Inter-American Development Bank

CBR Withdrawals

Understanding the Uneven Occurrence Across the Caribbean

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Country Department Caribbean Group

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Introduction

Multiple studies have highlighted the Caribbean as one of the geographic regions most severely impacted by the decline in correspondent banking relationships (CBRs). However, when examined at a disaggregated level, the Caribbean experience of de-risking is uneven across territories. Some countries have experienced sudden, widespread withdrawals of CBRs, which may appear concerted. Others have experienced some CBR losses and associated difficulties but over time have managed to find replacement relationships or reinforced existing CBRs, while still others have experienced very little to no loss of CBRs. For countries within a relatively small geographic region, the level of disparity as it relates to the loss of CBRs may appear counter-intuitive. The World Bank (2015) produced a report which may be regarded as one of the first multifaceted attempts at understanding the decline in CBRs globally. The utility of this study was the substantial effort by the World Bank to identify the motivating factors behind the decision to terminate CBRs. The authors identified the drivers of de-risking by surveying a cross section of interest groups, namely, large international banks providing correspondent banking services, local and regional banks with the capacity to act as both a respondent and a correspondent, and banking supervisors of both correspondent and respondent banks. The findings highlighted that while each financial institution and regulatory authority had its own unique mix of factors contributing to its own unique experience, the drivers could generally be grouped into two broad categories:

- Business-related causes, with the decision to terminate a CBR based solely on economic terms; and
- Regulatory risk-related causes, with the decision to terminate CBRs based on the higher risk of money laundering/terrorist financing (ML/TF) and the potential for material loss.

The authors also identified the fundamental linkage between the two categories, highlighting that in theory the inherent level of risk should influence the expected returns profile of the CBR for the correspondent bank. This suggests that the termination of CBRs by large international correspondent banks is a relatively complex decision incorporating multiple factors. Based on various discussion forums and constantly evolving analysis of global CBRs, some factors which may constitute key elements behind the de-risking decision include size of the economy and aggregate cross border flows, country and financial institution risk profile, and structure of the financial system.

As the Caribbean region continues along the path of economic development, it is critical that regional economies maintain access to the global payments infrastructure. The purpose of this technical note is two-fold: It aims to better understand the inherent characteristics of the region which may have contributed to the varying degrees of CBR termination to date, and it aims to better understand the perceived shortfalls in the region. These insights are key for the development and implementation of any corrective measures to enhance the region's appeal to correspondent banks and to ensure that this global phenomenon does not become a hindrance to the region's growth and development.

Stakeholder Perspectives

The World Bank (2015) describes the perspective of various interest groups included in the survey.

Large International Banks – According to the World Bank (2015), anti-money laundering/countering the financing of terrorism (AML/CFT) and know-your-customer (KYC)-related concerns were identified as key drivers of the termination or restriction of CBRs by large international banks. Table 1 below highlights ten of the key reasons for CBR restriction/termination identified by the banks surveyed.

Table 1: Key Reasons for CBR Restriction/Termination Identified by Large International Banks

Reason	Percentage of Total Responses
Concerns about ML/TF risk	95
Imposition of international sanctions	90
Lack of compliance with AML/CFT or sanctions regulations	85
Overall risk appetite	85
Concerns or insufficient information about respondent banks' CDD procedures	80
Lack of profitability of certain foreign CBR services/products	80
Respondent banks' high-risk customer base	75
Respondent banks' jurisdiction subject to countermeasures or identified as having strategic AML/CFT deficiencies by FATF	75
Inability/cost to undertake customer due diligence on respondent banks' customers	65
Changes to legal, regulatory, or supervisory requirements	45

Local and Regional Banks – Respondent banks identified economic factors as a key driver in the decision taken by large international banks to terminate or restrict CBRs. The inadequacy of the return proposition presented by some CBR products or services was the most popular reason identified by local and regional banks, accounting for 46 percent of responses.

Table 2: Key Reasons for CBR Restriction/Termination Identified by Local and Regional Banks

Reason	Percentage of Total Responses
Lack of profitability of certain foreign CBR products or services	46
Overall risk appetite	37
Structural changes to financial institution and/or reorganisation of business portfolio	35
Changes to legal, regulatory, or supervisory requirements	31
Concerns about ML/TF risk	19
Inability/costs to undertake CDD on respondent bank's customers	15
The sovereign credit risk rating of the jurisdictions of respondent banks	15
Industry consolidation within jurisdictions	13
Compliance with pre-existing legal/supervisory/regulatory requirements	9
Imposition of international sanctions	8

Banking Authorities – Supervisory authorities for both respondent and correspondent banks also highlighted profitability considerations as the key driver of the decision to restrict or terminate CBRs.

Table 3: Key Reasons for CBR Restriction/Termination Identified by Supervisory Authorities

Reason	Percentage of Total Responses
Lack of profitability of certain foreign CBRs	64
Overall risk appetite of correspondent	55
Changes to legal, regulatory, or supervisory requirements in correspondent's jurisdictions with implications for maintaining CBRs	48
Concerns about ML/FT risk	48
Inability/costs for correspondent to undertake CDD on respondent's customers	36
Structural changes to correspondent (including merger/acquisition) and/or reorganisation of business portfolio	27
Jurisdiction identified as having strategic AML/CFT deficiencies by Financial Action Task Force (FATF) (or other international body)	23
Compliance with pre-existing legal/supervisory/regulatory requirement by correspondent	18
High-risk customer base of respondent	18
Concerns about or insufficient information about respondent's CDD procedures (for AML/CFT or sanctions purposes)	14

