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# UNDERSTANDING BANK DE- RISKING AND ITS EFFECTS ON FINANCIAL INCLUSION

An exploratory study

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**“De-risking” refers to financial institutions exiting relationships with and closing the accounts of clients considered “high risk.” There is an observed trend toward de-risking of money service businesses, foreign embassies, nonprofit organizations, and correspondent banks, which has resulted in account closures in the US, the UK, and Australia. Low profit, reputational concerns, and rising AML/CFT scrutiny contribute to de-risking, which can further isolate communities from the global financial system and undermine AML/CFT objectives. This paper explores the drivers of and responses to de-risking, highlights case studies of financial access, and provides recommendations to banks, regulators, and bank customers.**

**This research report** was written to share research results, to contribute to public debate and to invite feedback on development and humanitarian policy and practice. It does not necessarily reflect the policy positions of the organizations jointly publishing it. The views expressed are those of the authors and not necessarily those of the individual organizations.

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# EXECUTIVE SUMMARY

This report is based on a four-month exploratory study on the impacts of bank de-risking practices on financial inclusion, carried out between November 2014 and February 2015. “De-risking,” or “de-banking,” refers to the practice of financial institutions exiting relationships with and closing the accounts of clients perceived to be “high risk.” Rather than manage these risky clients, financial institutions opt to end the relationship altogether, consequently minimizing their own risk exposure while leaving clients bank-less. This exploratory study was designed to identify the core drivers of this practice and its implications for financial inclusion goals, particularly as they affect vulnerable communities. It provides a number of relevant case studies highlighting innovative approaches to, and lessons learned from, addressing de-banking challenges across six different sectors with varying degrees of banking incentives, as well as a set of recommendations about how invested stakeholders can better address de-risking challenges.

De-risking practices have not been localized in any particular population, community, or industry. However, in recent years there has been an “aggregation of results” best described as a trend toward de-risking of sectors, including money service businesses (MSBs), foreign embassies, nonprofit organizations (NPOs), and correspondent banks. Those closures have had a ripple effect on financial access for the individuals and populations served by those businesses. Regulatory authorities continue to emphasize that de-risking is not in line with international guidelines, and in fact is a misapplication of the risk-based approach. Yet in the absence of clear instructions or an incentive to bank these clients, account closures continue across the United States, the United Kingdom, and Australia. These closures have significant humanitarian, economic, political, and security implications, effectively cutting off access to finances, further isolating communities from the global financial system, exacerbating political tensions, and potentially facilitating the development of parallel underground “shadow markets.”

Unfortunately, little empirical data is available about the extent and nature of the client relationships being exited and the decision-making processes of financial institutions. This presents challenges to assessing the scale and scope of the problem, identifying vulnerable communities affected by the reduction in services, and developing effective responses. Nevertheless, this study endeavors to illuminate a number of existing trends and themes relating to the issue and provides some insight into likely factors behind de-risking practices.

Below is a summary of the key findings:

1. The goals of financial inclusion, and anti-money laundering and countering the financing of terrorism (AML/CFT), are not inherently in conflict; however, tensions do emerge in practice. Overly restrictive AML/CFT measures may negatively affect access to financial services and lead to adverse humanitarian and security implications.
2. Rather than reducing risk in the global financial sector, de-risking actually contributes to increased vulnerability by pushing high-risk clients to smaller financial institutions that may lack adequate AML/CFT capacity, or even out of the formal financial sector altogether.
3. A lack of empirical data about the extent and nature of the client relationships being exited and the decision-making processes of financial institutions impedes an assessment of the scale and scope of the problem as well as the development of effective responses.
4. De-risking represents a market failure. All invested stakeholders (banks, regulators, and bank customers and clients) appear to be acting rationally and in their own best interest, but in so doing have created unintended consequences for financial inclusion goals.
5. In such clear instances of market failure, either government or the public sector must intervene to re-align market factors, either through incentive programs or through enhanced regulatory guidance.
6. Regulatory authorities have been unable to keep up with prevailing market trends in this area.
7. Policymakers, regulators, banks, and other stakeholders have not shown the necessary accountability and leadership to address de-risking from a structural and systemic position. The ambiguity of regulatory frameworks, coupled with a lack of empirical information about de-risking criteria, has allowed responsibility for addressing the problem to shift continually

among stakeholders. De-banked customers are left without clear expectations and unable to anticipate and protect themselves against impending account closures.

8. Communication among relevant stakeholders is improving, but it is still limited at practical levels, which results in information stovepipes and siloed, ad hoc efforts to address the issue across institutions, departments, industries, and jurisdictions that do not adequately and comprehensively address market factors.
9. Regulatory authorities across jurisdictions must cooperate and coordinate more fully in order to develop streamlined definitions, standards, and policies that reduce compliance burdens and improve accountability.
10. Already suffering reputational harm following the 2008 financial crisis, financial institutions incur additional reputational damage due to AML/CFT enforcement actions. However, de-risking also has public relations repercussions, since banks are seen as cutting off crucial funds to vulnerable populations. There may also be the potential for reframing the issue as one of corporate social responsibility and for highlighting the potential “reputational returns” of continuing to cater to underserved communities.

# 1 INTRODUCTION

In recent years, the international community has begun to focus on financial inclusion as part of a broader strategy to reduce poverty, encourage economic development, and promote stability and security. For the purposes of this paper, the term “financial inclusion” refers to the provision of accessible, usable, and affordable financial services, either through the formal or informal financial sector, to underserved populations. This includes the estimated 2.5 billion “unbanked” individuals worldwide who lack access to a formal bank account, the vast majority of whom reside in developing countries.<sup>1</sup> Financial inclusion also applies to “underbanked” communities, where people lack reliable access to or are unable to afford the associated costs of financial services. In the US alone, 50.9 million adults are considered underbanked and have relied on alternative financial services in the past 12 months, including payday lenders, pawn shops, or check-cashing services.<sup>2</sup>

The international focus on financial inclusion has coincided with increased attention to anti-money laundering and countering the financing of terrorism (AML/CFT) frameworks as crucial tools for advancing stability and security objectives and for curbing criminal and violent extremist activity. The focus on AML/CFT has resulted in regulators’ increased scrutiny of the formal and informal financial sectors, as well as international pressure on low-capacity countries to develop and implement effective AML/CFT frameworks. Although overly strict approaches to AML/CFT may inadvertently limit financial access, their respective aims do not inherently conflict. Proportionate and calculated implementation of AML/CFT measures can help to advance financial inclusion goals, drawing more economic activity into the formal banking sector and consequently enhancing transaction monitoring and customer due diligence, which in turn help advance AML/CFT goals.

However, with risk appetites declining in the wake of the 2008 financial crisis, many financial institutions have opted to exit relationships assessed as being high risk, unprofitable, or simply “complex,” such as those with money service businesses (MSBs), foreign embassies, international charities, and correspondent banks. Closures of these entities’ bank accounts affect financial access for the individuals and populations those businesses serve. MSBs and other financial service providers, often referred to as “alternative money transfer services,” hold accounts with formal financial institutions (banks), which allow them to perform transactions and serve as an access point and gateway for their traditionally underserved client bases. They fill an important gap, particularly in jurisdictions with nascent financial systems where the informal sector is in fact the main provider of formal and traditional banking services. Such relationships also exist internationally. Financial institutions in developing economies often rely on correspondent banking relationships to provide access to the global financial system and underpin trade finance. Charities operating in conflict and other sensitive environments rely on all of these channels to move much needed resources internationally.

Although some non-bank financial service providers are noted for their traditionally low fees—including the remittance sector—others have been described as predatory, due to their staggering fees and disproportionate targeting of vulnerable communities.<sup>3</sup> For example, annualized payday loan fees can amount to three- or even four-digit interest rates,<sup>4</sup> which represent significant costs to the 80 percent of US borrowers who renew or roll over their initial loans.<sup>5</sup> Unbanked or underbanked communities, particularly in the developing world, are also vulnerable to private lenders. These “loan sharks” offer no legal customer protection measures and have anecdotally been linked to extortion and even threats of violence.<sup>6</sup> As banks close the accounts of non-bank financial service providers, underserved communities may be forced to increase their reliance on these types of costlier and less-regulated options.

As financial institutions re-calculate risk appetites and decide to exit relationships, they directly and negatively affect these sectors and the populations they serve. For example, in August 2014, Westpac Banking Corp. followed other major Australian and UK banks and announced

the closure of numerous money transfer operators' accounts over concerns about AML/CFT and rising compliance costs.<sup>7</sup> This followed the precedent set in the wake of Barclays' May 2013 decision to close money transmitter accounts and the subsequent temporary injunction filed by Dahabshiil, one of the largest Somali remittance companies in the UK.<sup>8</sup> The closure of these bank accounts not only threatens these businesses but also jeopardizes the vital flow of remittances to Somalia from diaspora populations, which constitute an estimated 25 to 45 percent of the country's GDP and serve as a key source of income for more than 40 percent of its vulnerable population.<sup>9</sup>

Financial exclusion is a huge barrier for disadvantaged populations. On an individual level, financial exclusion limits the ability of vulnerable populations to manage cash flows, build capital and savings, and mitigate economic shocks.<sup>10</sup> On a macroeconomic level, financial inclusion is linked to economic and social development, and improvements in financial access have been shown to contribute to reductions in extreme poverty and wealth inequality.<sup>11</sup> Additionally, expanded access to the financial sector helps finance small business and microenterprise: a positive correlation has been found between financial inclusion and employment opportunities, and it is generally believed to positively affect economic growth.<sup>12</sup>

Women and other vulnerable groups are disproportionately affected by limited financial access. For example, in developing countries, 46 percent of men have a bank account, compared to 36 percent of women.<sup>13</sup> Immigrants are another heavily affected population: factoring out socioeconomic and demographic considerations, immigrants are six percent less likely to have a checking account and eight percent less likely to have a savings account in the US than their American-born counterparts.<sup>14</sup> Without formal bank accounts, these underserved populations commonly rely on the remittance sector to send money to their families back home, and women have increasingly emerged as a key sending demographic. Although they remit about the same amount as men, women are shown to remit higher percentages of their income, more frequently, and for longer durations than their male counterparts.<sup>15</sup> Reductions in the remittance sectors due to MSB account closures stand to further isolate these communities from the global financial system, exacerbating existing financial inclusion challenges.

In an effort to ensure AML/CFT measures do not unduly limit financial access, international standards urge financial institutions to adopt a risk-based approach (RBA). Financial institutions are advised to assess their money laundering (ML) and terrorist financing (TF) vulnerabilities and to formulate policies and allocate resources according to their unique risk profiles and risk exposure. Although this approach is designed to allow for flexibility, it also introduces ambiguity and immense subjectivity around which actions are in fact required to meet international AML/CFT standards. High- and low-capacity jurisdictions alike struggle in implementing the RBA, and those perceived as being deficient in their implementation have been publicly listed by the Financial Action Task Force (FATF) and subjected to its ongoing global AML/CFT monitoring process—potentially dissuading international investors and hindering economic growth and trade relations. For financial institutions, concern over ambiguity in the RBA has been compounded in recent years by the imposition of large fines and enforcement actions related to inadequate AML/CFT compliance procedures.

