1, LC – 9, PC – 30, NC - 9
	Panama[2]	C -1, LC – 3, PC – 26, NC - 18
	Switzerland	C – 11, LC – 21, PC – 13, NC – 3, NA - 1
	Isle of Man	N/A
OECD/G-10	USA	C – 15, LC – 28, PC – 2, NC – 4
	Canada	C – 7, LC – 23, PC – 8, NC – 11
	UK	C – 24, LC – 12, PC – 10, NC - 3

[2] Detailed Assessment Report – FATF Recommendations for Anti-Money Laundering and Combating the Financing of Terrorist Report conducted by the IMF as at January 2014

Figure 1: Basel Core Principals of Banking Supervision

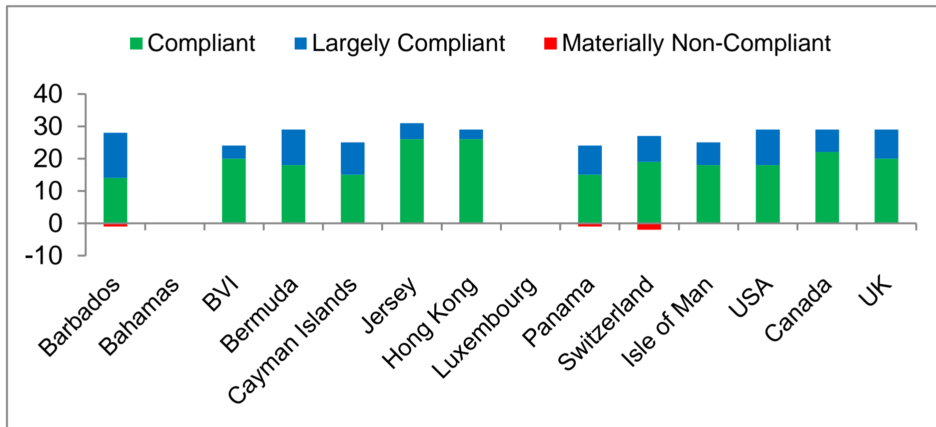


Figure 2: FATF Recommendations

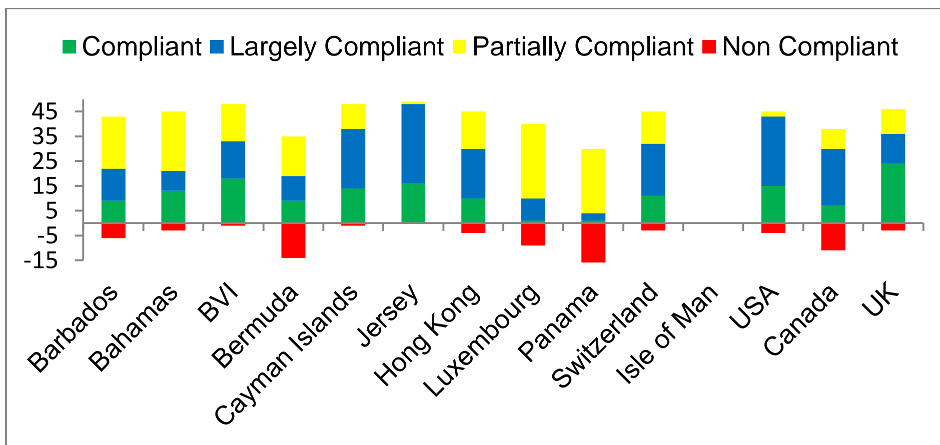


Figure 3: OECD Peer Global Reviews

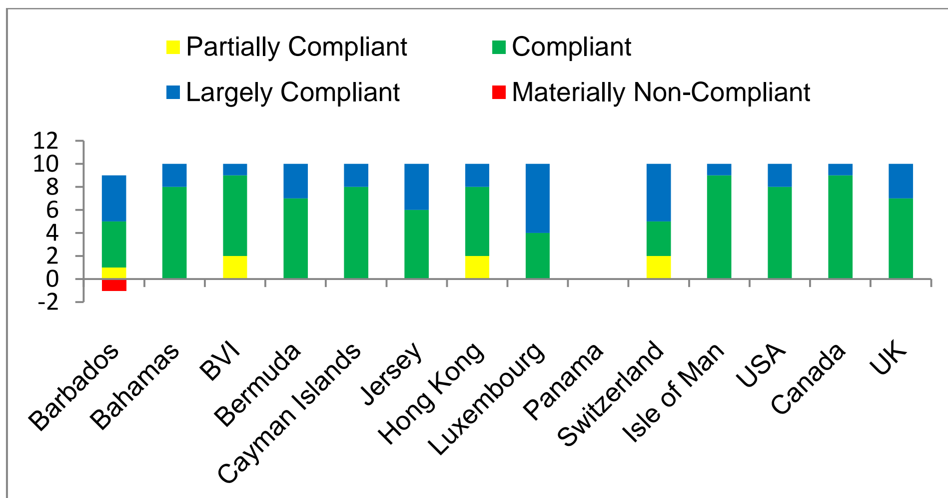


Table 3: OECD Peer Global Reviews

C – Compliant, LC – Largely Compliant, PC – Partially Compliant

Category	Jurisdiction	Year of Assessment	Assessment Report	Rating
Caribbean IFCs	Bahamas	2013	Phase 1 and 2 reports conducted	LC
	Barbados	2014	Phase 1, supplementary and Phase 2 reports conducted	PC
	Bermuda	2013	Phase 1, supplementary and Phase 2 reports conducted	LC
	British Virgin Islands	2013	Phase 1, supplementary, Phase 2 and supplementary reports conducted	LC
	Cayman Islands	2014	Phase 1, supplementary and Phase 2 reports conducted	LC
IFC	Hong Kong	2013	Phase 1 and 2 reports conducted	LC
	Isle of Man	2013	Combined Reports	C
	Jersey	2013	Combined and Supplementary reports conducted	LC
	Luxembourg	2013	Phase 1, 2 and supplementary reports conducted	LC
	Panama	2015	Phase 1 and supplementary reports conducted	N/A
	Switzerland	2016	Phase 1, supplementary and Phase 2 reports conducted	LC
OECD	Canada	2013	Combined reports conducted	C
	USA	2013	Combined reports conducted	LC
	UK	2013	Combined and supplementary reports conducted	LC

**No compliance rating is assigned until the Phase 2 Peer Reviews are completed.*

Source: Global Forum on Transparency and Exchange of Information for Tax Purposes: Peer Reviews, OECD Publishing

4. OTHER INTERNATIONAL REGULATORY INFLUENCES

In addition to the regulatory issues relating to prudential supervision, anti-money laundering and the exchange of tax information, there are additional de-risking pressures on banks, arising from worldwide concerns about tax evasion. A number of initiatives, at national and international levels, have been introduced to arrest what is seen as "aggressive" tax avoidance through international financial transfers. Some types of transfer, such as those resulting from transfer pricing, have long been frowned upon. (Transfer pricing is the practice of shifting profits from one country to another by charging for nonexistent services or supplies, or by overpricing/underpricing for what was actually delivered.) However, other practices, and countries that host certain activities, employ perfectly legitimate company and institutional