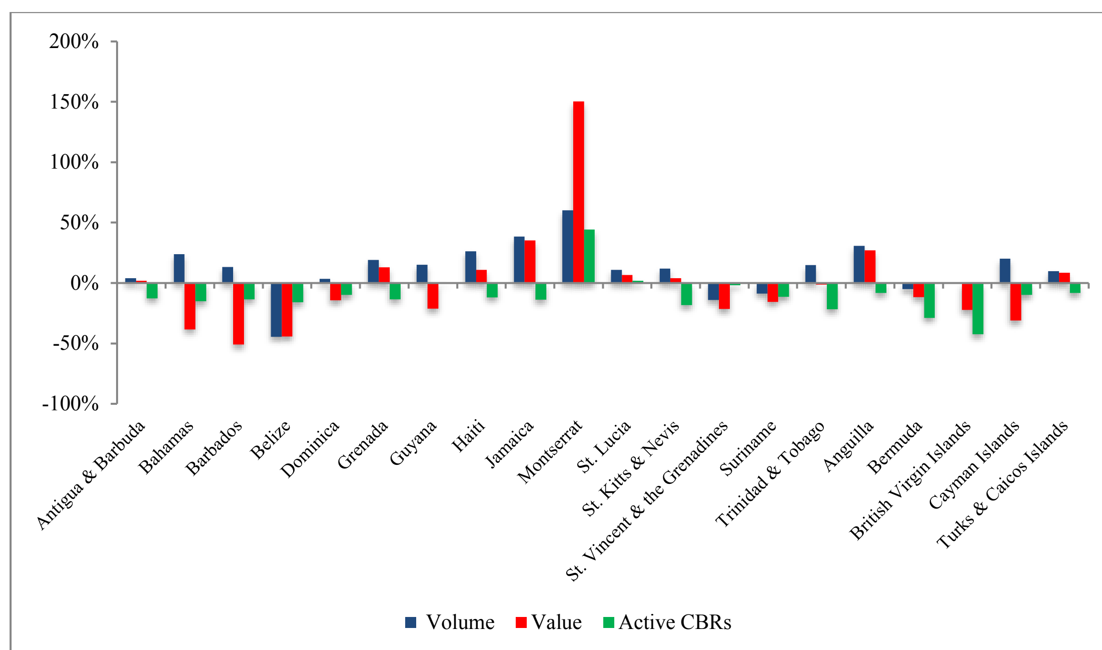
Across all stakeholder perspectives two common themes emerged: profitability and risk. This insight raises fundamental questions, and the answers may prove valuable in better understanding the withdrawal of CBRs. If respondent banks, due to inherent characteristics such as geographic location, level of development of the region of operations, and the nature of their customers, were viewed as an elevated risk by a correspondent bank, why were the correspondent banks unable or unwilling

to alter the pricing structure to bring into balance the risk/return relationship? Additionally, why was relationship termination by the correspondent banks viewed as a more viable alternative in some cases and not others? What unique characteristics of particular institutions or jurisdictions motivated correspondent banks to retain some of these relationships? While it is beyond the scope of this study to answer these questions, this study aims to analyse the experience of the region to see what common themes emerge.

Structural Characteristics of the Caribbean Region

Several studies on the decline of CBRs have identified it as a global phenomenon impacting multiple regions across Europe, the Middle East, Africa, Asia, and Latin America and the Caribbean. The analysis of correspondent banking conducted by the Committee on Payments and Market Infrastructure (CPMI, 2016) suggests that while global aggregate correspondent banking transaction volumes grew over the period 2011–2015, active correspondent banking relationships declined markedly during the same period. The World Bank (2015) also pinpointed small jurisdictions with relatively low volumes of business/transactions as experiencing some of the most marked declines in foreign CBRs. The report went on to highlight "…small jurisdictions with significant offshore banking activities" as being acutely impacted by de-risking and identifying the Caribbean region as potentially the most severely impacted geographic region. These observations were further supported by the Financial Stability Board (2017), which used SWIFT data to identify declines in the number of active correspondents across all corridors for the Caribbean in 2012, 2014, and 2015. While these two studies helped to bring into focus the challenges confronting the Caribbean Community (CARICOM), Wright (2016) first identified the country-specific impact of de-risking across the region. He described the Caribbean experience of de-risking as wide-ranging, from moderate levels of impact on the domestic financial sector in Barbados and The Bahamas to economically damaging declines in CBRs experienced in Belize. The Financial Stability Board (2017) further supported the work of Wright (2016), highlighting the change in active CBRs, message volumes, and value of transactions during the period 2012–2016.

Figure 1: Volume and Value of Messages and Active CBRs



The nuanced experience of de-risking in the Caribbean to date therefore raises a fundamental question: what factors have allowed some Caribbean countries and their financial institutions to remain attractive to correspondent banks while others appear to be deemed practically unbankable?

Economic activity in the CARICOM region, measured by indicators such as GDP and balance of payments components, provides crude approximations of the potential level of cross-border flows in the region. As a collection of small developing nations, the Caribbean region does not present a compelling business case for correspondent banking services relative to larger regions such as Latin America, as can be seen in Table 4.

Table 4: GDP and Trade Openness in the Caribbean

	GDP (US$ bil.)	Trade Openess (X+M, % of GDP)
The Caribbean	**66.9**	**164.1**
Bahamas	8.2	102.3
Barbados	4.5	96.8
Belize	1.5	136.3
Guyana	2.8	142.7
Jamaica	15.3	80.8
Suriname	5.1	118.2
Trinidad and Tobago	23.8	98.9
Eastern Caribbean Currency Union	5.6	95
Latin America and the Caribbean	**5,722**	**44.5**

The International Monetary Fund (2013) estimated total GDP of the Caribbean region at USD 66 billion across 15 countries[1] and trade openness as 164 percent. Conversely, Latin American GDP was estimated at a significantly larger USD 5.6 trillion, approximately 84 times larger than the Caribbean economy. These statistics underscore the greater economic potential and business prospects to be derived from doing business in Latin America relative to the Caribbean.