This exploratory report sets out to unpack concepts, identify and fill the knowledge gap, and contribute to the discussion around bank de-risking practices and their implications for financial inclusion goals. Specifically, the report seeks to:

1. Outline key drivers of de-risking practices;
2. Map the existing narrative of key stakeholders and assess its impact on the current regulatory climate;
3. Identify the effects of bank de-risking on financial inclusion goals, particularly for vulnerable communities;
4. Summarize relevant case studies to highlight innovative approaches and lessons learned to address de-banking challenges across a variety of diverse sectors; and
5. Provide recommendations to address de-risking challenges for financial institutions, government, and regulatory bodies in developed and developing countries, and bank customers who are at risk of being de-banked.

The report focuses on the impact of de-risking on previously banked populations, whether those services are accessed directly or through an alternative financial service provider, and does not seek to assess the extent to which de-banking has affected populations that do not currently have access to financial systems.

## METHODOLOGY

This exploratory report was informed by an extensive desk-based literature review on de-risking at the financial institution and policy levels, including customer exit programs, risk modeling, profit modeling and pricing, stress testing, capital gains, market failures, and regulatory approaches. The research team framed analysis of these concepts within existing narratives related to financial inclusion and integrity, previously assessed effects of financial exclusion, the stability and integrity of the global financial system, the risk-based approach, and existing AML/CFT frameworks. An extensive review of existing regulatory frameworks and guidelines was conducted at the state, national, and international levels, as well as an analysis of stakeholder narratives to develop a comprehensive mapping of the existing de-risking landscape. A complete index of sources reviewed is included in Annex 1.

A roundtable discussion was held jointly and simultaneously in New York and Washington, DC, on February 19, 2015, with 40 key stakeholders, including representatives from the US Federal Reserve Board; the US Department of the Treasury; the US Department of State; the United Nations Department of Political Affairs; USAID; the United Nations Analytical Support and Sanctions Monitoring Team concerning Al-Qaida, the Taliban, and associates (1267/1989 Monitoring Team); the Permanent Missions of Kenya and Eritrea to the United Nations; the World Bank; the Financial Services Volunteer Corps; money transmitters; civil society; academia; and the media. Additionally, the research team conducted semi-structured interviews with representatives from financial institutions, MSBs, academia, and civil society organizations focused on financial inclusion and gender issues.

## 2 DRIVERS OF DE-RISKING

The 2008 financial crisis had far-reaching consequences, including a shift in the dynamic between regulatory authorities and financial institutions. In response to accusations that they were lax in their duties before the crisis,<sup>16</sup> US regulators have increased scrutiny on financial institutions. This has manifested in a particular focus on AML/CFT, perhaps in light of allegations that proceeds from organized crime and drug smuggling provided the liquidity

necessary for banks on the verge of collapse during the crisis.<sup>17</sup> There is a perception that banks were not held sufficiently accountable for their role in the 2008 crisis,<sup>18</sup> and the rise in enforcement actions for AML/CFT may be an attempt by regulators to punish banks for wrongdoing.

Financial institutions have responded by significantly scaling back risk appetites, which has resulted in the wholesale de-banking of entire customer bases. Financial institutions use different measures and indicators to assess termination of accounts and do not publicly release information about the criteria they use to determine when relationships will be formally exited. These benchmarks vary significantly across institutions due to a number of factors, including: (1) bank size—small, medium, or large; (2) risk appetite and absorption capacity—the willingness and capacity of financial institutions to absorb risk given the prevailing regulatory climate; and (3) potential profit modeling and forecasts.

These declining risk appetites coupled with rising AML/CFT scrutiny globally are the most commonly cited reasons for de-risking. However, the core issues are much more nuanced and involve a complex mix of push and pull factors affecting all stakeholders. Below is a summary of some of the key factors driving de-risking practices from the perspective of financial institutions. These are often perceived as stand-alone risks, but sometimes have degrees of interconnectivity or relation, namely: perceived or assessed client risk; client profitability; compliance costs and pressures; fines and penalties; reputational and legal concerns; and an overall shift from corporate responsibility to individual liability.

## PERCEIVED OR ASSESSED RISK

Underlying the practice of de-risking is the assumption that the affected customers present a higher risk of using their bank accounts as a medium for raising, moving, and storing funds that are somehow tainted. For example, the accounts could be used to launder money, finance terrorist activity, violate sanctions regimes, or support other illicit activities, such as drug smuggling or tax evasion.

One sector that has traditionally been perceived as high risk is MSBs. MSBs are non-bank institutions that provide financial services such as money transmission, currency exchange, or check cashing, often with much lower fees than traditional banking institutions and without the requirement to maintain a formal account. However, limited and varying levels of regulatory oversight, as well as challenges to conducting customer due diligence (CDD) in many recipient payout locations and jurisdictions, have raised concerns about AML/CFT vulnerabilities. Even if MSBs are in full compliance with the sending jurisdictions' regulations, transactions are often perceived as risky when the recipient jurisdiction lacks adequate AML/CFT frameworks or borders jurisdictions that are subject to sanctions, have limited governance capacities, or are experiencing conflict. Additionally, MSB operators in sending locations often pool funds from several individual transactions to deposit in one lump sum, which obscures information about the original source of the funds. These funds are then transferred to clearinghouses, which often reside in "conduit states," such as Jordan, Turkey, and the UAE. This additional stopover of funds adds a layer of suspicion and complexity, particularly when conduit states are perceived to have lax AML/CFT controls. MSBs suffered significant reputational setbacks following the terrorist attacks of September 11, 2001, when the US government shut down the largest MSB serving the Somali community, al-Barakaat, over suspicions it had been used to funnel money to al-Qaida. The 9/11 Commission eventually found no evidence that MSBs, including al-Barakaat, had been used to fund the attacks,<sup>19</sup> but the industry has continued to suffer reputational repercussions as a result of the negative publicity. For Somali MSBs in particular, the current concern revolves around al-Shabaab and piracy. Given the lack of a formal banking structure in Somalia, MSBs provide vital financial services to the Somali community and are seen as the missing links in moving and storing funds, whether knowingly or indirectly. A clear herd mentality has emerged: The closure of MSB accounts by one major bank

has caused other financial institutions to reassess these accounts, which has in turn resulted in closures across the board.<sup>20</sup>

MSBs, and money transfer operators in particular, have arguably become the public face of the de-risking debate, in large part because of humanitarian concerns related to the reduction of vital remittance flows to vulnerable communities in Somalia. However, correspondent banking relationships have also been targeted as a key vulnerability in AML/CFT regimes and have been subjected to de-risking practices. Correspondent banks provide back-end services such as check clearing, foreign exchange trading, and fund transfers on behalf of another financial institution. Frequently, foreign financial institutions will maintain correspondent banking accounts at US banks to gain access to the US financial system and currency. However, these practices suffer AML/CFT vulnerabilities similar to MSBs—discrepancies in regulatory guidelines across jurisdictions, potential for “stripping” or concealing important CDD information, and limited transparency about the complete nature of transactions, which limits banks’ capacity for meaningful behavioral profiling of, and oversight over, their clients.<sup>21</sup>

Financial institutions also view certain foreign embassies as high-risk clients. Foreign embassies and Permanent Missions to the UN in the US rely on US bank accounts to provide services such as payroll issuance and cash management. However, embassies often struggle with issues related to politically exposed persons and are viewed as vulnerable to the laundering of the proceeds of corruption and the embezzling of state funds. Foreign embassies also present risks related to potential sanctions violations. For example, in 2014 JP Morgan blocked a transfer from a Russian embassy in Kazakhstan to an insurance company owned by a US-sanctioned bank. This came after a 2011 decision by the bank to exit relationships with many foreign diplomatic outposts over concerns about money laundering and terrorist financing.<sup>22</sup> These concerns are further complicated by diplomatic immunity and the embassies’ legal status as a foreign territory, which limit the banks’ ability to monitor transactions.<sup>23</sup>

Certain types of charities and NPOs are perceived as particularly risky as well, either because of the nature of their work transferring money internationally, their areas of operation, including conflict zones and other high-risk environments, or both. According to a recent member survey of Muslim Charities Forum, a coordinating body representing the largest Muslim NPOs in the UK, 37 percent experienced difficulties in opening a bank account, with the greatest problems related to aid operations in jurisdictions facing conflict and violent extremist threat, such as Somalia, Sudan, and Iraq. One concern is that terrorist organizations may pose as legitimate NPOs to conduct fundraising activities, or that legitimate funds or assets may be misappropriated to finance terrorist activity. One notable case involves the US labeling of the Yemeni politician Abdulwahab al-Humayqani as a “specially designated global terrorist” because of allegations that he used his prominent status to fundraise through his affiliated charities and then transferred the proceeds to al-Qaida in the Arabian Peninsula (AQAP).<sup>24</sup>

However, NPOs remain reluctant to speak out about the impact of de-risking practices, as they fear reputational damage and greater financial exclusion.<sup>25</sup> NPO reluctance has been mirrored in other de-banked customer bases, further complicating efforts to identify affected communities adequately in the absence of empirical data released by financial institutions or regulatory authorities.

## CLIENT PROFITABILITY

Low profitability of the customer base has often been cited as a key, if not the most important, driving factor behind de-risking practices. Although public image and publicity considerations are an issue for financial institutions, the core decision-making driver remains straightforward and clear: a cost-profit analysis. According to a study conducted by the British Financial Services Authority in 2011, the banks surveyed appeared willing to maintain what appeared to

be unacceptable risks related to the handling of the proceeds of crime if the relationships were profitable.<sup>26</sup>

Although MSBs offer a loyal and regular client base, the average transaction amount is small. The high number of transactions adds operational and compliance burdens, which is further compounded by complex and overlapping regulatory frameworks involved in working across jurisdictions. In the final analysis, the volume of transactions often does not offset the additional costs of banking this customer base. For example, profitability was a factor in Barclay's decision to close MSB bank accounts. Barclays developed a "Minimum Standards" document in 2013 following a review of its MSB client base. At the draft stage, one of the requirements was that the customer should yield actual or potential annual revenue of at least 100,000 GBP and have at least 10 million GBP in net tangible assets.<sup>27</sup> Although the first consideration was removed from the final document, the view that high profitability can offset high risk remained a key consideration in the subsequent de-banking decisions related to MSB accounts. Out of its total 414 MSB clients, Barclays decided to continue providing corporate banking to 156, including only 19 of the 165 money remitters.<sup>28</sup>

Profitability is also a factor in assessing correspondent banking relationships. In the face of rising scrutiny, financial institutions have increasingly found themselves accountable for knowing not only their customers but also their customer's customers (Know Your Customers' Customers, or KYCC) as well. This requirement increases the risk for banks engaging in correspondent bank relationships, particularly in those jurisdictions labeled high risk.<sup>29</sup> KYCC is a much more intensive and costly process for financial institutions, and the lack of trust that has developed between financial institutions and their perceived "high risk" clients related to the implementation of AML/CFT controls has often led banks to decide the risk is not worth the benefit in these sectors. Financial institutions are arguably rational in their determination that the bottom line does not sufficiently offset the risk and therefore banking these clients is not in their own best interest. Given the lack of both market and regulatory incentive, the subsequent account closures represent a clear case of market failure, particularly in light of the key social and financial inclusion benefits inherent in the continued provision of services to these customer bases.