arrangements to pay the minimum taxes for which they are liable. Until now, such practices were generally acceptable worldwide, but in the wake of recent scandals about low rates of taxation paid by global companies, new guidance is in preparation to tighten the rules under which such transfer may be permitted. In this section we discuss three initiatives: the OECD Base Erosion and Profit Shifting Initiative (BEPS); the US Foreign Account Tax Compliance Act (FATCA); and the OECD Common Standard on Exchange of Information.

(a) The OECD Base Erosion and Profit Shifting Initiative (BEPS)

The OECD BEPS project seeks to update international tax rules in a coordinated way. The project is intended to address the following:

- Coherence—removing gaps in the tax regimes that allow companies to escape tax obligations they would otherwise incur;
- Substance—aligning tax obligations with the location of value added; and
- Transparency—guidelines for tax reporting and disclosure.

The OECD is developing new guidelines for tax information requirements of the digital economy and is crafting a multilateral treaty to implement certain BEPS recommendations. These initiatives are works in process, but some OECD countries

have taken unilateral action, including increased tax audits, high-profile investigations, and significant legal changes, without regard to any consensus the project might reach.

(b) The Foreign Account Tax Compliance Act (FATCA)

The purpose of FATCA is to ensure that US persons with financial assets outside the US declare their income and assets. All financial institutions outside of the US will be required to enter into an agreement with the Internal Revenue Service (IRS) to transmit the relevant information to the IRS, via their host government. The information to be submitted should allow the IRS to determine which account holders and beneficiaries are subject to US tax, and financial institutions are required to impose at 30% withholding tax in some circumstances. The FATCA guidelines formally came into effect in January 2014. However, in most cases, withholding on gross proceeds will not begin until January 1, 2017[3], at the earliest. This starting date is in question, because the US has intimated to some countries, including Barbados, that it will not be ready to provide tax information on request, as the Act requires.

As things now stand, "the US does not provide its FACTA partners with the same information about U.S. financial institutions that foreign financial institutions must provide to the IRS". (US Department of the Treasury (2016). The United States did not sign on to the OECD's Common Reporting Standards (CRS) (Knobel, 2016, and Long and Erwin, 2016) and it does not plan to implement the OECD standard for the exchange of information (Zagaris, 2015).