Caribbean International Financial Centres

Over time the Caribbean has garnered a reputation as a high-risk region for ML/TF. Several factors have driven this perception, including the growth and development of international financial centres (IFCs) across several Caribbean countries, the cash-intensive nature of many regional economies, and the labelling of the region as a major transhipment point for illegal narcotics, firearms, and human trafficking. While some of this labelling may appear subjective, it is useful to explore the rationales commonly cited for the perception of the region as high risk from an ML/TF perspective.

International financial centres, or offshore financial centres as they are sometimes known, have been met with contrasting views in the global economy. For developing nations, IFCs are regarded as engines of global trade and investment and an increasingly important economic pillar which drives economic growth for many small developing nations. Conversely, developed nations have viewed IFCs with growing hostility, as it is perceived that corporate structures related to these jurisdictions are designed to shift revenue to lower-tax jurisdictions. The argument has also been made that the increasingly stringent regulations placed on Caribbean IFCs has caused a migration of offshore capital to developed economies despite robust institutional frameworks (Worrell, et al., 2016). The Organisation for Economic Co-operation and Development (OECD) (2017) defines IFCs as "…jurisdictions with financial centres that contain financial institutions that deal primarily with non-residents and/or in foreign currency on a scale disproportionate to the size of the host economy. Non-resident-owned or controlled institutions play a significant role within the centre. The institutions in the centre may well gain from tax benefits not available to those outside the centre."

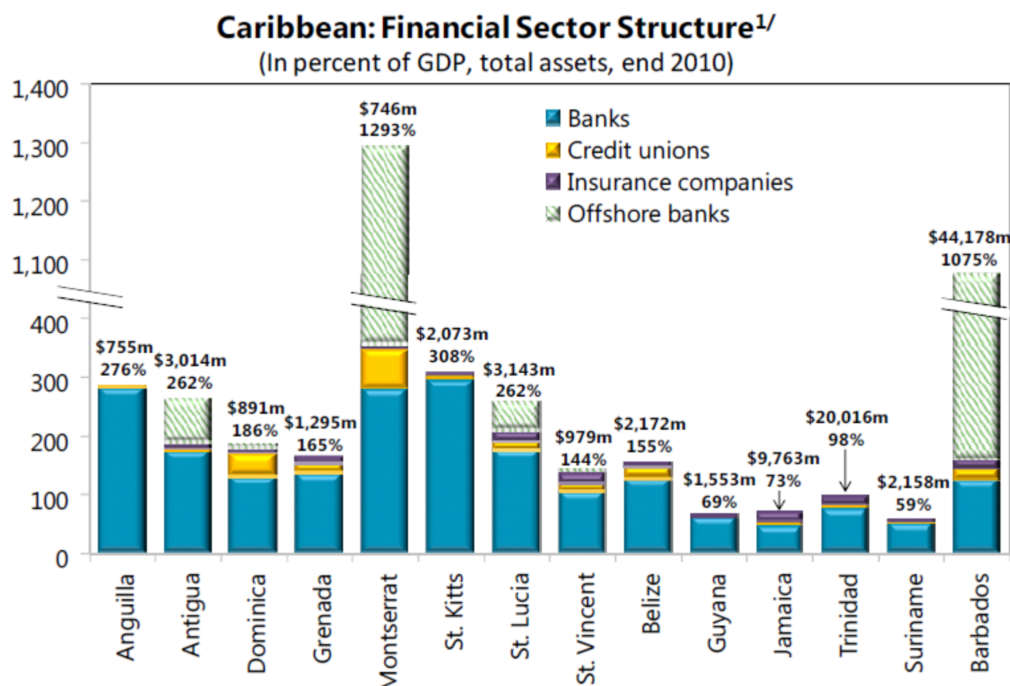
The intent of this research is not to evaluate the merits of these arguments, but rather to discuss the influence of IFCs on the decision to terminate CBRs in the region. Many small island developing states (SIDS) have looked to the services sector as a primary engine of growth. In the Caribbean, this had been predominantly in the form

[1]Caribbean states consist of: The Bahamas, Barbados, Belize, Guyana, Jamaica, Suriname, Trinidad and Tobago, and ECCU member states.

of tourism due to the region's natural characteristics and linkages to developed source markets. However, the volatility of tourism sector performance over time underscored the need for many regional states to diversify their economies. International business and financial services emerged as a popular avenue for economic diversification and a viable pillar to support the economic growth and development agenda of many Caribbean nations.

Several Caribbean states have developed into IFCs of varying scales, including major players such as The Bahamas, Barbados, the British Virgin Islands, and the Cayman Islands. The international community constantly scrutinises these IFCs. Regional IFCs are often represented as having relaxed regulatory regimes, and the legal/corporate structures established in these jurisdictions have been periodically labelled as vehicles for corporations and wealthy individuals to conceal wealth and avoid taxation. Figure 2 highlights the significance of the international sector in several Caribbean nations. Notably, in IFCs such as Antigua, Barbados, Montserrat, and St. Lucia, the assets controlled by offshore banks represented a material proportion of total financial sector assets.

Figure 2: Caribbean Financial Sector Structure



Following the 2008 global financial crisis, several developed nations began to aggressively address tax revenue leakage from their jurisdictions related to IFCs. In the case of the United States, it was addressed through implementation of the Foreign

Account Tax Compliance Act[2] (FATCA) and followed by the OECD-sponsored Common Reporting Standard[3] (CRS). The U.S. Department of Justice (DOJ) also played a key role in addressing tax revenue leakage by acting as an enforcer. The DOJ spearheaded several high-profile investigations and civil or criminal cases. In several instances, large international banks were required to pay hundreds of millions of dollars in fines for their roles in aiding tax evasion by American citizens and businesses.