## INCREASED COMPLIANCE COSTS AND PRESSURES

According to the 2014 KPMG Global Anti-Money Laundering Survey, 78 percent of compliance professionals in top global banks reported increases in the total investment in AML compliance, with 22 percent of those respondents indicating an increase of 50 percent during the three-year period from 2011 to 2014.<sup>30</sup> Translating that into concrete expenditures, HSBC spent \$800 million on its compliance and risk management program in 2014, an increase of \$200 million from the previous year.<sup>31</sup> Australian investment bank Macquarie told investors that its direct compliance costs had tripled over the past three years, to nearly \$250 million as of 2014.<sup>32</sup> At Standard Chartered, regulatory costs are adding one to two percent to annual costs, totaling approximately \$100–200 million each year. The bank has also doubled the number of staff in its financial crime unit and increased legal compliance staff by 30 percent.<sup>33</sup> Although these sums are not staggering for large institutions with multi-billion-dollar annual profits, they are often cited as a key factor in the decision to de-bank clients as rising compliance costs further cut into the profitability of certain customer bases.

The divergence of regulatory approaches across state, national, and international jurisdictions is a key factor in driving up compliance costs. According to the 2014 KPMG Survey, differences in national legislation and data privacy, coupled with the fast pace of regulatory change, were listed as the top challenges to implementing internal AML/CFT procedures. This divergence can be viewed as an invisible cost of globalization, with traditionally jurisdiction-focused regulatory

frameworks struggling to keep up with an increasingly integrated global economy. Navigating these complex and dynamic frameworks can be difficult and costly, and increasing scrutiny from regulators has heightened concerns that procedures will be deemed inadequate. According to KPMG, 63 percent of respondents felt regulators should provide more guidance on compliance measures, and 43 percent sought a stronger relationship with regulators. In the Middle East and Africa, 56 percent of KPMG respondents stated they would like to see increasing international cooperation to facilitate consistency of regulatory approaches.<sup>34</sup> Ultimately, the cost of regulatory compliance may be shifted to bank customers in the form of higher fees, restricted credit, and a reduction in available services and products.<sup>35</sup> For low-income individuals and low-profit margin businesses that are unable to absorb these additional fee structures, this cost-shifting may result in the effective discontinuation of services and exclusion from the financial sector.

## RISING FINES AND PENALTIES

Further influencing the risk-versus-profitability analysis for financial institutions is the imposition of massive fines for AML/CFT deficiencies and sanctions violations. Data from the Association of Certified Anti-Money Laundering Specialists (ACAMS) indicates that although there was a modest rise in AML/CFT-related enforcement actions in 2012, in the same year there was a 131-fold increase in fines and monetary settlements paid by banks for AML/CFT and sanctions violations.<sup>36</sup> Regulatory fines and monetary settlements under deferred prosecution agreements rose from \$26.6 million in 2011 to \$3.5 billion in 2012. This includes a \$1.9 billion settlement paid by HSBC to US and UK regulators for their failure to properly monitor wire transfers that were linked to Mexican drug cartels, and for violation of sanctions laws through their business with clients in Iran, Libya, Sudan, Myanmar, and Cuba.<sup>37</sup> It is worth noting that, with the exception of Cuba, all of the sanctioned clients resided in significant oil exporting countries—which further suggests the importance of profitability in the decision to assume risk.

Fallout from the 2008 financial crisis, including widespread negative media coverage, has contributed to the rise in monetary fines as regulators have come under increasing pressure to hold institutions accountable for misconduct.<sup>38</sup> Regulators have indicated that hefty fines and enforcement actions are imposed only on the most willful, sustained, and egregious offenders (for example, the 2012 HSBC fines marked the third time in a decade the bank had been penalized for lax controls and ordered by US authorities to improve its monitoring practices<sup>39</sup>). However, as William Hoffman, a former chief counsel at the US Office of Foreign Assets Control said, “It can be frustrating for banks because they are throwing millions of dollars a year into sanctions and AML compliance programs and are the front cops for the US Government, but they are still getting these huge penalties.”<sup>40</sup>

## REPUTATIONAL CONCERNS

The implications of non-compliance extend beyond the imposition of fines, which are often only the tip of the iceberg in terms of financial costs resulting from enforcement actions. Additional losses can be seen in the forced end of a business line or limitations on the provision of specific products.<sup>41</sup> In extreme cases, it can even result in the revocation of the bank’s operating charter. One area of particular concern is the potential reputational damage incurred as a result of enforcement actions levied on the bank. As regulatory scrutiny increases, so does the likelihood that a bank will be found in violation of, or, at the very least, deficient, in its sanctions and AML/CFT procedures. Concern over the ability of banks to survive the resulting enforcement mechanisms can negatively affect relationships with investors and have a volatile impact on stock prices. For example, at HSBC, one high-profile fund manager announced in September 2013 that he was selling a multi-billion-dollar holding as a direct result of concern over the impact of future fines.<sup>42</sup> Rumors of impending enforcement actions for BNP Paribas triggered an overall market loss of approximately \$12.7 billion, despite a slight increase in stock

prices following the announcement that the bank had sufficient funding to pay the \$8.9 billion fine.<sup>43</sup> These enforcement actions also have implications for balance sheets, as regulators use their power to force firms to hold more capital, liquidity, solvency, or all three to protect against failure.<sup>44</sup> Although they are frequently cited as a main driver, the long-run implications of reputational damage remain to be seen. For example, every “global systemically important bank,” or bank whose failure may trigger a financial crisis, as identified by the Financial Stability Board, has now been fined, which makes it difficult for investors and stakeholders to avoid engagement with tarnished institutions.<sup>45</sup>

On the other hand, de-risking itself has public relations repercussions, since banks are being portrayed as cutting off crucial lifelines to vulnerable communities. This builds upon existing negative perceptions of financial institutions resulting from their perceived responsibility for the 2008 financial crisis. In turn, there are potential “reputation returns” for banks in continuing to engage with vulnerable communities, and highlighting this narrative may serve as a key entry point for reframing the conversation as one of corporate responsibility. Oxfam America is uniquely poised to assist in these types of efforts and has seen successes in this arena before, including a grassroots activism and media campaign to encourage Starbucks to recognize Ethiopian coffee trademarks.<sup>46</sup> For Starbucks, these types of initiatives, including others to re-invest in local communities and push for the sale of African-grown “free trade” coffee, have reduced criticisms of its exclusive business operations as they tapped into shifting public perceptions toward more socially conscious business models.<sup>47</sup> Promoting the benefits of these types of returns may help recalibrate risk-reward analysis and establish a voluntary and private sector response to the de-risking market failure.

## ENHANCED CORPORATE AND INDIVIDUAL ACCOUNTABILITY

Historically, regulators have shied away from criminal prosecutions for AML violations over concern that the repercussions, including the potential revocation of a bank charter, would jeopardize the broader financial system, thus giving rise to the concept of “too big to jail.”<sup>48</sup> One of the cases most commonly cited as a deterrent to criminal prosecution is that of the accounting firm Arthur Andersen LLP, which in 2002 was convicted of obstruction of justice related to the shredding of documents tied to the Enron securities fraud case. This conviction was later overturned in 2005, but by then the firm had effectively gone out of business.<sup>49</sup>

Instead of criminal prosecution, regulators in the UK and the US have traditionally relied on deferred prosecution agreements (DPAs), according to which banks voluntarily agree to a set of conditions in exchange for the suspension of criminal charges. DPA conditions can include monetary penalties, improvements in compliance measures, changes to bank management, and cooperation with regulatory and law enforcement authorities. For example, in addition to the \$1.9 billion fine levied on HSBC, the bank also signed a five-year DPA that included the placement of 100 monitors from US regulatory authorities to ensure that remedial actions were being implemented. If HSBC is found non-compliant during that period, it runs the risk of both a criminal conviction and the potential loss of its US banking license.<sup>50</sup> As the shock value of large fines dissipates, some are concerned that financial institutions have begun to view fines simply as “the cost of doing business,” and as a result they are not likely to have an impact on changing underlying bank behaviors. In response, regulators have made a deliberate and significant shift toward stronger enforcement measures to ensure both corporate and individual accountability.<sup>51</sup> For example, France’s largest bank, BNP Paribas,<sup>52</sup> pleaded guilty in June 2014 to charges related to the processing of more than \$8 billion in transactions on behalf of Sudanese, Iranian, and Cuban entities subject to US economic sanctions. This represented the first time that a global bank had pleaded guilty to large-scale systematic violations of US economic sanctions, and resulted in the imposition of an \$8.9 billion fine. Conditions of the BNP

Paribas plea deal included action against 45 employees, including dismissals, cuts in compensation, and demotions.<sup>53</sup>

Beyond repercussions levied at the banking institutions, senior staff have also begun to incur direct personal impacts. Executives are routinely named and often dismissed in the aftermath of enforcement cases, and although they may escape criminal prosecution, they often face career-ending reputational damage.<sup>54</sup> Setting an important precedent, the BNP Paribas deal does not mention immunity from prosecution for any associated individual.<sup>55</sup> As one European banking executive framed it, “From my point of view, there is an orange suit sitting in the US and the regulator is saying it’s there waiting for me.”<sup>56</sup>

Low profitability, rising compliance costs, reputational concerns, and increasing fears over civil and criminal penalties have all helped create a system in which *risk avoidance* has replaced *risk management*. However, the same factors that contribute to the high-risk assessment of these clients are also what make them most reliant on international banking services. For many of these clients, banking relationships offer critical access to the global financial system for vulnerable and otherwise underserved communities, and account closures negatively affect both financial inclusion and AML/CFT objectives in the immediate and longer terms.

## 3 MAPPING THE EXISTING NARRATIVES

There is currently a clear lack of leadership and accountability on de-risking. Responsibility for addressing the problem continually shifts among regulators, policymakers, banks, and the customer base. Regulatory authorities continue to emphasize a risk-based approach that relies on financial institutions’ risk assessments and compliance monitoring mechanisms to identify, disclose, and terminate suspicious activity. Financial institutions have rejected the role of primary watchdog in select markets and instead opt to remove themselves from these markets altogether. However, the lack of transparent criteria for de-risking has left affected customers unclear of expectations and often feeling unduly persecuted. The client base has focused its messaging on the critical humanitarian impact these account closures will have on vulnerable communities; however, their pleas do not appear to resonate with business-minded financial executives, who may fear criminal liability and financial repercussions. Regulators have yet to step in to mitigate this market failure and appear unwilling or unable to provide additional clarity regarding regulatory standards in this ever-changing compliance landscape.

To better assess and identify the current de-risking environment, the project team compiled a summary of some of the key stakeholder statements and guidance notes related to de-risking. This includes both public documents and themes discussed during private consultations between the research team and various stakeholders. This section is not presented as an exhaustive list but rather offers preliminary mapping of existing narratives. The accompanying listing of bibliographic resources also offers additional reading and an opportunity to delve deeper into individual narratives.