(c) OECD Common Standard on Exchange of Information

The Common Reporting Standard (CRS) was developed by the OECD together with G-20 countries. It calls on jurisdictions to obtain tax-relevant information on non-residents from their financial institutions and exchange that information automatically with other jurisdictions on an annual basis. It sets out the financial account

[3] The US has indicated to Barbados that it will not be able to share information on Barbados' taxpayers as required under the IGA until the testing phase, which currently includes Barbados, has been completed. Barbados has however not been advised when the full reciprocal functionality of the Agreement is likely to materialise.

information to be exchanged, the financial institutions that need to report, the different types of accounts and taxpayers covered, as well as common due diligence procedures to be followed by financial institutions.[4]

Among jurisdictions that have signed on to the Convention on Mutual Administrative Assistance in Tax Matters[5] are Barbados (January, 2016), Canada (January, 2014), and the UK (January, 2011).[6] As of July, 2016, 101 jurisdictions have committed to the Automatic Exchange of Information.

[4] A legal basis for automatic exchange of information already exist, such as Article 26 of the OECD Model Tax Convention. It is intended to replace these with automatic exchange relationships on the basis of a multilateral exchange instrument

[5] OECD Convention on Mutual Administrative Assistance in Tax Matters 'Chart of Participating Jurisdictions'

[6] Participating jurisdictions to which the study relates in the Convention on Mutual Administrative Assistance in Tax Matters are as follows:
Barbados entered into force 01-11-2016; Bermuda entered into force 01-03-2014; British Virgin Islands entered into force 01-03-2014; Canada entered into force 01-03-2014; Cayman Islands entered into force 01-01-2014; Isle of Man entered into force 01-03-2014; Luxembourg entered into force 01-11-2014; United Kingdom entered into force 01-10-2011

5. OTHER MATERIAL INFLUENCES AND CONSIDERATIONS

(a) Penalties and Loss of Franchise Value

The perceived zero tolerance approach by some regulatory authorities in developed countries, and large fines for AML/CFT deficiencies and alleged misconduct, are a further incentive for banks to de-risk. Table 4 reports on some of the largest fines that have recently been imposed on international banks. What makes the case for de-risking even more compelling is the fact that a handful of questionable transactions may result in disproportionate penalties and loss of franchise value.

Table 4: Recent AML/CFT related Fines and Penalties

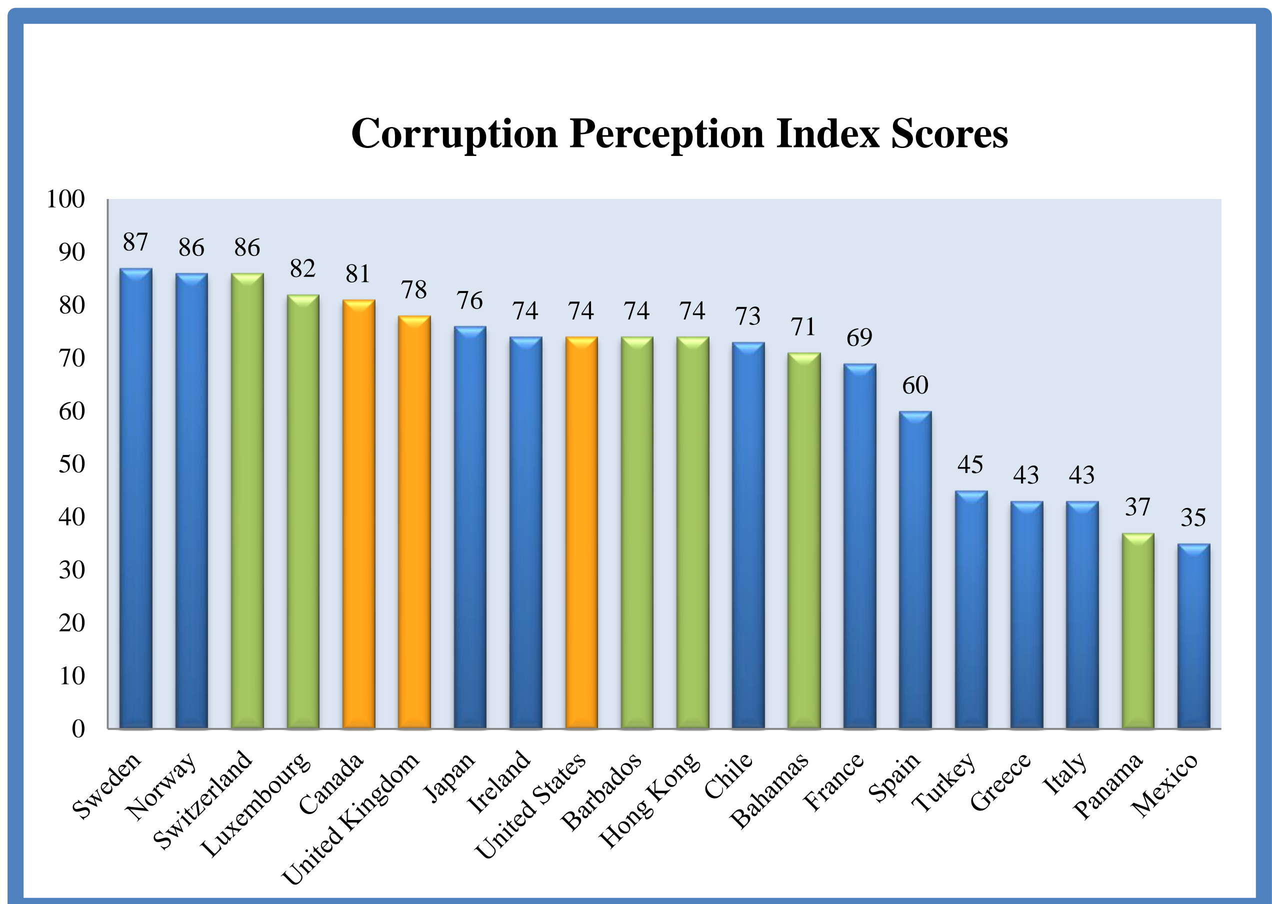
The table highlights recent fines and penalties related to AML/CFT regulation adopted breaches in the UK and US. The largest fines were imposed by US regulatory authorities on non-US banks.