From the perspective of the correspondent banks, these developments would have undoubtedly raised concerns about the legal and regulatory risk associated with doing business in some jurisdictions such as IFCs. From a practical perspective, this new aggressive pursuit of tax evaders meant that correspondent banks providing services to institutions in these IFCs (either via direct respondent relations or via nested relationships) were now confronted with the potential for material losses resulting from fines if implicated in transactions related to tax evaders.

Cash-Intensive Economies

The perception of the region as being cash-intensive is often anecdotal, and to date little research has been done on the use of cash regionally and relative to developed countries. However, the region should examine the structural characteristics that may have led to the situation where cash remains the dominant medium of exchange and settlement for a large proportion of retail transactions. Understanding the underlying structural factors confronting the region which may have impeded the adoption of electronic payment methods over time is vital in balancing the argument and supporting the development of an appropriate plan to redress this perceived shortcoming.

The growth of payment networks such as Visa and MasterCard, coupled with steady advancements in payments software and telecommunications, has meant that over time many developed nations have shifted away from physical cash. Despite the proximity of the region to North America and the consistent influx of tourists from advanced economies, the adoption of electronic payment methods does not appear to have kept pace in many Caribbean countries. The 2017 United Nations[4] (UN) World Economic Situations and Prospects Report (United Nations, 2017) categorises most

[2] The Foreign Account Tax Compliance Act, passed as part of the HIRE Act, generally requires that foreign financial institutions and certain other non-financial foreign entities report on the foreign assets held by their U.S. account holders or be subject to withholding on withholdable payments. The HIRE Act also contained legislation requiring U.S. persons to report, depending on the value, their foreign financial accounts and foreign assets.
[3] The CRS developed by the OECD in response to the G20 request calls on jurisdictions to obtain information from their financial institutions and automatically exchange the information with other jurisdictions on an annual basis.
[4] The UN Office of the High Representative for the Least Developed Countries, Landlocked Developing Countries and Small Island Developing States (UN-OHRLLS).

Caribbean countries as SIDS. SIDS are recognised as a distinct group of developing countries facing specific social, economic, and environmental vulnerabilities. These vulnerabilities, which constitute constraints to sustainable development efforts by these nations, include: a narrow resource base, inhibiting the benefits of economies of scale; small domestic markets and high costs for energy infrastructure, transportation, communication, and servicing; low and irregular international traffic volumes; limited opportunities for the private sector; and a heavy reliance of their economies on the public sector. These vulnerabilities may also have acted as obstacles to the growth and development of electronic payment methods in many Caribbean countries.

Regional income levels and the proportion of disposable income of the average Caribbean citizen are among the factors that may explain the lagged adoption of electronic payment methods across much of the Caribbean. The average income level of most Caribbean countries is much lower than that of developed countries. In theory, this may translate into lower average earnings and lower disposable income available for discretionary consumption and/or savings. From a practical perspective, individuals with less disposable income may less be likely to use financial services such as bank accounts and alternative forms of payment such as debit or credit cards. This may be because these types of services, while convenient, come at a cost, which may be deemed prohibitive to many operating below a certain earnings threshold. Table 5 lists the per capita GDP of several Caribbean nations and some advanced economies, highlighting the disparity.

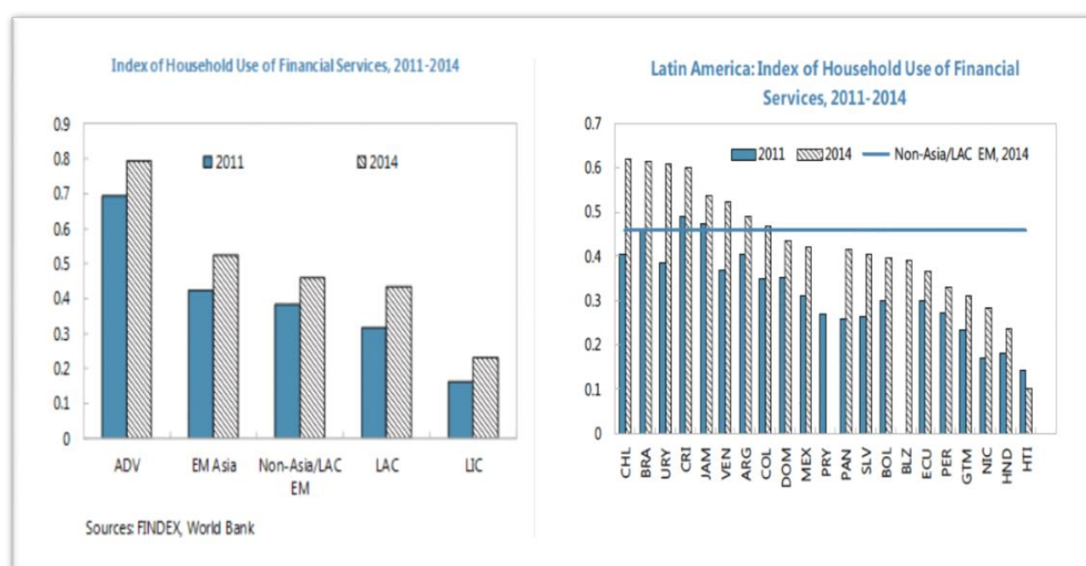
Table 5: Caribbean: GDP Per Capita

Country	2016 GDP per capita (constant 2010 US$)
Latin American and the Caribbean	
Antigua	13,159
Bahamas	20,568
Barbados	16,157
Belize	4,043
Dominica	6,896
Guyana	3,758
Jamaica	4,769
Suriname	7,661
Trinidad and Tobago	15,786
St. Lucia	7,104
Argentina	10,148
Colombia	7,525
Mexico	9,707
Advanced economies	

