St. Kitts Branch Financial Services Regulatory Commission

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DE-RISKING

What is 'De-Risking'?

'De-risking' refers to the practice of financial institutions terminating or restricting business relationships with clients or categories of clients to avoid, rather than mitigate, risk.

Topics Discussed:

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Causes and Effects of 'De-Risking'

Causes

The drivers of de-risking are complex and include: increasing profitability; reducing reputational risk; lower risk appetites of banks; regulatory burdens related to the implementation of anti-money laundering and counter-terrorist financing (AML/CFT) requirements; the increasing number of sanctions regimes; and regulatory requirements in financial sector. The main causes of de-risking by financial institutions may be categorized as:

* Economic/business related - this may be driven by the need to reduce higher costs associated with compliance and increased regulatory capital requirements including consequential regulatory fines and penalties; and
* Regulatory and risk related - the decision to de-risk a client or category of clients is based on the level of money laundering/terrorist financing (ML/TF) risk of the client or category of clients deemed unmanageable, due to these risks.

The two categories of causes listed above are inter-connected since higher risk can result in greater cost. De-risking may also occur when banks have specific concerns with individual accounts. These may include: inability to identify the beneficial owner or interested party, payment transparency, source of funds/wealth, and lack of confidence that the client is equipped to manage specific risks associated with its operations.

Effects

The most notable example of de-risking is one where financial institutions cease to provide accounts to and transact business with high risk clients or product sectors. Total withdrawal from a specific sector or customer group is at the farthest end of the de-risking spectrum. Similar de-risking responses may include financial institutions:

* limiting their exposure to certain high risk sectors e.g. Money Services Businesses
* taking steps to avoid over concentration with a particular type of risk e.g. Correspondent Banking.
* limiting the types of services offered to higher risk relationships e.g. cash clearing activity, bank notes etc.
* curtailing certain products and services in and for certain countries and customer sectors.

High Risk Businesses/Clients

The following businesses/clients are considered high risk under AML/CFT standards and are most likely to be affected from de-risking:

- Domestic Banks
- Money Services Businesses
- Foreigners/Non-residents residing in high risk countries
- Casinos
- Charities/Non-Profit Organizations
- Politically Exposed Persons (PEPs)
- Persons associated with drug trade or illegal activities

Implications of 'De-Risking' for Financial Institutions

Whilst the full impact of de-risking is not yet fully understood, consequences to the real economy, financial stability, and global economic development, have been identified.

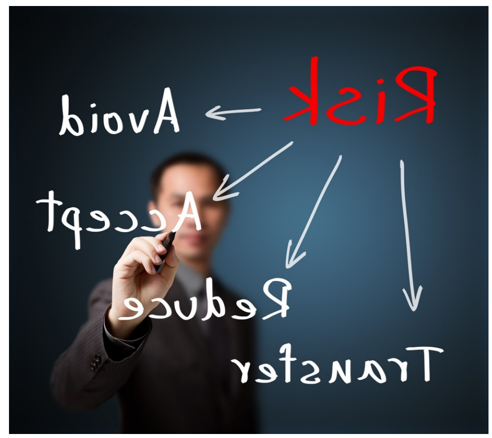
A survey conducted by the World Bank Group demonstrated that the products and services identified as being most affected by de-risking and the subsequent withdrawal of correspondent banking relationships are: check clearing, clearing and settlement, cash-management services, international wire transfers.

In addition, the survey revealed that in terms of the client segments most significantly impacted, over 69 percent of responses received from the banking authorities indicated that money transfer operators and other remittance companies are most impacted, followed by small and medium domestic banks (44 percent) and small and medium exporters (26 percent).