# INTERNATIONAL AML/CFT BODIES

## Financial Action Task Force

The Financial Action Task Force's (FATF) is:

*...an inter-governmental body established in 1989 by the Ministers of its Member jurisdictions. The objectives of the FATF 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. The FATF is therefore a 'policy-making body' which works to generate the necessary political will to bring about national legislative and regulatory reforms in these areas.<sup>57</sup>*

The FATF has formulated a series of recommendations recognized as international standards on AML/CFT and currently packaged as the "40 Recommendations." The 40 Recommendations<sup>58</sup> include a comprehensive list of measures countries should undertake in order to combat money laundering and terrorist financing, and represent the core international standards on AML/CFT. The FATF has recognized the importance of balancing AML/CFT with financial inclusion goals, and it issued revised guidance in 2013 to assist countries in developing policies that support these mutually reinforcing goals.<sup>59</sup> In October 2014, the FATF raised the issue of de-risking at its triannual Plenary Session. In the resulting media advisory, it said:

*'De-risking' should never be an excuse for a bank to avoid implementing a risk-based approach, in line with the FATF standards. The FATF Recommendations only require financial institutions to terminate customer relationships, on a case-by-case basis, where the money laundering and terrorist financing risks cannot be mitigated. This is fully in line with AML/CFT objectives. What is not in line with the FATF standards is the wholesale cutting loose of entire classes of customer, without taking into account, seriously and comprehensively, their level of risk or risk mitigation measures for individual customers within a particular sector.*

*The risk-based approach should be the cornerstone of an effective AML/CFT system, and is essential to properly managing risks. The FATF expects financial institutions to identify, assess and understand their money laundering and terrorist financing risks and take commensurate measures in order to mitigate them. This does not imply a 'zero failure' approach.<sup>60</sup>*

## The G20

It was expected that the G20, an assembly of governments and leaders from 20 of the world's largest economies,<sup>61</sup> would discuss the topic of de-risking at its annual meeting in November 2014, in Brisbane, Australia. Unfortunately, the resulting communiqué did not address de-risking or AML/CFT, although it did reiterate a commitment to strengthening the resilience of the global economy and the stability of the financial system more broadly.<sup>62</sup>

## Basel Committee

The Basel Committee on Banking Supervision<sup>63</sup> provides a global forum for cooperation on banking supervisory matters, with the goal of enhancing the understanding of key supervisory issues and improving the quality of banking supervision worldwide. In 2011 and 2013, it issued a comprehensive set of reform measures, called Basel III, designed to strengthen the regulation, supervision, and risk management of the banking sector.<sup>64</sup> Although compliance is not

mandatory, it is often viewed as the global standard for financial institutions related to capital adequacy, stress testing, and market liquidity risk.

# NATIONAL GOVERNMENTS

## United States

The US dollar is the most commonly used currency for cross-border capital flows, rendering those transactions subject to US AML/CFT laws, which are jointly referred to as the Bank Secrecy Act or BSA. This has made the US a major player in AML/CFT regulation, so considerable attention has been paid to the regulatory climate and approaches adopted by US regulators.<sup>65</sup> On the whole, US regulators have reiterated their commitment to the risk-based approach as the most effective means for balancing financial inclusion and AML/CFT goals. However, some view the US as applying a much stricter standard than that outlined in the FATF Recommendations.<sup>66</sup>

In April 2005,<sup>67</sup> the Financial Crimes Enforcement Network (FinCEN) and the Federal Banking Agencies issued a joint guidance note on obtaining and maintaining banking services for MSBs. The note was designed to clarify the requirements for, and assist banking organizations in, appropriately assessing and minimizing risks posed by providing banking services to MSBs. In November 2014, FinCEN issued a new statement on the topic, excerpted here:

*Refusing financial services to an entire segment of the industry can lead to an overall reduction in financial sector transparency that is critical to making the sector resistant to the efforts of illicit actors. This is particularly important with MSB remittance operations.*

*FinCEN does not support the wholesale termination of MSB accounts without regard to the risks presented or the bank's ability to manage the risk. As noted, MSBs present varying degrees of risk, and not all [MSBs] are high-risk. Therefore, when deciding whether to provide services to an MSB customer, financial institutions should assess the risks associated with that particular MSB customer.*<sup>68</sup>

The Office of the Comptroller of the Currency (OCC) also issued a statement in November 2014, excerpted below:

*As a general matter, the OCC does not direct banks to open, close, or maintain individual accounts, nor does the agency encourage banks to engage in the termination of entire categories of customer accounts without regard to the risks presented by an individual customer or the bank's ability to manage the risk. The OCC has always taken the position that banks must apply the requirements of the Bank Secrecy Act based on their own assessment of risk for all customer accounts.*

*The safety and soundness of an institution can be threatened when a bank lacks appropriate risk management systems and controls for the products or activities it provides or the customers it serves. Moreover, the failure to implement and maintain such controls can provide money launderers, fraudsters, terrorists, and other criminals with access to our financial system.*<sup>69</sup>

Additionally, Thomas J. Curry, Comptroller of the OCC, spoke on the topic at an ACAMS conference in March 2014:

*You shouldn't feel that you can't bank a customer just because they fall into a category that on its face appears to carry an elevated level of risk. Higher risk categories of customers call for stronger risk management and controls, not a strategy of avoidance. Obviously if the risk posed by a business or an individual is too great to be managed*

*successfully, then you have to turn that customer away. But you should only make those decisions after appropriate due diligence.*<sup>70</sup>

## European Union

The euro is the second largest currency used in global payments. For this reason, EU AML/CFT policies and enforcement practices have the potential to affect de-risking decisions. This is particularly true as stringent enforcement mechanisms in the US may drive business transactions away from the US dollar and toward the euro.

In 2015, the European Union adopted the Fourth Anti-Money Laundering Directive (IP/13/87) to help strengthen AML/CFT frameworks.<sup>71</sup> The Directive includes two legal instruments: a “Directive on the prevention of the use of the financial system for the purposes of money laundering and terrorist financing,” and a “Regulation on information accompanying transfer of funds to secure “due traceability” of these transfers.”<sup>72</sup> The Directive went into effect in June 2015, with a two year implementation period for Member States. A statement by EU Commissioner Věra Jourová described the passage of the legislation:

*... The EU is leading by example by putting in place a robust framework, which focuses on greater effectiveness and improved transparency with no legal loopholes for criminals and terrorists to slip through and abuse the financial system. We now have the tools at hand to better detect and trace billions of euros which come from criminal proceeds or financial flows which support terrorist groups and activities.*<sup>73</sup>

Additionally, in August 2015 the European Parliament adopted a revised Directive on Payment Services. The directive, known as PSD 2, strives to “improve security, widen consumer choice, and promote innovation”<sup>74</sup> within the payment services industry, which includes the MSB sector. A press release issued by the European Parliament on May 5, 2015 describes the directive’s effect on widening consumer choice in the following way:

*... A bank servicing such an account [payment services account, which includes MSBs] could deny this third party access to a payer’s payment account only for objectively justified and evidenced security reasons which have been reported to the supervisory authorities.*<sup>75</sup>

Although PSD 2 is still awaiting a vote by the European Parliament and formal adoption by the EU Council of Ministers, it has the potential to improve the provision of banking services to the MSB sector.

## United Kingdom

Following the Barclays account closures, the UK has emerged as a key player in the de-risking arena. In July 2014, the British Joint Money Laundering Steering Group issued a guideline related to the provision of financial services to MSBs.<sup>76</sup> This guideline, which was later given ministerial approval from HM Treasury,<sup>77</sup> reiterated the compliance requirements for the sector and provided clear examples of high- and low-risk indicators. Although the guideline was referred to as “legal safe harbor” in the UK Parliament,<sup>78</sup> it is not legally binding, and therefore compliance with the measures outlined does not guarantee protection from prosecution. With regards to account closures, it reads:

*There is no requirement in the ML [money laundering] Regulations that a firm must close an account that is the subject of a suspicious activity report. Firms are therefore not expected automatically to terminate existing accounts of MSBs based solely on the discovery that the customer is an MSB that has failed to comply with registration requirements (although continuing non-compliance by the MSB may be an indicator of heightened risk). In these circumstances, further enquiries ought to be made.*<sup>79</sup>

## Australia

In 2014, Australian MSBs faced significant account closures when the last remaining major bank processing these transactions, Westpac Bank, announced it was exiting these relationships.<sup>80</sup> Although the Somali diaspora is much smaller in Australia than in the UK or US,<sup>81</sup> it was able to partner with the Australian Remitters and Currency Providers Association (ARCPA) to create an effective and vocal lobby. In response, the Australian government developed an inter-agency task force, with legal, foreign affairs, regulatory, and law enforcement actors to serve as an intermediary between financial institutions and affected stakeholders, including hosting a multi-stakeholder meeting in December 2014.<sup>82</sup> There has also been engagement from ARCPA in developing a Remittance Code of Practice and Compliance Best Practices guideline to help banks assess more confidently the risk of maintaining MSB relationships.<sup>83</sup>

While this multi-stakeholder collaborative approach led by the Australian government has been noteworthy, affected stakeholders have expressed concerns about its effectiveness to date, in terms of eliciting solution-driven feedback from banks and government, or in reaching solution-focused outcomes.

Despite these challenges to date, it is hoped that direct engagement between affected stakeholders and banks toward reaching workable remittance solutions will continue, with assistance from the Australian Attorney-General's Department.<sup>84</sup>

Australia has a robust AML/CFT regime, one that is grounded in the AML/CTF Act 2006<sup>85</sup> and the Financial Transaction Reports Act 1988 (FTR Act)<sup>86</sup> and implemented by the Australian Transaction Reports and Analysis Centre (AUSTRAC), which serves as the national financial intelligence unit and AML/CFT regulator. Although Australia's national risk assessment remains classified (much as in other jurisdictions), AUSTRAC has published a scrubbed report aimed at strengthening the nation's AML/CFT regime by improving industry and public awareness of existing risks.<sup>87</sup> The production of this report, though sanitized, represents a noteworthy effort to improve transparency around AML/CFT risks and strategies. By providing insight into systemic vulnerabilities, regulators can assist financial institutions in calibrating their risk assessments and in developing mitigation strategies that do not necessitate the wholesale de-banking of customer bases.

## FINANCIAL INSTITUTIONS

Although financial institutions have found themselves at the center of the de-risking debate, they have been reluctant to speak on or off the record about their handling of the practice. The resulting ambiguity has led to further confusion about how the customer base can best adapt practices to avoid being de-banked. In private discussions with the research team, bank staff expressed the following themes and areas of concern:

- Regulators have been “asleep at the switch” for years and are now trying to catch up by shifting the regulatory burden to financial institutions.
- Basel III has failed to strengthen regulation, supervision, and risk management.
- There is a growing fear of “getting it wrong” among working-level compliance officers that has helped foster declining risk appetites, particularly over the possibility that compliance officers will now be held personally liable as corporate responsibility shrinks away.
- Senior management has provided this general direction and guidance as a translation of policy.
- Profitability is a driving concern for de-risking practices: it is simply “not worth the hassle and costs” to engage with this customer base.

- There is a need to incentivize financial institutions to engage with these customers and help realign the cost-benefit analysis.
- The financial system, largely a product of the 1970s, is “old and outdated.” Without a costly and intensive overhaul, the system cannot manage these risks, given the prevailing regulatory climate, and so banks are opting simply to exit relationships.