Company	Date	Nature of ML/FT Breach	Regulatory Authority	Culpability Established	Monetary Penalty
HSBC	2012	AML/CFT control deficiencies	US Treasury/Department of Justice	Deferred Prosecution Agreement	USD 1.9 billion
Credit Suisse	2014	Aiding Americans in Tax Evasion efforts - a predicate offence to money laundering as defined by the FATF	US Department of Justice/ Federal Reserve/NY Department of Financial Services	Felony Conviction	USD 2.6 billion
UBS AG	2009	Accused of Defrauding US Tax Authorities	US Treasury /Department of Justice	Deferred Prosecution Agreement	USD $780 million
EFG Private Bank	2014	Breach of FSA Principle 3	Financial Conduct Authority (UK)	Early stage settlement of investigation	GBP 4.2 million
Barclays PLC	2015	AML/CFT control deficiencies	Financial Conduct Authority (UK)	No admission of guilt	GBP 72 million
Standard Chartered PLC	2014	AML/CFT control deficiencies and sanctions violations	NY Department of Financial Services	Deferred Prosecution Agreement	USD 667 million
ING Bank N.V	2012	Violations of US Sanctions related to Cuba, Iran, Burma, Sudan and Libya	US Department of the Treasury - Office of Foreign Assets Control (OFAC) / Department of Justice	Settlement of potential liability	USD 619 million
Money Gram	2012	Failures in AML/CFT control framework	US Department of Justice	Deferred Prosecution Agreement	USD 100 million

(b) Transparency International Index

There is a popular misperception to the effect that countries which are adversely affected by de-risking are in some way more deficient than OECD countries with respect to international regulatory guidelines. We have shown that the documented reports of international regulatory agencies do not lend support to that notion. We have further evidence from the international markets, in the form of the *Corruption Perception Index Score*, published by Transparency International. Of the Caribbean countries listed in the index, Barbados has the same score as the US and the Bahamas scores more highly than does France.

Figure 4: Corruption Perception Index Scores



Source: Transparency International 2014

6. EVIDENCE OF DE-RISKING

(a) The World Bank and the IMF

The World Bank's 2015 study on the drivers of the global withdrawal from correspondent banking is the most comprehensive analysis of this phenomenon to date.

Table 5 below summarises the responses to the WB survey.

Table 5: Comparing drivers of termination/restriction of foreign correspondent banking relationships (CBRs) for different survey respondents

Reason	Banking Authorities (%)	Large International Banks (%)	Local / Regional Banks (%)
Lack of profitability of certain foreign CBR services/products	64	80	46
Overall risk appetite	55	85	37
Changes to legal, regulatory or supervisory requirements in correspondent's jurisdiction that have implications for maintaining CBRs	48	45	31
Structural changes to correspondent – M&A or re-organisation of business portfolio	27	30	35
Concerns about money laundering/terrorism financing risk	48	95	19
Inability/Cost to undertake CDD	36	65	16
High-risk customer base	18	75	8
Imposition of international sanctions on jurisdiction or respondent	7	90	8
Concern about, or insufficient information about respondents CDD procedures	14	80	6
Respondent's jurisdiction subject to countermeasures or identified having strategic AML/CFT deficiencies	23	75	4