Country	2016 GDP per capita (constant 2010 US$)
Canada	50,231
USA	52,194.
UK	41, 603
Japan	47,607

While several regional economies have achieved higher per capita GDP levels than those of the wider Caribbean region, there is also a significant disparity in income levels between the region and developed nations. A 2015 IMF study on household financial inclusion in the Latin America and the Caribbean (LAC) region noted that while the LAC region experienced notable improvement from 2011 to 2014, it continued to lag behind other emerging markets. Additionally, the report highlighted the shortcomings of LAC with respect to account holdings and savings. The IMF estimated at the time that only 47 percent of households in LAC had an account at a formal financial institution versus 60 percent of households in emerging Asia. The IMF report also considered the results of a 2012 financial inclusion survey administered in Mexico (IMF 2015). This survey revealed the rationale of survey respondents for not maintaining a bank account. Seventy-five percent of those without an account cited low income as the primary constraint. While this report may not pertain exclusively to the Caribbean, it highlights some of the work required in the region to understand the degree of financial inclusion across the Caribbean region and how access to financial services can be supported and enhanced.

Box 1: Household Use of Financial Services



The cash-intensive nature of an economy is a difficult data point to measure and observe, and at present no agreed methodology exists for determining the level of cash usage of a country. To monitor cash usage in its own economy, the Bank of Canada (2015) developed a crude proxy for estimating cash usage. A simple ratio of cash in circulation scaled over GDP could provide some insight into the extent of cash usage across the region and support analytical comparisons with more advanced economies with greater levels of financial inclusion.

Table 6 below shows the level of cash usage in several Caribbean countries and some advanced economies. Notably, the percentage of cash in circulation relative to GDP appears to fall within the 3–6 range for multiple countries, with the exception of Barbados and Guyana. Notably, the 9 percent ratio in the United States appears elevated relative to other advanced economies. A number of factors could account for this, including the use of U.S. dollars in several countries that have dollarized, and the fact that the United States is the global economic and political power driving continued demand for U.S. dollars as a stable store of value.

Table 6: Currency in Circulation

Country	Currency in Circulation as a % of GDP
The Caribbean	
Bahamas	3
Barbados	11
Belize	9
Guyana	12
Jamaica	5
Trinidad and Tobago	6
Eastern Caribbean Currency Union	6
Developed countries	
United Kingdom	4
United States of America[5]	9
Canada	5

The ratio of currency in circulation to GDP of several Caribbean countries provides some insight into the true cash-intensive nature of regional economies. However, it is apparent that more work is required in this area if the region is to forge ahead in retaining and rebuilding correspondent banking relationships.

The perceived regional dominance of cash is a multifaceted problem. Thus far we have considered it primarily from the households' perspective. However, the

[5] The Federal Reserve Bank of New York noted that U.S. notes and coins in circulation have risen rapidly in recent decades, and that much of the increase was caused by demand from outside the United States. The Federal Reserve estimates that most of the cash in circulation today is outside the United States.

perspectives of businesses of all types and sizes are an important aspect to consider in seeking to understand the dominance of cash across much of the region. The choice of payment methods, or lack thereof, when transacting business regionally undoubtedly has some influence on the prevalence of the payment methods which thrive in the various Caribbean economies. Where electronic methods of payment are readily available and reliable, a migration away from cash would be expected. Therefore, as cash usage appears to have remained prevalent across the region, we must consider what obstacles may have impeded the adoption of electronic payment methods over time.

Fostering growth in electronic payment methods and the gradual migration away from cash requires payment-processing technology to be widely accessible and reasonably priced. Electronic payments require reliable, relatively high-speed telecommunications services to facilitate the exchange of information between the financial institutions of the purchaser and the merchant. If such telecommunications services aren't available or the cost is prohibitive, merchants will be less inclined to accept the more efficient methods of payment, opting instead for the perceived safety of cash. However, this same preference for cash as a mode of payment by merchants may in turn impact the ML/TF risk perception of the bank about its business. Additionally, from a business perspective, the costs associated with accepting electronic methods of payment needs to be attractive enough to merchants to ensure widespread adoption across various transaction dollar values.

ML/TF Risk: Perception vs Reality

The Basel AML Index proves a useful tool to understand the perceived relative riskiness of the Caribbean from a ML/TF standpoint. The index presents an objective, independent measure of broad ML/TF risk presented by a country, communicated via a composite risk score for each country and a relative ranking. The Basel Index risk score is bounded between 1 and 10, with 1 signifying low ML/TF risk and 10 indicating high risk. The risk score utilises 14 indicators across five broad categories to derive a weighted composite risk score. The five categories of indicators considered by the Basel Index are ML/TF risk, corruption risk, financial transparency and standards, public transparency and accountability, and political risk.

The overall risk score for each country seeks to provide a holistic assessment of the structural and functional elements in its AML/CFT framework, indicating the level of vulnerabilities to ML/TF (Basel Institute on Governance, 2017). Notably, the FATF and its AML/CFT assessment process via mutual evaluation reports accounts for the

single highest weighting (35 percent) of the 14 indicators used in the Basel AML Index. In February 2012, the FATF introduced a new assessment methodology incorporating technical compliance with its AML/CFT recommendations as well as effectiveness of a country's AML/CFT framework.