In the media, financial institutions have traditionally focused their narrative on pressures from regulators. Below are a few quotations from financial executives highlighting the prevalent mentality.

*We are kind of in a Ping-Pong match between financial inclusion and avoiding regulatory scrutiny and we are the ball.”*

—Pamela Dearden, managing director for financial crimes enforcement at JP Morgan Chase.<sup>88</sup>

*Our sense of how well we have to manage that risk is evolving with the regulatory landscape. And the result is that we are exiting and becoming more conservative about providing services to certain segments.*

—Bob Werner, head of global financial crimes compliance and AML operations at HSBC Holdings Plc.<sup>89</sup>

*It is a risky world for us out there in terms of enforcement actions and other actions,” said ...I think if there is a tipping point—[banks] are probably going to tip to de-risk.... At this point, I don't think financial institutions can take their own risk of not making that determination to de-risk.<sup>90</sup>*

—Julie Copeland, general counsel for JPMorgan Chase.

Financial institutions have remained opaque even to the account holders with whom they are exiting relationships. For example, Merchants Bank of California recently terminated numerous accounts after receiving a Consent Order from the OCC requiring the bank to enhance its procedures to detect potential violations of the law. A letter received by affected account holders included little information as to the reason for the closure, citing only the “complexity of your business.”<sup>91</sup>

## THE CUSTOMER BASE

During the research team’s discussions with representatives from affected customer bases, a common theme emerged related to the dire nature of the problem. MSBs reported a drastic reduction in services and highlighted the potentially catastrophic ramifications for recipient communities. The customer base has also expressed the sentiment that compliance efforts were being undervalued, and that regulatory burdens had become excessive and prohibitory.

However, the customer base has yet to develop a unified voice with which to advocate for these issues. Lack of clarity around those affected, competing business interests, the diversity and number of stakeholders, and political considerations within sectors have helped develop siloed arguments that focus on the nuanced challenges facing each unique customer base, rather than addressing the wholesale and systemic implications. Although a nuanced approach is necessary to fully understand the scale and scope of the problem, the development of a broader and overarching argument may help regulators and financial institutions to focus efforts on alleviating short-term concerns while contributing to long-term sustainable solutions.

## CIVIL SOCIETY

Although a number of organizations focus on financial inclusion, very few civil society groups are aware of or directly active in the de-risking space. For those that are, discussions have traditionally focused on the humanitarian impacts of the practice. While these make for dramatic

and compelling arguments, the research team believes they do not resonate with staff at financial institutions who are focused on the bottom line. This disconnect has served to further isolate stakeholders and discourage the development of an open, inclusive, and comprehensive discussion of the topic. Although it is important to advocate for affected populations and demonstrate the impact these decisions have on real-world contexts, it is also important to align the discourse with the prevailing themes and drivers from individual stakeholder perspectives in order to improve cooperation and coordination and develop sustainable long-, medium-, and short-term solutions.

## 4 IMPACTS OF DE-RISKING

The negative repercussions of financial exclusion are clear, and the de-banking of sectors that provide access points to the formal financial sector for underserved populations and jurisdictions stand to exacerbate these issues even further. However, beyond identifying sectors vulnerable to de-risking, it is challenging to identify which communities are most vulnerable and to assess the urgency and scale of the threat without information on the number and type of accounts being closed. Anecdotal evidence indicates that de-risking practices will likely result in the further isolation of vulnerable communities, particularly women, from the formal financial sector and may have wide-ranging humanitarian, economic, and security implications.

### SHIFTING AML/CFT RISK

Although de-risking is partly intended to reduce the vulnerability of the formal financial sector to abuse from money launderers and terrorist financiers, many have argued that the practice in fact has the opposite effect. With the closure of accounts at many major financial institutions, customers have been forced to rely on smaller banks and credit unions that may not have adequate capacity to deal with higher-risk customers. According to James Richards, a top AML official at Wells Fargo, "The ironic result of de-risking is re-risking ... you are sending them to banks that probably can't handle it."<sup>92</sup>

The termination of account relationships may also encourage entities to move into less regulated channels, thus reducing transparency and limiting monitoring capacities.<sup>93</sup> These underground "shadow banking" systems, defined as transactions that do not use traditional financial systems, can have real and important economic contributions but can also be a key source of systematic risk due to their limited or lack of regulatory oversight. Shadow banking systems may also result in increased costs for customers, as they become customers' only available financial service option. Furthermore, they operate without oversight and thus are less accountable to customers, leaving customers with little recourse if services are not provided.

### REDUCTION IN TRADE FINANCE

The closure of correspondent banking accounts presents a tangible threat to international trade finance, particularly for the developing world. Correspondent banking relationships are the connective tissue linking various points across the global financial system, offering foreign banks access to US and European financial markets and, more importantly, foreign currency. This is important for emerging markets, as the majority of the world's cross-border capital flows, including commodity markets and trade finance, are conducted in US dollars. The US dollar is used for 44.6 percent of all world payments, followed by the euro at 28 percent and the British pound at nearly eight percent.<sup>94</sup>

As financial institutions close the correspondent accounts of foreign banks, they effectively cut off access to the currencies required to conduct international trade and enable international investment, essentially de-banking entire countries. For developing economies, this can have a significant impact on economic growth and in turn government provision of social and security services. Additionally, retreating from correspondent banking relationships has resulted in a growing concentration in correspondent banking business, with the majority of relationships being held by fewer and fewer banks.<sup>95</sup> This presents a threat, since the default of one of these interconnected banks could lead to closures of customer banks, as well as severely reduced access to the global financial system for developing economies.

It is difficult to assess the scope of the threat, but banking executives have indicated that firms are dropping as much as one-third of correspondent banking relationships, which has resulted in the closure of thousands of accounts.<sup>96</sup> In the UK, a survey by the British Bankers' Association revealed an average seven-and-a-half percent decline in correspondent banking relationships since 2011, with two banks severing one-fifth of all accounts.<sup>97</sup> Across the euro zone, daily transactions settled through domestic and international correspondent banking relationships averaged more than 1.1 trillion euros. Despite the large scale of transactions, the number of domestic and foreign corresponding banking relationships has steadily decreased since 2002, dropping from more than 25,000 to less than 15,000.<sup>98</sup> In 2014, the *Financial Times* reported that, "A leading central banker said at a private meeting in Davos that authorities were increasingly worried by 'financial abandonment' of some parts of the world as leading banks severed relationships with local lenders."<sup>99</sup>

## HUMANITARIAN CONCERNS

The existing narrative about the impact of de-risking practices has focused largely on humanitarian issues, particularly those related to interruptions in global remittance flows. The most notable case studies come from Somalia, where more than 40 percent of the population relies upon remittance inflows, which account for between 25 to 45 percent of the country's total GDP.<sup>100</sup> Any reduction in these flows would have a clear and tangible impact on the country, as well as on the vulnerable communities who receive the more than \$1.3 billion sent in global remittance flows each year.<sup>101</sup> Numerous reports have highlighted the personal and dire repercussions of any curtailment of remittance flows, including family members' inability to pay for health care, food, housing, and school fees.<sup>102</sup>

Syria is also vulnerable to reductions in remittance flows due to the pressing humanitarian concerns resulting from the ongoing violence. Despite completing its AML/CFT action plan, Syria remains subject to the FATF global monitoring process and is listed as a risky jurisdiction, largely as a result of its security situation.<sup>103</sup> The presence of terrorist groups in the country poses an additional transactional risk because of the potential misappropriation for terrorist financing. With more than 4 million Syrian refugees estimated to be outside the country and another 7.6 million displaced internally, reductions in remittance flows stand to further exacerbate an already dire humanitarian situation.

NPOs operating in conflict or unstable zones also suffer from de-risking. NPOs provide vital services in areas undergoing drastic humanitarian crises, and any interruption of services could have far-reaching effects. In the UK, there are a growing number of NPOs working in the Middle East and other high-risk geographic areas that have suffered from payment delays or account closures.<sup>104</sup> In July 2014 Ummah Welfare Trust saw its account abruptly terminated by HSBC Bank. The charity has an annual turnover of about \$39 million and works in a variety of jurisdictions across the Middle East and Asia, including Syria and Gaza.<sup>105</sup>

"If you are a person with good will and you decide you want to set up a charity in Somalia or Yemen or Syria, opening a bank account for that is really near to impossible," says Abdulrahman Sharif, executive director at the Muslim Charities Forum, who also indicated that as a re-

sult, many organizations have stopped working in parts of the Middle East.<sup>106</sup> In these already vulnerable communities, any interruptions in work or service provision can have serious humanitarian and security repercussions.

## INCREASED FINANCIAL EXCLUSION

Although there is limited empirical evidence about the impact of de-risking on financial inclusion rates, it is likely that such an empirical assessment would largely underestimate the negative externality imposed. Existing banked populations are being cut off from financial services—whether directly or through the curtailment of services provided by alternative financial service providers—but equally important is the opportunity cost of lost potential for the unbanked population facing heightened barriers to inclusion. Given the well-documented evidence of the benefits of financial inclusion for poor and marginalized communities, we can in theory presume that the impact of curtailing access to financial services will be significant. On a macroeconomic level, access to financial services has been shown to reduce poverty and income inequality.<sup>107</sup> From a microeconomic perspective, access to formal savings and credit instruments has allowed people to cope better with shocks, smooth income, and invest in income-generating activities. Evidence has also shown that the availability of financial services for poor households has translated into better nutrition and health outcomes, increased years of schooling for children, and female clients empowered to confront gender inequities more effectively.<sup>108</sup>

From a financial inclusion perspective, de-risking stands to do the most harm in the developing world. Most of the world's 2.5 billion unbanked adults live in developing countries, with only 41 percent of adults in developing economies having an account at a formal financial institution, as compared to 89 percent in developed economies.<sup>109</sup> In these countries, the unbanked often face common barriers to financial inclusion, including a lack of financial literacy, low income and erratic cash flows, and high transportation and opportunity costs, as well as personal risk associated with traveling long distances to reach banks. Furthermore, banks have historically excluded the rural poor, since their business does not offer sufficient profit margins to offset the high transaction costs of opening branches in remote locations.<sup>110</sup> NPOs, governments, and financial institutions have devised innovative solutions to these challenges, including relying on alternative financial services and developing and supporting digital financial services platforms that capitalize on the high mobile phone penetration rates seen in many rural areas. But most of these still rely on connectivity with the formal banking system, and many of these platforms are falling into a regulatory gray area with limited AML/CFT oversight. As banks' appetite for risky and less profitable business has declined, new challenges are being introduced that will likely halt, or even reverse, the progress of financial inclusion.