Source: World Bank Survey on De-risking (2015)

Changes to the legal, regulatory or supervisory requirements in the jurisdictions of correspondent banks were highlighted as a major reason for the decline in CBRs by

both international banks and banking authorities. Some of the most frequently highlighted changes in regulatory requirements or legislation included:

- Implementation of Basel III and the Liquidity Coverage Ratio (LCR);
- Updates to the FATF recommendations in 2012 and increased regulatory compliance costs; and
- Increased scrutiny by regulatory authorities in handling AML/CFT deficiencies and transgressions.

In a June 2016 speech[7] to the New York Federal Reserve Bank, the IMF managing director Christine Lagarde stressed the significance of ensuring measures to increase financial stability do not stymy access to the global market and expressed her concern that countries with small financial systems are being marginalized. This is of utmost importance given that the use of correspondent banking relationships (CBRs) have positively impacted financial inclusion as is evidenced in Brazil, Colombia, India, Kenya and Mexico (World Bank, 2014). The World Bank study further highlights how the procedures undertaken by the Brazilian, Colombian and Mexican regulators to facilitate correspondent banking were critical in enabling banks and other formal financial institutions to expand their networks. The withdrawal of CBRs is also a threat to the Caribbean's growth and stability especially in Bermuda, the Cayman Islands and the British Virgin Islands where the IBFS sector is the largest contributor to employment, foreign exchange receipts, tax revenues and GDP growth (Worrell & Lowe, 2011).

(b) Implementation of the LCR and its Impact on Correspondent Banking

The Basel Committee on Banking Supervision introduced a liquidity coverage ratio (LCR) in response to the 2007-09 financial crisis. The LCR was designed to ensure banks were capable of meeting short-term liquidity requirements during turbulent periods by requiring them to hold sufficient high quality liquid assets (HQLAs) to meet the repayment of short-term debt over an extended period of market disruption/turbulence during which wholesale funding is inaccessible. The LCR is

[7] https://www.imf.org/en/News/Articles/2016/07/15/13/45/SP071816-Relations-in-Banking-Making-It-Work-For-Everyone

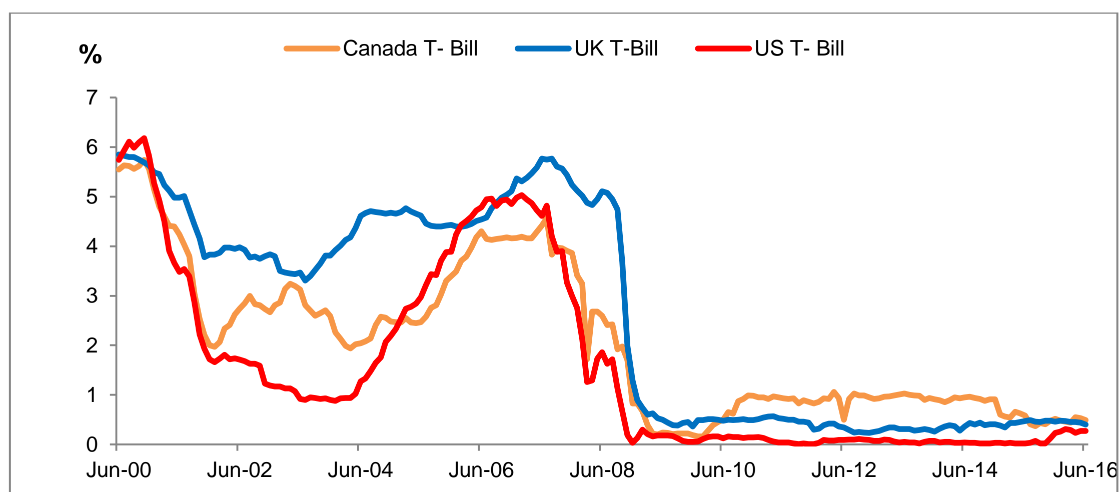
defined as the ratio of high quality liquid assets to anticipated total net outflows during an extended period of market stress, generally 30 days.

$$LCR=\frac{High\ Quality\ Liquid\ Assets}{Net\ Cash\ Outflows\ Over\ a\ 30\ Day\ Period}$$

High Quality Liquid Assets (HQLAs) include cash, near-cash, central bank reserves, securities, government and corporate bonds and government guaranteed instruments.