Importantly, not all countries have undergone the mutual evaluation process under the new assessment methodology. The report accompanying the Basel AML Index 2017 highlights the potential impact on country risk scores from the FATF's new approach stating, "…the revised FATF methodology tends to result in less favourable ratings in some countries because the actual implementation of laws seems to lag behind the technical compliance" (Basel Institute on Governance 2017, p.3). At the time of publishing of the 2017 index and report, only one of the lowest-risk countries (Sweden) and two Caribbean countries (Jamaica and Trinidad and Tobago) had been assessed using the new methodology. Therefore, over time, it could be reasonably expected that the scores of some countries might worsen as the revised methodology is applied in the assessment of more countries (Basel Institute on Governance, 2017).

The Basel Institute on Governance (2017) revealed that the ten highest-risk countries were low-income economies with no major role as global financial centres and located in Asia, the Middle East, and Sub-Saharan Africa. Additionally, the report highlighted the poor composite risk score of these high-risk countries as being driven primarily by weak AML/CFT systems combined with structural and functional vulnerabilities such as high rates of perceived corruption, weak judicial systems, and poor financial sector standards. Conversely, the ten lowest-risk countries generally exhibited strict AML/CFT compliance evidenced by favourable performance in the FATF mutual evaluation process. Additionally, lower-risk countries were identified as typically portraying strong public and financial transparency regimes and low levels of corruption (Basel Institute on Governance, 2017).

From the Caribbean perspective, the composite risk scores generally fell around the mid-point of the scale, with risk scores ranging from 4.52 for Anguilla to 7.35 in the case of Haiti. The average risk score for CARICOM member countries was 6.01, which suggests a moderate to slightly elevated level of ML/TF risk associated with doing business in the region.

Table 7: Basel Risk Scores

Country	Basel overall risk score
Antigua and Barbuda	5.72
Bahamas	6.25
Barbados	5.94
Belize	6.69
Dominica	5.04
Grenada	5.79
Guyana	6.24
Haiti	7.35
Jamaica*	6.65
Montserrat	N/A
St. Lucia	5.65
St. Kitts and Nevis	5.85
St. Vincent and the Grenadines	5.89
Suriname	6.92
Trinidad and Tobago*	6.76
Anguilla+	4.52
Bermuda+	5.54
British Virgin Islands+	6.09
Cayman Islands+	6.74
Turks & Caicos Islands+	4.67

*: Overall score based on new FATF evaluation, which includes an effectiveness assessment.

+: Denotes country is CARICOM associate member.

ML/TF risk scores and indices such as this are likely to be a fixture in most large international financial institutions, influencing strategy and decisions regarding correspondent banks doing business with banks in specific jurisdictions or geographic regions. The available data and risk scores suggest that while the region presents an elevated ML/TF risk, it is not excessive by any measure. At present this serves as a de facto vote of confidence in the region's ML/TF framework, potentially providing correspondent banks with a certain level of comfort about the AML/CFT frameworks in Caribbean countries. However, only two Caribbean countries have been assessed under the new assessment methodology, which considers effectiveness. This underscores the need for Caribbean countries to begin addressing any shortfalls in their AML/CFT frameworks ahead of their own mutual evaluation assessment. In light of the implementation of the more challenging effectiveness assessments, Caribbean countries must ensure their ML/TF risk ratings do not worsen significantly under this new approach.

Financial System Structure as a Driver of CBR Terminations

The ownership structure of regional financial institutions also appears to be an important factor in the level of correspondent banking relationship terminations experienced from country to country across the Caribbean region. Generally, banks operating in the region can be divided into three broad categories: foreign banks, large indigenous banking groups, and small indigenous banks. Generally, foreign banks operating in the region are branches or subsidiaries of much larger North American banking groups.

Canadian financial institutions have a strong market presence in several Caribbean countries. There are also a number of regionally owned and governed indigenous banks operating across the region. In most cases, these indigenous banks are relatively small from a balance sheet and regional footprint perspective and operate in only a few markets. Some of these indigenous banks have managed to grow and develop into major regional banking groups with operations in multiple Caribbean jurisdictions and significant balance sheets in excess of USD 1 billion. These large indigenous banking groups account for a material portion of the market share in the jurisdictions where they operate and are capable of actively competing with the foreign banks present in these markets. Of the three sub-categories of regional banking institutions, the smaller, more isolated indigenous banks appear the most susceptible to loss of CBRs. In order to understand why one segment of the financial services sector appears overly vulnerable, it is useful to consider the inherent characteristics of each category of regional banking institutions in turn.

Foreign banks/banking groups – In most instances, these financial institutions operate as direct subsidiaries or branches of North American banking groups and are typically very large, with regional assets in excess of USD 1 billion. Their significant size and regional operations enable them to control material portions of the regional financial services market, which in turn equips them to capture a large portion of total cross-border transactions between the Caribbean region and the rest of the world.

Foreign banks also benefit from strong oversight by their North American parent institutions. This oversight may manifest in several forms, including: North American executives on the board of directors of regional banking operations; rotation of North American managers to fill key regional executive or senior management roles; and extensive regular reporting of the regional bank to its parent on key issues, such as financial performance indicators, risk metrics, and major trends/projects. Foreign banks are also relatively well integrated both regionally and globally with their parent

institutions. This allows regional operations to leverage the resources and subject matter expertise housed at their parent institutions.

With respect to correspondent banking, regional foreign banks have the benefit of leveraging their parent bank's reputation to obtain and/or maintain new or existing correspondent banking relationships. Additionally, regional foreign banks also have the capability of running their cross-border transactions through their parent bank/head office accounts. This option significantly mitigates any risk of disruption from loss of correspondent banking relationships.