In addition, disruption to the operations of NPOs that expressly target financial inclusion in the developing world will have a direct impact on financial exclusion rates. These organizations have often served as the intermediary between banks and the financially-excluded poor in remote areas, linking informal community-based savings groups to formal financial services. As banks exit relationships with these organizations, these links may become unsustainable. For example, Uniones de Crédito y Ahorro (UNICAs) are small self-organized community groups in Peru whose members pool savings and provide loans to each other. In operation since 2006, these have issued 90,000 loans and served more than 12,000 families who otherwise lacked access to financial services.<sup>111</sup> The Peruvian government is now working to link these groups with formal bank accounts, but the pooled nature of the funds and the challenge of identifying end recipients may discourage banks from engaging with these kinds of organizations, particularly in other jurisdictions where the government is not as actively engaged. The exact impact de-risking will have on financial inclusion remains difficult to assess in light of the reluctance of affected customer bases to speak about the loss of services, coupled with the lack of empirical data on de-banked communities that can be cross-referenced against the geographical operations of financial inclusion NGOs.

# VULNERABLE COMMUNITIES, GENDER, AND MINORITY ISSUES

Rural, low-income, and minority communities, such as women and youth, are disproportionately affected by lack of access to the formal financial sector. Among those living below the \$2 per day poverty line, women are 28 percent less likely than men to have a formal bank account. There is a gender gap of six to nine percentage points across income groups in developing countries, which underscores the higher barriers to financial inclusion women face.<sup>112</sup> Unequal distribution of power, resources, and responsibilities between men and women has led to discriminatory procedures inhibiting women's access to finance. For example, lower income can make bank accounts unaffordable for women; gender norms restricting their mobility can make it difficult for them to physically reach banks; and access to bank accounts may require evidence of property rights or a husband's signature.<sup>113</sup> However, although there are gender-specific barriers to financial inclusion, there are also gender-specific gains.

Women are a powerful driver of economic growth; in many developing economies, production inefficiency owing to the lack of a women's labor market creates a gender-specific incentive to use access to finance as a means of undertaking self-employment.<sup>114</sup> Women also exhibit spending patterns that are different from men's, often using increased access to funding for human development inputs such as food and education. This has been quantified in many instances across the developing world. For example, one study, conducted in Ivory Coast, found that when women's share of cash income increased, the household spent significantly more on food and less on alcohol and cigarettes. The findings of another study, in Brazil, were that when women earned more non-labor income, increases in the probability of child survival were 20 times greater than when men earned increased non-labor income at comparative rates.<sup>115</sup>

Furthermore, financial inclusion has been shown to contribute to women's empowerment, reducing gender inequality in developing regions. Increased access to financial resources and the ability to invest in income-generating activities can increase women's decision-making power within the household and their influence over how money is allocated.<sup>116</sup> As the financial inclusion of women may have a differential socioeconomic impact to that of men, it follows that their exclusion from the formal financial sector leaves these potential human development gains untapped. To the extent that de-risking may exacerbate the difficulties women already experience gaining access to financial services, de-risking will also have a gender-specific effect on humanitarian outcomes.

## HUMAN RIGHTS IMPLICATIONS

There is a great deal of literature on the abuse of anti-terrorism and terrorism financing laws to persecute political dissidents and minority groups in both the developing and developed world.<sup>117</sup> Although stronger customer due diligence protocols and de-risking may have benefits as far as limiting banks' exposure to entities that may be involved in these human rights controversies, it is possible that tightening AML/CFT regulations may give rise to further curtailments of free speech and minority rights globally as governments abuse counter-terrorism methods to target dissidents.

In the developing country context, where national laws and norms may conflict with internationally accepted human rights standards, financial exclusion in particular may increase the risk of human rights violations. To the extent that de-risking severs vulnerable populations' access to financial services, it may also force the poor to choose alternate coping strategies that put human rights at risk. One such strategy is the shift to child labor to supplement household income and mitigate economic shocks. Evidence has shown, for example, that child labor rates

are higher in countries with underdeveloped financial systems<sup>118</sup> and that transitory shocks lead to greater increases in child labor where credit constraints are binding and access to finance is limited.<sup>119</sup>

There may also be concerns about domestic violence in developing regions. It has been shown that access to finance increases women's empowerment and can reduce incidents of domestic violence overall. A study conducted in rural South Africa found that economic and social empowerment of women through access to finance and education on women's rights contributed to reductions in intimate partner violence, with the risk of violent incidents reduced by more than half after two years.<sup>120</sup> Where bank de-risking increases financial exclusion, it may also limit the scope for such gains.

Additionally, the research team has encountered a perception among the customer base that these account closures are intentionally targeting specific demographics, such as those who identify as religiously or culturally Muslim. Although it is difficult to ascertain the validity of these claims without empirical data on account closures, there have been anecdotal reports of Muslim charity-focused account closures in the UK by HSBC.<sup>121</sup> HSBC maintains that the decisions to close accounts were "absolutely not based on race or religion,"<sup>122</sup> and according to Tom Keatinge, director of the Centre for Financial Crime and Security Studies at the Royal United Services Institute, "The result of these [de-risking] decisions might look like Islamophobia but I am certain no UK bank is actively going to close out Islamic charities. They made decisions that predominantly affect Muslim charities given the regions they operate in."<sup>123</sup>

## NATIONAL AML/CFT REGIMES

In low-capacity countries actively engaged in AML/CFT activities, building frameworks that are compliant with international standards such as the 40 FATF Recommendations remains the primary focus. Much attention is paid to the development of adequate legal frameworks that often seek to align with the most stringent standards in order to receive positive risk assessments from international bodies. Although many of these boxes have been checked at the policy level, implementation of these standards can prove challenging, even for developed economies. The risk-based approach is designed to allow for the flexibility to address unique jurisdictional risks, but limited institutional and human resources in low-capacity countries have presented challenges to conducting the sector risk assessments necessary to identify the appropriate calibration. Coordinated and sustained capacity-building initiatives would help support effective implementation of AML/CFT standards, which would in turn strengthen financial integrity across the global system and help inspire trust between the financial institutions and sectors operating in low-capacity countries.

Given limited data on affected communities and jurisdictions, it is difficult to ascertain the impact of de-risking practices on the development of national AML/CFT regimes. It is possible that reductions in correspondent banking relationships will incentivize political will to strengthen AML/CFT regimes in developing economies. In select cases in some East African and Asian countries, the FATF Public Statement has been useful in galvanizing political support to strengthen frameworks in order to reduce risk ratings and encourage broader financial engagement and economic growth. Regardless of the motivations, any positive AML/CFT gains in high-risk jurisdictions will help strengthen the entire system and reduce vulnerabilities throughout the transactional chain.

# OPPORTUNITIES FOR INNOVATIVE SOLUTIONS

The exclusion of an entire customer base from the formal financial sector has created a window of opportunity for innovative banking solutions. This area is precisely the point where incentive for profit can be cultivated, yet it remains nascent and controversial. One of the most notable innovations for the developing world is the rise of mobile money platforms, which bring financial services directly to the rural unbanked by allowing users to conduct financial transactions, including bill payment and fund transfers. The most notable mobile money platform is M-Pesa, which is very successful in Kenya, with more than 15 million users performing more than 2 million transactions daily.<sup>124</sup> Another area that may offer promise for financial inclusion is the rise of digital currencies such as Bitcoin. Bitcoin is a virtual private currency that is not controlled by any central authority or supported by any economic system but offers the promise of substantially reduced fees.<sup>125</sup> Although its use has grown in developed countries,<sup>126</sup> lack of a broad technological understanding and infrastructure to handle transactions in digital currencies have limited and will continue to limit its implementation in developing economies in the near term.

Although these services are poised to fill the gap resulting from de-banking practices, they present additional complications for regulators who are already struggling to keep up with changing technological landscapes. Efforts have been made to address these disconnects, including the designation by FinCEN of cryptocurrencies as MSBs, which subjects them to existing regulatory frameworks. Beyond remedying the repercussions of de-risking, these technologies stand to advance financial inclusion goals significantly by tapping into existing networks and attracting lucrative investment opportunities that help tip the risk-reward balance back in favor of the customer base.

Conversely, decreased appetite for risk may leave banks reluctant to invest in new and innovative approaches to adapting international banking standards to developing contexts. Research has shown that reducing documentation requirements could potentially increase the share of adults with a formal bank account in Sub-Saharan Africa by 23 percent.<sup>127</sup> However, given heightened AML/CFT scrutiny and increasingly strict Know Your Customer (KYC)/CDD programs, this is an unappealing option. As costs of AML/CFT compliance increase, it is also unlikely that fees associated with opening and keeping a bank account will be reduced, despite the fact that high fees have been cited as a major barrier to financial inclusion of people living in poverty.

## 5 INSTRUCTIVE LEARNING: CASE STUDIES

The concept of de-risking is not new, and a number of sectors have struggled with complex legal and regulatory challenges that have restricted their access to the formal financial structure, or with perceptions of risk that have led to unfavorable cost-benefit analyses. The section below summarizes a number of relevant case studies that showcase innovative approaches to, and lessons learned from, addressing de-banking challenges across a variety of diverse sectors with varying degrees of banking incentives. The six case studies include:

1. The steps being taken by the profitable US marijuana industry to mitigate legal complexities at the state and federal level;
2. The impact of political ramifications on embassy account closures;

3. The impact of negative blowback from Operation Choke Point on sectoral reputation and regulator engagement;
4. Experiences developing a streamlined set of common requirements for mortgage loan originators;
5. The potential for advocacy and resource linkages with cryptocurrency given the sector's US classification as an MSB; and
6. The current state of safe corridor and safe harbor initiatives and discussions.

## BANKING MARIJUANA BUSINESS PROCEEDS IN THE US

Although marijuana remains illegal at the federal level in the US, a number of states and the District of Columbia have passed laws in recent years legalizing it for both medical and recreational consumption.<sup>128</sup> This has led to the rapid development of marijuana dispensary businesses, which in turn need financial services to operate. The conflict between state and federal legislation presents a unique challenge for financial institutions looking to provide services to this growing industry, as engagement in the sector opens the bank up to civil and criminal penalties related to federal BSA, AML, and narcotics law violations. The lack of access to banking services has forced marijuana dispensaries to deal exclusively in cash, complicating state tax efforts, creating security risks, and providing a prime opportunity for potential abuse of the industry by money launderers.<sup>129</sup> Aaron Smith, executive director of the National Cannabis Industry Association, has called the lack of banking services “the most urgent issue facing the legal cannabis industry today.”<sup>130</sup>

Regulators have attempted to address this burgeoning issue, and in February 2014 the US Department of Justice issued a memo indicating that the eight “federal law enforcement priorities” guiding prosecution in states where marijuana is legal would also apply to the federal prosecution of financial crimes for marijuana-related business.<sup>131</sup> The US Department of the Treasury also issued a guidance note on the provision of financial services to marijuana-related businesses consistent with BSA obligations.<sup>132</sup> In essence, the message was that federal regulators would show prosecutorial restraint as long as banks are able to ensure that customers comply with state legislation and not violate any of the eight priorities, which include sale to minors, interstate smuggling, use of firearms, and adverse public health consequences.<sup>133</sup>

However, the guidance notes specifically do not offer any sort of “safe harbor” for financial institutions providing services to marijuana-businesses, specifically including the line: “Nothing herein precludes investigation or prosecution, even in the absence of any one of the factors listed above, in particular circumstances where investigation and prosecution otherwise serves an important federal interest.”<sup>134</sup> The argument from financial institutions engaged in this sphere is that these guidance notes are too vague and impose a heavy burden on banks to know not only their customers, but also their customers’ customers. Don Childears, president and CEO of the Colorado Bankers Association says of the guidance notes, “At best, this amounts to ‘serve these customers at your own risk’ and it emphasizes all of the risks.”<sup>135</sup>

This is similar to the argument being made by financial institutions working with MSBs: Regulatory ambiguities, the potential for strict penalties, and burdensome compliance measures all increase the risk and cost associated with banking these clients. But given the potentially lucrative nature of the marijuana industry—considered the fastest growing industry in the US, totaling \$2.7 billion in 2014<sup>136</sup>—there is a clear market incentive to assume the risk for marijuana businesses that does not exist for less remunerative clients, such as MSBs and NPOs. In addition, the profitability of the industry allows banks to price for the increased AML risk and enables marijuana businesses to absorb the high costs of compliance.