The higher liquidity requirements associated with the LCR create a drag on bank profitability, as inherently more liquid and higher rated instruments carry a lower yield. Additionally, the monetary policy environment globally is characterised by very low to zero interest rates in the G10 member countries. Figure 3 below illustrates the interest rate environment for three G-10 member countries and underscores diminished earning potential associated with short-term liquid assets which forms the base of the HQLA. The combined effect of higher liquidity requirements and an ultra-low interest rate environment increases the fragility of the international financial system, and may therefore prove to be counterproductive.

Figure 5: Selected Treasury Bill Rates



Note; In percentages, per annum.
Source: Bloomberg

What is more, the true liquidity of these assets is called into question. Following the market disruptions during 2007 – 2009 many of the largest fixed income dealers

have significantly scaled down their operations and are holding lower inventories of fixed income securities. They are reacting to the implementation of new regulations requiring greater capital to support these types of businesses and declines in their risk appetite following the financial crisis. With diminished trading appetite on the part of dealers who make the market, it may be impossible to realise more than a fraction of the value of supposedly liquid assets in the event of a future financial crisis.

(c) The Financial Action Task Force's Anti-Money-Laundering and Countering-Financing-Terrorism (FATF AML/CFT) Recommendations

Recent revisions to the FATF's recommendations include:

- The adoption of a risk-based approach to AML/CFT,
- Implementation of UN targeted financial sanctions against persons or entities financing the proliferation of weapons of mass destruction; and
- Designating tax crimes as predicate offences to money laundering.

In addition, banks have been confronted with increasing uncertainty regarding the appropriate level of Know-Your-Customer (KYC) standards for clients with third party business, commonly referred to as Know-Your-Customer's-Customer (KYCC).
The cumulative impact of these changes has been a significant increase in compliance costs across the board in the financial services sector. From the perspective of a large international bank offering correspondent banking services globally all of the previously highlighted factors alter the profitability equation. Increased compliance costs, lower profitability and uncertainty, combined with highly publicised, large civil money penalties, is a strong incentive for financial institutions to err on the side of caution and withdraw from activities and countries where the potential returns cannot cover the risks of doing this business. The greater the proportion of an institution's client portfolio that is regarded as higher risk, the higher the cost of risk mitigation measures. Larger proportions of high risk clients within the portfolio will require additional resources for:

- Investments in IT infrastructure;

- Greater Data Collection from new clients as well as on an on-going basis for existing clients; and
- Increased staff to navigate the growth in regulatory requirements as well as to conduct greater scrutiny of client transactions.

What is more, a higher proportion of clients being designated as high risk may also attract greater regulatory scrutiny, requiring additional resources to interface with regulatory authorities and satisfy any information/data requests. These increased costs further erode the profitability of providing banking services.

(d) The uneven Playing Field

There is evidence that the inequity of tax treatment by the US and its FATCA partners has resulted in a re-location of trust companies of non-U.S. persons to move to the U.S. to avoid the CRS (Cotorceanu, 2015).

The commitment by IFCs to implement the CRS and the US's simultaneous refusal has reportedly sparked a wave of business migrating from IFC jurisdictions such as Switzerland, the Cayman Islands, and Bermuda to the US. This business has often times been booked in US States with strong secrecy laws and weak oversight such as Delaware and Nevada (*Financial Times,* 2016).

International Financial Centres (IFCs) can be categorized into those that ply their trade "onshore" and "offshore". Onshore Financial Centres refer to those jurisdictions, typically developed nations, with a prominent International Business and Financial Sector (IBFS) where transactions are initiated within the country. The majority of recent literature on IFCs has focused on Offshore Financial Centres (OFCs) due to their rise in importance in the global network of finance. The disproportionate burden on financial institutions operating in small offshore IFCs limits their ability to open new markets and attract new businesses (Invest Barbados, 2014) and diverts that business to onshore markets.

The global financial system is skewed in favour of onshore IFCs although smaller, poorer countries tend to lead their OECD counterparts with regard to

enforcing the rules on corporate transparency (Findley, Nelson and Sharman, 2012). It is at least three times harder to obtain an untraceable shell company in countries considered to be tax havens than in some developed countries. In order to remove this anomaly, Persaud (2014) contends that international regulations should be focused on products and effectiveness of measures instead of countries and processes.