Large indigenous banking groups – This category of regional banking institutions is born out of the remnants of foreign bank branches/subsidiaries that may have been divested. Aspects of the regional operations of these institutions share some common traits with their foreign counterparts. Large indigenous banks are often similar in size to their foreign counterparts, with total assets well in excess of USD 1 billion and operations across multiple Caribbean countries.

Relatively large balance sheets and market share allow these institutions to capture a substantial proportion of cross-border transactions, thereby providing scope for large volumes of transactions flowing through correspondent banks. Large indigenous banks are also becoming increasingly cohesive, resulting in robust head office oversight regionally, ensuring regional consistency in business policies and processes and integrated approaches to risk management. The volume of cross-border transactions captured by institutions is comparable to that of their foreign bank counterparts. This level of business activity underpins the positive business case at the level of the international correspondent bank, meeting correspondent banks' internal profitability hurdle and justifying the continued correspondent banking relationship.

Small indigenous banks – These institutions generally operate in one or two jurisdictions. Typically, they are unable to benefit from economies of scale or access the level of resources and expertise available to their larger regional counterparts. With assets often totalling less than USD 500 million and with generally no dominant market positioning, these institutions are usually unable to capture a material share of the cross-border flows related to their country of operations.

In addition, the board oversight and management of some of these smaller institutions may be relatively weak, leading to ineffective AML/CFT frameworks. This may add to the concerns of correspondent banks already considering terminating relationships with these small indigenous banks. From the perspective of the correspondent bank, these small indigenous banks may present the least attractive business case, with small transaction volumes, significant weakness in AML/CFT

structures, and little impetus by the board of directors and senior management to address these weaknesses.

The decline in CBRs regionally has been uneven across Caribbean countries, as shown in Table 8. However, the ownership structure and average size of institutions may have some explanatory power with respect to the severity of CBR losses experienced in various jurisdictions.

Table 8: Commercial Bank Characteristics and CBR Loss

Country	Number of commercial banks	Asset base of commercial banking sector (expressed in USD)	Estimated average total assets of commercial banks	Proportion of foreign-owned financial institutions	Severity of CBR loss reported
Bahamas	8	9.96 billion	1.2 billion	75%	25% - 75%
Barbados	5	6.6 billion	1.3 billion	100%	< 25%
Belize	5	1.5 billion	300 million	20%	> 75%
Trinidad	8	20.7 billion	2.6 billion	75%	25% - 75%
Jamaica	8	4.2 billion	525 Million	50%	> 75%
ECCU	20	10.4 billion	520 Million	63%	25% – 75%

Source: Alleyne et al. IMF (2017).

From the available data three outliers can be identified: Barbados, Belize, and Jamaica. Barbados is an outlier due to a relatively low severity of CBR losses, at less than 25 percent of institutions impacted compared to other Caribbean countries. Notably, within the sample of Caribbean countries considered, Barbados is the only jurisdiction without any small indigenous banks, as its commercial banking sector consists entirely of large banking groups, both North American and indigenous, each possessing a material share of the Barbados market. This characteristic merits further investigation, as it may be an indication of several underlying factors including:

i) The strong reputation of the Barbados commercial banking sector due to the presence of three prominent North American banking groups and two major indigenous banking groups;

ii) Access by Barbados-based banks to greater resources to support their AML/CFT frameworks, potentially signalling that these institutions may be more effective at managing ML/TF risk;

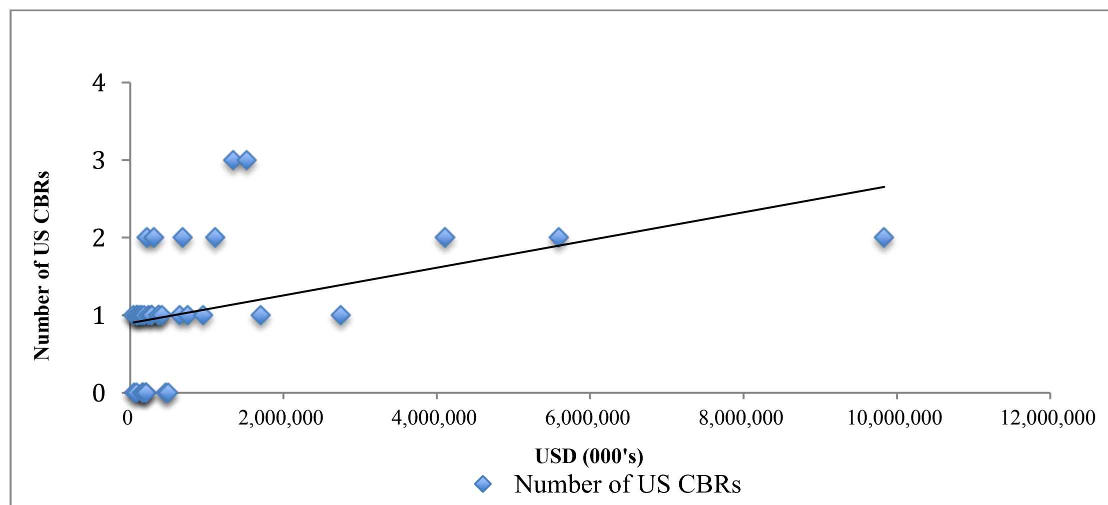
iii) The ability of each commercial bank to capture a material share of the financial services market, potentially providing each institution with sufficient cross border activity to remain attractive to correspondent banks; and

iv) The possibility that on a stand-alone basis the Barbados operations of these banking groups may not provide adequate cross-border volumes. However, at the group/consolidated level, correspondent banks may be earning a satisfactory return, incentivising the maintenance of all CBRs related to the banking group.