Banking Sector: Loss of Corresponding Banking Relationship

As a consequence of the current legal and regulatory requirements and expectations, coupled with reputational, legal and regulatory risks, banks have taken action by either exiting correspondent bank relationships completely, exiting high risk elements of correspondent banking, or accepting only a limited number of correspondent relationships. The ramifications of this stance may include:

- The financial exclusion of certain correspondent banking relationships may have serious political, economic and social consequences, including in areas such as international payments and transactions, which are so critically important to economic growth in both developed and developing markets.
- There is significant potential for displacement risk in banks and other financial institutions which can be exacerbated by the de-risking of correspondent banking. This could result in the transfer of business to less well regulated finance providers or jurisdictions, or in some instances, to more dubious underground means in order to conduct financial transactions. Thus, as they will be excluded from access to the official financial system, this will reduce the ability of the authorities to monitor or track their activities, particularly due to a corresponding likely reduction in meaningful suspicious activity reports.
- Whilst all banks recognize the need for stringent regulation and oversight of correspondent banking activity, some of the requirements have become so challenging to implement, and carry such significant reputational and regulatory risk, that banks with responsibility to other stakeholders have adopted a robust approach to risk appetite. As a consequence, banks are reducing and exiting such services.



Why Businesses choose not to 'de-risk'

Some institutions consider other alternatives to de-risking to adequately manage their AML/CFT risks. This decision is influenced by the following factors :

- The opportunity for growth. By adding another perspective to what others might perceive as too risky, companies may establish a more robust control environment, which can enable senior management to pursue additional growth opportunities.
- By de-risking, you are giving your competitors a competitive advantage. Whenever a company turns away a client, that client then seeks to conduct business with another company in the same field.
- Senior management is confident with the AML/CFT controls in place to manage and monitor risk. If the company's policies and procedures are adequate and the company possesses a strong culture of compliance to identify potential weaknesses/risks, then management may decide to enter into or maintain business relationships that are considered 'high risk'.

Measures to Circumvent 'De-risking'

The only way to circumvent 'de-risking' is to properly manage and monitor your risks. In order to do this, the following risk analysis and control steps should be taken:

- Assess—As outlined in the *Financial Services (Implementation of Industry Standards) Regulation (FSR), No. 51 of 2011, paragraph 34,* prior to the establishment of a business relationship and periodically thereafter, the regulated business should assess the risk of the relationship. This involves conducting a proper due diligence check on the client.
- Plan—The decision to establish or maintain a relationship with a high risk client should be made by senior management. This decision should only be taken if the company is prepared to take on the risk. Such business relationships should be subject to enhanced monitoring of transactions.
- Implement—Risk mitigation strategies and preventative plans should be implemented after the decision to establish or maintain high risk business relationships is made.
- Monitor and Review—The company must continue to monitor its client's transactions to detect any suspicious activities. The company must also review and update their AML/CFT policies and procedures and risk mitigation strategies periodically to ensure it is aligned with the AML/CFT Regulations of St. Kitts and Nevis and emerging trends.

Implication of 'De-risking' for Stakeholders

As stakeholders, we have to ensure that financial institutions are taking a risk-based approach to implementing AML/CFT measures. The implementation of these measures should be aimed at managing risk, rather than avoiding it.

De-risking can introduce risk and opacity into the financial system, as the termination of business relationships has the potential to force entities, and persons into less regulated or unregulated channels, thereby increasing money laundering and terrorist financing risks. Moving funds through regulated, traceable channels facilitates the implementation of AML/CFT measures.

The political and regulatory perspectives in relation to managing money laundering and other financial crime will inevitably result in conflicts with other public policy agendas and commitments, such as economic development, financial stability and financial inclusion. It is therefore imperative that all stakeholders including governments, regulators, civil society and the private sector ensure that their concerns are robustly addressed.

References:

- *Financial Services (Implementation of Industry Standards) Regulation (FSR), No. 51 of 2011.*
- *Anti-Terrorism (Prevention of Terrorist Financing) Regulations (ATR), No. 47 of 2011.*
- *Anti-Money Laundering Regulations (AMLR), No. 46 of 2011.*
- *FATF, Discussion Paper, Global Impact and Unintended Consequences for Exclusion and Stability, October 2014.*
- *The World Bank Group, Fact Finding Summary from De-risking Surveys, November 2015.*

KNOW YOUR RISK, UNDERSTAND YOUR RISK!

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