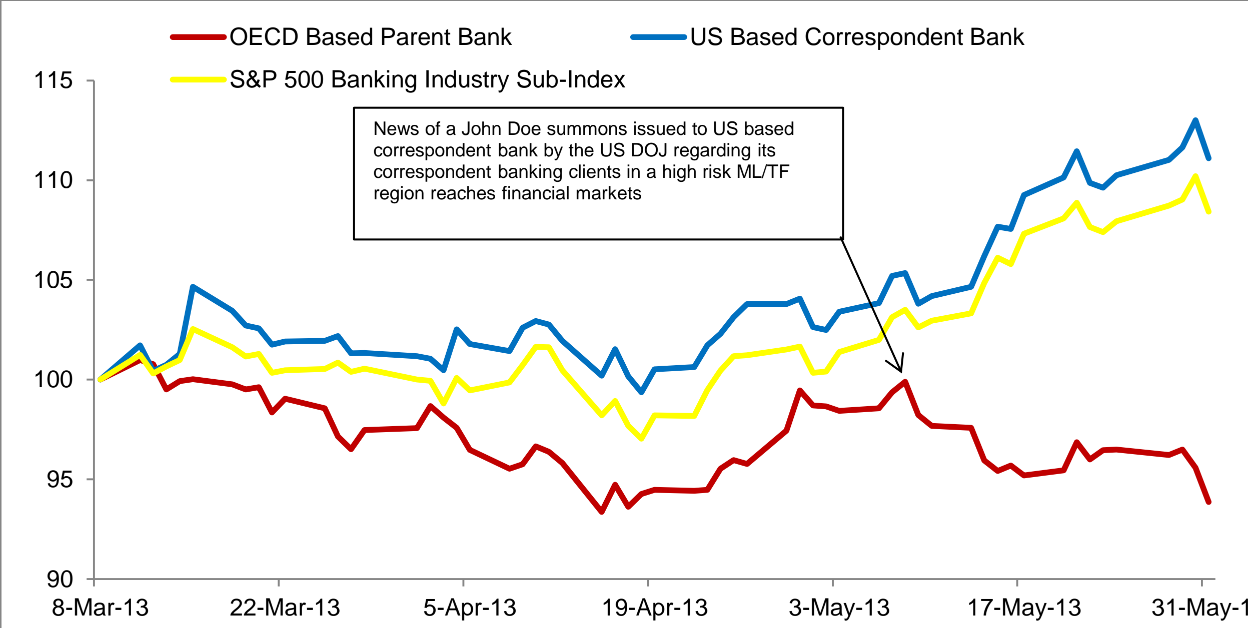
The United States' disclosure rules preserve advantages for domestically incorporated trusts owned by residents and non-residents, while concurrently setting different disclosure rules worldwide (Scannell & Houlder, 2016). Other protectionist measures available in US onshore IFCs include strong asset protection laws, secrecy provisions, and exemption from personal or corporate income taxes for non-resident investors. There are fewer information and compliance requirements for setting up an untraceable shell company in the US than in any other IFCs with the exception of Kenya (Findley, Nielson, & Sharman, 2012). Moreover, Oregon, Montana and the District of Colombia adhere to the OECD's outdated 1999 criteria for tax havens which have now been abandoned by the international financial community (Zagaris, 2015; OECD, 1998).

Morris and Henson (2013) compared the regulatory capability of major OFCs with their onshore counterparts. Their research shows how onshore regulators, interest groups and politicians cherry-pick aspects of compliance to justify competition-restricting measures. Caribbean entities have stringent corporate transparency rules that necessitate the disclosure of beneficial owners and the updating of such information on the corporate registry (Zagaris, 2015), and Caribbean regulatory standards are on par with international practice (Worrell and Lowe, 2011). Misinformation and protectionist measures create incentives for businesses to move from the well-supervised and compliant Caribbean to "jurisdictions that have little reason to heed a European or American call for prudential cooperation in financial matters" (Brantley & Morris, 2016).

(e) The Impact of Uncertainty – A Practical Case Study

As highlighted earlier, the perceived zero tolerance approach by regulatory authorities is multifaceted and warrants careful consideration by bank executives. In one instance, the US Department of Justice issued a John Doe summons to a US based bank which provided correspondent banking services in a geographic region deemed to be "high risk" by the Department of Justice. The John Doe summons was served in order to gain access to data of US tax payers who might have held undeclared accounts with banks operating in the "high risk" region. The US based correspondent bank was directed to produce records identifying US taxpayers with accounts at banks based in the high risk region and utilising the US bank as correspondent bank for clearing and settlement of international transactions.

All parties involved in the summons fully complied with its requirements and no additional measures were taken by the DOJ or IRS. However, the uncertainty created by the episode fuelled speculation about the possibility of large government penalties if any US tax payers were found to be holding undeclared accounts/assets with respondent banks in the "high risk" region. The speculation and uncertainty created by the episode was manifested in the equity price of the parent institution of one of the respondent banks operating in the "high risk" area. The parent bank, a publicly traded, OECD headquartered institution saw a 5.9% decline in the value of its equity in the days and weeks following the announcement of the John Doe summons. Aggregated, the decline in the market capitalisation of the parent institution was approximately USD 2 billion, driven by fear and uncertainty created by the new zero tolerance regulatory regime.