The severity of CBR terminations appeared to be much worse in both Belize and Jamaica, with more than 75 percent of the commercial banking sector impacted by CBR terminations in both instances. Belize is a SIDS with a small commercial banking sector characterised by an average asset base of USD 300M and dominated by indigenous banks (80 percent) with no affiliations to larger banking groups. Given the small size of the banks, the seemingly limited scope for cross-border transactions and lack of support from a larger, more attractive parent, the provision of correspondent banking services to most Belizean institutions appears likely to have been unattractive to correspondent banks. Jamaica is a more unusual case given its relatively large economy and the presence of multiple North American and indigenous Caribbean banking groups.

A cross section of data collected from indigenous commercial banks highlights the importance of institution size in maintaining correspondent banking relationships with US correspondent banks. Figure 3 suggests a positive relationship between indigenous bank asset base and number of U.S. CBRs.

Figure 3: Correlation between Bank Size and U.S. CBRs



Source: Caribbean Association of Banks Summary of Findings: Correspondent Banking 2016.

Conclusion

The significant amount of discussion and research on the global decline in CBRs has highlighted a number of factors that may have contributed to CBR terminations. However, international consensus on the true drivers of this phenomenon and the way forward remains elusive. The only point on which there is general agreement is that CBR terminations are a function of the interaction of various factors, chief among them the risk and return characteristics underpinning the CBR. The severity of CBR withdrawals has varied across regions and, in the Caribbean case, from one island to the next.

In light of this experience, it is crucial for the region to carefully explore the drivers of its own CBR losses to ensure that adequate, effective actions are taken. Multiple suggestions on the way forward have emerged from different stakeholder groups. However, given its small resource base and the severity of CBR withdrawals, the Caribbean region must recognise that all suggested solutions are not created equal and may not be viable for regional adoption. It is therefore imperative that stakeholders, including regional financial institutions, governments, regulatory authorities, and the business community, work together to craft solutions that are viable in the Caribbean context.

Correspondent banks doing business in the region consider the region's risk profile to be a key driver of CBR decisions. The region must therefore continue to improve its AML/CFT infrastructure to manage and positively influence the international perception of the Caribbean region with respect to AML/CFT. International financial institutions providing correspondent banking services in the Caribbean will undoubtedly use risk analysis tools such as the Basel AML Index. The region therefore needs to understand how financial institutions use ML/TF risk management measures such as the Basel AML Index to inform their business strategy and risk appetite.

The importance of ML/TF risk methodologies and the messages they communicate to the management of correspondent banks cannot be understated. Since many of these ML/TF risk ratings methodologies utilise FATF mutual evaluation assessments as a key input, Caribbean nations should devote significant energy to maintaining and improving compliance with the FATF standards and improving performance in FATF assessments, particularly in light of the changes made to the organisation's mutual evaluation assessment methodology that incorporate effectiveness. The enhanced assessment methodology being utilised in the fourth round of mutual evaluations has already resulted in some countries facing worse

results relative to their third-round assessment. The region therefore runs the risk of deteriorating assessment results if efforts are not concerted. Circumstances in the Caribbean suggest that one of the strongest signals that Caribbean nations could send concerning the strength of their AML/CFT frameworks is a strong performance in the FATF fourth-round assessments. If not, the region may run the risk of another wave of CBR withdrawals should correspondent banks view the region's AML/CFT framework as deteriorating.

The cash-intensive nature of the Caribbean has been cited as another key driver of the region's high ML/TF risk perception. While part of this problem is structural relating to low-income levels in several Caribbean countries, much of the region has lagged in the adoption and growth of electronic payments. There is no short-term fix for this challenge, but governments, regional financial institutions, and the private sector must work together to encourage the use of electronic payment systems, which will over time reduce the region's reliance on cash.

Governments and regional telecommunications companies must also support the development of efficient telecommunications infrastructure on which electronic payment methods depend. Regional financial institutions must continue to innovate, invest, and compete to lower transaction costs, which would facilitate widespread installation of electronic payment terminals. This has the potential to create a virtuous cycle benefitting both clients and regional financial institutions. As clients are incentivised to migrate towards electronic means of payment, this will reduce the level of anonymous cash transactions at businesses serviced by Caribbean banks; thus, their ML/TF risk may decrease over time. As the ML/TF risk of the bank's clients declines, the ML/TF risk of regional financial institutions has the potential to decline over time, all other factors remaining equal.

These changes will require buy-in by the regional business community to encourage the ease and use of electronic payment methods to settle commercial transactions of varying size. Reduced cash settlement for commercial transactions also benefits regular businesses of all sizes because it reduces the administrative burden associated with managing large sums of cash and lowers the operational risk related to potential fraud and theft involving cash transactions.

Finally, financial institution size and structure and their implications for the decision to terminate CBRs must be further explored. North American banking groups operating in the region appear largely insulated from the withdrawal of correspondent banking services. Indigenous banking groups, while affected to varying degrees across islands, have been able to cope and replace CBRs over time. Small indigenous banks, however, appear to be the most vulnerable, at-risk segment of the regional financial

system. Thus, initial efforts should focus on this segment. The exploration of industry consolidation via mergers and acquisitions may result in beneficial outcomes, such as the growth and development of other indigenous banking groups capable of competing regionally and capturing enough cross-border flows to be attractive to correspondent banks. Additionally, larger, more profitable institutions could result in more resources being freed up to deploy to the AML/CFT frameworks of these newly formed indigenous banking groups, which would enhance their attractiveness to correspondent banks.

In closing, the Caribbean region must explore and develop its own unique solution to addressing the decline in correspondent banking. The region faces a set of unique inherent challenges. A thoughtful approach must be employed to address them rather than accepting methods and suggestions offered by stakeholders with fundamentally different economies and financial systems.

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