Given the legal sensitivities, marijuana businesses often remain tight-lipped about where they are obtaining financial services, but FinCEN director Jennifer Shasky Calvery has indicated that 105 banks and credit unions are currently working with the marijuana industry.<sup>137</sup> The 2014 FinCEN guidance indicates that banks are required to file suspicious activity reports (SARs) for all transactions related to marijuana businesses, as they remain “funds derived from illegal activity” under federal law. However, it outlines a three-tier system of filing designed to separate activities: those lawful under state legislation, those potentially violating state law, and those that have resulted in the decision to exit client accounts.<sup>138</sup> Although the legal caveat of “proceeds from illegal activity” does not apply to the customer base examined in this report, the tiered reporting system presents an interesting approach to mitigating risk and improving transparency. Given the high volume of transactions conducted by MSBs, the compliance burdens may preclude the sector from adopting this approach outright. However, it is worth further exploration to determine if some variation of this reporting method may be a viable solution to reducing bank liability and better balancing the burden of transaction monitoring and accountability between financial institutions and federal regulators.

Additionally, the marijuana industry has also fostered innovative financial market approaches at the state level, including the development of a credit union specifically for handling marijuana-related financial services. Colorado state banking regulators have approved a charter for this institution, the Fourth Corner Credit Union, but it has encountered delays in its application to the Federal Reserve Bank, potentially over concerns about the precedent this would set.<sup>139</sup> The development of this type of niche banking is an avenue worth exploring for MSBs and other de-banked clients, particularly given the lack of state-federal legality conflicts for these customers. If it could be properly incentivized, such a specialized system could reduce overall compliance costs and help create a standardized system for risk management.

## RESPONSES TO FOREIGN EMBASSY ACCOUNT CLOSURES

On May 13, 2004, FinCEN and the OCC issued a \$25 million fine to Riggs Bank of Washington, DC, for violations of suspicious activity reporting and for failure to establish adequate AML controls for its numerous foreign diplomat and embassy clients. As a result of the subsequent reputational damage, Riggs Bank was forced to sell its operations to PNC Bank of Pittsburgh in July 2004.<sup>140</sup> The ensuing crisis left embassies scrambling to find new banks to take their accounts, while the banks the embassies approached, wary of heightened scrutiny and reputational risk, were not eager to absorb their business.<sup>141</sup>

Banks instead began shedding foreign embassy accounts. The embassy of Angola, in Washington, DC, was the first to have all of its US bank accounts closed against its will, when Bank of America terminated business with the embassy in November 2010. In response, the Angolan government threatened to close the bank accounts of US companies in Angola, such as Chevron, Exxon, BP, and Boeing, as well as all US embassy bank accounts.<sup>142</sup> American businesses with interests in Angola began to express their concern to government officials and banks.<sup>143</sup> With diplomatic and organizational interests at stake, pressure for a solution was mounting on both a political and business front.

In a letter to the American Bankers Association (ABA), then-US Treasury Secretary Timothy Geithner and then-US Secretary of State Hillary Clinton pressed banks to resume business with foreign embassies, warning of the negative effect of account closures on US diplomatic relations. ABA president and CEO Frank Keating responded that the regulatory regime made banking with embassies nearly impossible.<sup>144</sup> US Treasury and State Department officials were pushing banks to engage with embassies but could not guarantee leniency on behalf of regulators, who had warned that foreign embassies pose heightened money-laundering risks as diplomatic immunity exempts them from reporting the source of funds in their accounts.<sup>145</sup>

Although the stalemate among regulators, banks, and the US government is familiar given the current situation surrounding MSB account closures, the threat to US foreign relations and American businesses abroad made the political stakes much higher. At the request of the State Department and US Treasury, several large banks began reopening accounts with foreign embassies at a premium.<sup>146</sup> Without the political incentive to find a solution, MSBs or small charitable organizations are unlikely to see the same results.

## OPERATION CHOKE POINT

First made public in March 2013, Operation Choke Point was an initiative by the US Department of Justice for investigating financial institutions doing business with industries deemed to be at high risk for fraud. According to a Justice Department official quoted in the *Wall Street Journal*, “We are changing the structures within the financial system that allow all kinds of fraudulent merchants to operate [with the intent of] choking them off from the very air they need to survive.”<sup>147</sup>

Operation Choke Point was predicated on a 2012 policy announcement from the US Federal Deposit Insurance Corporation (FDIC), which included a list of both legitimate and illegitimate merchant categories that have been “associated with high risk activity.”<sup>148</sup> Operation Choke Point interpreted existing law to imply that providing financial services to these merchant categories creates a “reputational risk” that is sufficient to trigger a subpoena by the Department of Justice.<sup>149</sup> However, a report by the US House of Representatives Committee on Oversight and Government Reform found that the Department of Justice lacked adequate legal justification for this initiative and called for its dismantling.<sup>150</sup>

Additionally, the report disclosed evidence which suggested that the true goal of the operation was to target industries that were deemed “high risk,” or that were otherwise perceived as questionable to the Obama administration.<sup>151</sup> The operation focused particularly on short-term lenders, including check cashiers and payday lenders, but also extended to other industries such as firearms and adult entertainment. The Department of Justice issued 50 subpoenas to banks and payment processors as part of the operation, which resulted in the abrupt closure of accounts associated with these merchant categories.<sup>152</sup> As a result of the operation, the report said, “Banks are put in an unenviable position: discontinue longstanding, profitable relationships with fully licensed and legal businesses, or face a potentially ruinous lawsuit by the Department of Justice.”<sup>153</sup>

In response to backlash from Operation Choke Point, the FDIC issued a letter indicating that all banks should take a risk-based approach to assessing individual client relationships on a case-by-case basis and not by industry operational risk.<sup>154</sup> This was followed by a memorandum to supervisory staff requiring examiners to put in writing their recommendation to terminate an account, which the financial institution must then have reviewed before the account was terminated.<sup>155</sup> The issuance of a defined list suggests that regulators were aware of the need for additional clarification around the definition of high-risk sectors but were forced to revert to the risk-based approach due to blowback from the operation, thus creating a potential credibility issue.

There are clear parallels between the de-banking resulting from Operation Choke Point and the de-risking challenges currently facing MSBs and other clients. Although there is no longer a federally defined list of high-risk merchant categories, stigmas and lingering reputational damage related to these customer bases continue to influence financial institution decisions, with MSBs also feeling unduly persecuted. Similarities also exist in the lack of clarity from regulators about what qualifies these industries as high risk, as well as what criteria trigger the decision to exit these relationships.

In both instances, the lack of clarity stems from concerns about regulatory enforcement and the broad assessment of risk based on entire merchant categories, not individual compliance

measures. Those affected by Operation Choke Point were able to show that de-risking activities in fact target the sector as a whole, a practice which was immediately disavowed by regulators. Although current de-risking practices are not as clearly linked to a defined government objective, it may be useful for de-banked customer bases to attempt to identify trends and patterns that both highlight the industry-focused targeting of de-risking practices and stress the humanitarian implications of these decisions.

## NATIONWIDE MORTGAGE LICENSING SYSTEM AND REGISTRY

As part of the Housing and Economic Recovery Act instituted in response to the 2008 mortgage crisis, the US passed the Secure and Fair Enforcement for Mortgage Licensing (SAFE) Act, which required states to implement licensing and registration systems for mortgage loan originators (MLOs). States were given the option of developing their own systems or participating in the Nationwide Mortgage Licensing System (NMLS) Federal Registry, an initiative created jointly by the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators.<sup>156</sup>

Although individual state requirements may vary, any MLO who works for a federal insured depository or is regulated by a federal banking agency is subject to so-called Common Requirements, including passage of a written qualified test and criminal background and credit checks, as well as pre-licensure education and continuing education requirements.<sup>157</sup> Building on these streamlined licensing procedures, the Federal Registry created a database including consolidated and standardized information about MLOs. Overall, the NMLS helped to improve information sharing among regulators, increase efficiencies by streamlining the licensing process and reducing regulatory burden, and enhance consumer protection and support anti-fraud measures.<sup>158</sup>

In 2012, NMLS was expanded to include other non-depository entities, including MSBs (and is now sometimes referred to as the Nationwide Multistate Licensing System). However, only 24 states now use NMLS for the licensing or registration of MSBs or both.<sup>159</sup> For the rest, licensing and examination still falls under state jurisdiction. MSBs are currently required to register with FinCEN and provide a list of all associated agents, an estimate of business volume, and information regarding ownership and control.<sup>160</sup> FinCEN maintains an electronic database of all registered MSBs which is available for public access but includes a clear caveat that inclusion in the registry does not equate to a certification of legitimacy.<sup>161</sup> FinCEN has also undertaken efforts to standardize bank examination procedures with the issuance of a BSA/AML Examination Manual in 2010.

The traditional reliance on a state-centric model has created a complicated regulatory web where MSBs doing business across state lines must comply with overlapping legal frameworks and licensure requirements. According to FinCEN, as of July 2014 there were 737 MSB companies holding a license to operate in more than one state. In total, these companies had registered more than 95,000 agent locations.<sup>162</sup> Standardizing these procedures can introduce transparency and accountability into the system, and the centralization of information can help prevent bad apples from exploiting regulatory gaps between jurisdictions. The further development and expansion of the NMLS may provide a key entry point for reducing compliance burdens and providing better transparency and accountability for MSBs, all of which may help reduce financial institutions' perception of risk for these customer bases.