A breakdown in the positive relationship between the publicly listed OECD parent bank, the US based correspondent bank and the broader S&P 500 banking Sub- index can be observed from the chart. Prior to the IRS/DOJ announcement on April 30th, 2013 a strong positive correlation is evident. However this correlation appears to unravel following the news of the DOJ investigation reaching financial markets. The uncertainty about the impact of the investigation resulted in negative investor sentiment towards the OECD Parent Bank. This ultimately resulted in selling pressure on the company shares and a lower equity value, directly impacting shareholder returns.

7. SUGGESTIONS FOR THE WAY FORWARD

We should bear in mind that the objectives of international financial reform and international tax reform are to make the international financial system safer, to make it more efficient, and to reduce incentives for unfair tax practices. To what extent are these objectives being achieved, on the basis of the evidence discussed in this paper?

International financial centres in the Caribbean are fully engaged with the international institutions overseeing the processes of international financial reform: the Financial Stability Board, the Basel Committee, the Financial Action Task Force, and the Global Forum. Furthermore, Caribbean countries fully endorse the objectives of the US, the OECD countries and the EU to arrest the erosion of national tax bases and to develop globally acceptable standards for the exchange of tax information. We have documented the Caribbean IFCs' level of compliance in all of these areas, and the Caribbean is on par with leading international financial centres globally, and with advanced economies. The quality of supervision in Caribbean IFCs and their high reputation for probity are attested to by independent analysis by Transparency International and others, as well as by published reports of international regulatory agencies.

There has been a loss of banking services throughout the Caribbean, driven by international regulatory tightening and by actions to punish perceived wrong-doing by international banks, despite the high quality of Caribbean regulatory systems, judged by comparison with international standards and practices in advanced economies. Our paper documents the many ways in which this has manifested itself, including the loss of correspondent banking services by domestic and regional banks, the pruning of banks' client lists, banking information systems and practices that discriminate in favour of the US and other advanced economies, withdrawal of international banks from selected countries and markets, and the revisions of global strategies of international banks to reduce their global footprint.

The result of all this has been a reduction in the efficiency of international financial markets because of what are in effect non-tariff barriers. International firms which would otherwise be motivated to establish subsidiaries and branches in Caribbean international financial centres in order to increase the efficiency and transparency of their global operations are being deterred because they are unable to open transactions accounts in the Caribbean with international banks whose names they know. Because the US, Canada and other OECD countries have less stringent customer information requirements for banks in their own countries than they do in Caribbean international financial centres, business is being diverted from the Caribbean to North America, even though the Caribbean provides more cost-effective services of comparable quality.

It is unclear whether there has been any impact on system safety as a result of the tighter regulations. There is no evidence of an improvement in safety, and the motives for shifting from a regulated, well informed environment where safety is high, to informal markets and to markets where information requirements are below international guidelines, have strengthened.

Tax planning will continue to be done, so long as there is not a single global tax system. The current international and national changes alter the landscape for tax planners, but little can be said about the effects on national tax bases, good or bad, based on Caribbean experience so far.

The first step towards addressing the global challenge of de-risking is to achieve an understanding of the reach and complexity of the problem. All international banks are affected by the regulatory changes, the intensified compliance requirements and the heightened risk of fines and penalties large enough to damage the value of their franchise. The banks' strategies in response are many and varied, and they are manifested in countries right across the globe, in Asia, Africa, the Middle East, Europe and the Americas. What is more, the situation is still evolving. International banks do not appear to have settled on their approaches to the evolving situation, and many of the agreed regulatory measures are in process and not yet complete. The reactions of those affected by the international regulatory initiatives are also in a state of flux. Some

countries and some institutions, bankers and their clients, have found alternative solutions to their banking challenges, only to find that those channels have also failed or that they have become more costly. In documenting the impact of de-risking we must take account of the business that has been diverted from more efficient and more closely regulated small international financial centres to advanced countries where regulation appears to be looser and more opaque, as well as business that may have been driven underground. We should also take account of the inefficiency costs of slowing the growth of cost-efficient, high quality international financial centres. The costs in terms of lost growth potential for international financial centres, though of great consequence to the centres themselves, is trivial compared to the cost in terms of the loss of efficiency of international finance and commerce. Those costs slow the growth of financial services in the originating countries, raise the costs of providing international financial services internationally and are therefore an additional cost to all international commerce.

The best approach to an acceptable framework to address the challenges of de-risking would be a coordinated, multifaceted approach, based on the application of some internationally agreed principles and limitation of liability. The approach should be informed by comprehensive documentation and analysis of the phenomenon on a truly global scale, involving all the relevant parties in official institutions and the private sector. The fact that this matter is exercising the minds of global leaders in politics and finance is an encouraging first step.

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