# CRYPTOCURRENCY AND OTHER TECHNOLOGY-BASED SOLUTIONS

Recently we have seen the explosion of cryptocurrency technology in the global financial marketplace. Most notable is the rise of Bitcoin, which has both grown and then collapsed rapidly in the six years since its inception.<sup>163</sup> Regardless of concerns about the stability and sustainability of specific cryptocurrency products, it has become clear that they represent a groundbreaking technological advancement. With this innovation comes great promise, including decreased financial fees, reduction in payment processing times, increased efficiencies in the financial system, user confidentiality and privacy protection, and the potential for expansion of financial services globally.<sup>164</sup>

However, these benefits come with a price. Digital currencies are based on the concept of anonymity. Although transactions are logged in a transparent public ledger called a “blockchain,” the ledger does not record customer information, only the IP address of the user. Along with the currently limited regulatory oversight of these technologies, this has made cryptocurrency technologies particularly attractive as havens for money laundering and other criminal activity. In 2014, Bitcoin exchange operator Robert Faiella was arrested for supplying \$1 million in digital currency that allowed people to conduct illegal transactions on Silk Road, an online black marketplace known for selling drugs.<sup>165</sup> In the largest online money laundering charge in history, Liberty Reserve, a Costa Rican-based digital currency service, was indicted by the US government in 2013 over allegations it handled 55 million transactions involving criminal proceeds, totaling \$6 billion. Richard Weber, head of the Internal Revenue Service (IRS) criminal investigation unit, said of Liberty Reserve, “If Al Capone were alive today, this is how he would be hiding his money.”<sup>166</sup>

Given the rapid pace of development and the divergent technological platforms currently being explored, it has become increasingly difficult for regulators to find ways to mitigate these risks without negatively affecting the potential for growth. In July 2011, US financial regulators took the first step in this process by amending the definition of money transmission services to include “other value that substitutes for currency.”<sup>167</sup> In response to industry requests for further clarification, FinCEN issued a guidance note in March 2013 that clearly defined which entities in the virtual currency realm are subject to BSA compliance.<sup>168</sup> Citing the point at which digital currencies are transferred into fiat currencies, the guidance defined the administrators and exchangers of digital currencies as MSBs but excluded users of virtual currencies. This designation has implications for cryptocurrency technologies, as they are now subject to registration, reporting, and record-keeping requirements.

The implications of this designation are still being determined by the cryptocurrency industry as it seeks to understand how CDD and SAR reporting requirements fit within existing structures. Meanwhile the industry continues to grow, and in 2014 global usage of digital currency averaged \$50 million a day.<sup>169</sup> Although this still lags well behind the \$32 billion processed by Visa and MasterCard daily,<sup>170</sup> it indicates a growing demand for the service, particularly given the limited infrastructure that exists for digital currency usage. This emerging industry is also backed by major power players: Netscape founder Marc Andreessen and LinkedIn founder Reid Hoffman put \$315 million into Bitcoin-related projects last year;<sup>171</sup> Winklevoss twins Cameron and Tyler have invested heavily in a regulated Bitcoin exchange;<sup>172</sup> and even the New York Stock Exchange has supported digital wallet providers.<sup>173</sup>

The potential for high industry profitability and the involvement of well-funded and politically connected backers may serve as key “push factors” in the development of regulatory frameworks that favorably balance industry growth and AML/CFT risk mitigation. Additionally, cryptocurrency companies stand to benefit immensely from existing human capital—staff are highly trained technologically, which may help them develop innovative procedures to ease regulatory burdens. One such technology includes automated transaction monitoring and

filtering systems, which have recently been used by the New York Department of Financial Services to help identify millions of potentially illegal transactions at one bank.<sup>174</sup> Although cryptocurrencies are currently regulated much like MSBs, it is clear that the two sectors have very different operating practices. Innovations developed by the cryptocurrency industry may prove to be applicable, at least in part, to more traditional MSBs, but the exact extent of the cross-pollination remains to be seen at this time. Advocacy groups and MSB organizations may also want to capitalize on this regulatory pairing to tap into the power of the cryptocurrency lobby, effectively connecting themselves to the push factors in this new industry.

## SAFER CORRIDOR VERSUS SAFE HARBOR PROJECTS

Attempts have been made to improve the security and transparency of specific remittance corridors. For example, in partnership with the World Bank, the UK announced a Somalia-specific Safer Corridors project in 2013 to track payments from the UK to Somalia.<sup>175</sup> This builds upon an earlier UK-supported program in Pakistan. Developed in 2009, the Pakistan program implemented strict monitors on money transfers into the country, which led to a dramatic increase in the funds transmitted, from \$6 billion between 2007 and 2008 to \$13 billion in 2011 and 2012.<sup>176</sup> The current Somali Safer Corridors project has largely been deemed a failure, and individuals we consulted have further indicated that it has hit a series of potentially insurmountable obstacles.

Beyond specific corridors, international discussion has considered broader “safe harbor” policies. The term “safe harbor” applies to the legal provision of amnesty from criminal prosecution and civil enforcement actions. There have been no clear case studies where a legally binding safe harbor policy has come into effect related to money laundering and terrorist financing. There are potential benefits to such a system, which allow banks a short-term reprieve from enforcement actions while longer-term solutions to de-risking challenges can be addressed. However, the development and adequate implementation of broad-based safe harbor projects are challenging and politically sensitive.

## 6 CONCLUSION AND RECOMMENDATIONS

### CONCLUSION

De-risking represents a clear instance of market failure. Regulators are scrambling to catch up with the current money laundering and terrorist financing landscape. As a result, they are increasingly shifting monitoring burdens to financial institutions, and the customer base is feeling the brunt of this shift.

**Financial institutions** have been thrust into a policing role, which they refuse to take on in light of a dispassionate cost-benefit analysis that determines the risk is not worth the reward of banking high-risk clients.

Threatened with the loss of access to financial services, the **customer base** is calling for increased clarity about compliance standards and the streamlining of regulatory burdens in an effort to decrease the perception of risk within their sectors.

However, **regulatory authorities** appear hesitant to move beyond the general ambiguity of the risk-based approach, particularly given the complex and dynamic regulatory landscape. In fact, the existing public narratives indicate that the risk-based approach is here to stay.

All invested stakeholders are understandably acting in their own best interests in order to protect themselves and their profits, but this has served to limit financial access. De-risking has significant economic, humanitarian, and security implications, and in many ways may be undermine the goal of reducing risk in the global financial system.

In instances of market failure, there are precedents for regulatory intervention, but addressing the issue will require a comprehensive response involving regulators, policymakers, banks, and other stakeholders. Below is a set of recommendations for invested stakeholders.

## RECOMMENDATIONS

### For government and regulatory authorities in financial hubs

- Develop policies and procedures that facilitate the accrual of aggregate metrics, including regular, routine publication of reports and aggregate data on bank de-risking, to assist multilateral, civil society, and non-governmental actors in better identifying the consequences of de-risking trends, implications, and affected communities.
- Supplement the risk-based approach with clear rules- or principles-based guidance where relevant (for instance, as it applies to high-risk jurisdictions and geographies) to provide clarity about AML/CFT requirements involving those clients deemed inherently high risk.
- Assume a leadership role in creating space for stakeholder discussion to develop concrete across-the-board actions to harmonize regulatory approaches, improve compliance, realign market factors, and build trust across sectors and jurisdictions.
- Consider balancing punitive measures, such as sanctions, penalties, and fines, with constructive models rewarding risk mitigation, including incentive mechanisms for financial institutions to engage with high-risk clients—potentially leveraging the Community Reinvestment Act<sup>177</sup> and its impact on incentivizing participation in the Low-Income Housing Tax Credit program<sup>178</sup>.
- Promote the continued integration of financial inclusion into mutual evaluation methodologies developed by the FATF and the World Bank to assess the impact of AML/CFT compliance on unbanked or vulnerable communities.
- Continue to support capacity-building programming in high-risk or low-capacity jurisdictions or sectors to improve compliance across the transactional chain and reduce ML/TF risks.
- For government and regulatory authorities in low-capacity and developing countries Continue to develop and refine the implementation of policies and legislative frameworks that align with international standards and promote financial inclusion goals, such as conducting national risk assessments and developing national AML/CFT strategies.
- Fast-track institutional development, such as that involving the financial intelligence unit or central bank, in order to facilitate trust-building in remittance-receiving countries' banking infrastructures and encourage foreign direct investment.
- Encourage regional cooperation and coordination on AML/CFT and focus on strengthening relationships with “conduit countries” through the signing of memoranda of understanding and increased information sharing.
- Promote effective regulation and legislation regarding emerging technologies such as mobile money as a means of promoting financial inclusion while balancing AML/CFT vulnerabilities.

Invest in large-scale financial literacy awareness-raising programs focused on women, youth, and other financially excluded communities.

- Explore the adoption of non-traditional identification policies to alleviate a primary obstacle to financial inclusion for vulnerable communities (for instance, biometric print, clan elder physical identification).
- Sign, implement, and enforce anti-corruption declarations.

## **For financial institutions**

- Review and revise enterprise-wide KYC policies and procedures to better identify, mitigate, and manage risk.
- Continue to invest resources in compliance departments, but assure adequate staffing and resourcing of operational and technological teams, who are often tasked with the practical implementation of compliance directives.
- Consider and harness the reputational return of demonstrated corporate social responsibility campaigns focused on the extension of financial services, particularly to underserved communities and individuals.
- Formulate risk tiers that allow for the capture of multiple layers of complexity, and not inherently and disproportionately rooted in basic units of analysis such as “jurisdiction” or “nationality.”
- Review and fine-tune client onboarding practices to collect necessary information, while explaining to the client how that information is used and what purpose it serves.
- Assess “simple” or “limited” bank accounts that have caps on overall value, frequency of use, and size of transactions as a means of extending financial inclusion, lowering the cost of banking small value accounts, and balancing money laundering and terrorist financing risk.
- Consider establishing a fee structure for high-risk accounts to help offset the cost of potential enforcement actions—where there is a business incentive, there is a way.
- Mitigate risk of insufficient CDD by customer agencies by implementing enhanced transaction monitoring processes and technologies.
- Engage with and provide adequate resources to technological stakeholders to explore innovative approaches to reducing compliance burdens and improving transactions monitoring.
- Conduct a proactive market assessment to identify areas for potential profitability while boosting access for the de-risked and unbanked.
- Consider joining MSB associations in an observer capacity, to enhance sector understanding and build trust.

## **For the “customer base”: MSBs, NPOs, among others**

- Professionalize internal standard operating procedures and provide continued staff training on AML/CFT standards and practices, flagging of suspicious transactions, and whistleblowing.
- Conduct sectoral or multi-sectoral risk-based assessments to identify core vulnerabilities and promote the effective allocation of resources to mitigate ML/TF risk.
- Focus on “front end” de-risking by conducting enhanced assessments prior to client onboarding.
- Establish or join local, national, and global sectoral associations to improve discussion and coordination regarding AML/CFT compliance efforts and to develop a unified voice of advocacy in de-risking forums.

- Capitalize on the classification of digital technologies such as MSBs to promote advocacy and resource linkages that will help develop innovative ways to reduce regulatory burdens and promote the sustainability of services for both sectors.
- Promote engagement and trust building by offering on-site tours for compliance officers and relationship managers to enable first-hand assessments of existing vulnerabilities and develop strategies to improve compliance.
- When approaching banks, disclose requested information during the onboarding process to demonstrate openness and transparency and to build trust.

## ADDITIONAL AREAS OF RESEARCH

- Analyze tax implications for the IRS related to de-banking practices—loss of revenue might serve as an incentive for legislative engagement.
- Explore banking practices related to foreign terrorist fighter accounts.
- Include gender demographics in empirical research on vulnerable communities affected by de-risking. Explore whether existing behavioral studies related to risk and spending patterns of men versus women can be factored into financial institution's risk-analysis models.
- Explore engagement with international bodies, such as the UN, which have the ability to improve access to financial services for vulnerable communities.
- Explore the feasibility of developing an internationally recognized certification program to promote transparency and accountability related to AML/CFT programs and standards—for example, best-in-class certificates.

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