International banking
Poor correspondents

Big banks are cutting off customers and retreating from markets for fear of offending regulators

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"IT'S a pre-emptive cringe in the face of American regulation," says a senior executive at a big bank. His firm, along with most of its peers, is rapidly culling banking relationships and retreating wholesale from markets, countries and lines of business that might attract the ire of regulators or prosecutors. So widespread is the practice that there is now an accepted term for it: "derisking". It is fraying the network of relationships that tie the global financial system together, driving up the costs of finance for poor countries and people.

One of the main casualties of the cringe is the very institution of correspondent banking. This is the informal mesh of arrangements allowing the customer of a bank in one country to send money to someone in another country, even if the bank in question does not have a branch there. The system is as old as international finance itself, dating back to the earliest promissory notes and letters of credit written by banks in classical times. Yet it is now being threatened by an overzealous interpretation and enforcement of rules aimed at preventing money-laundering and starving terrorists of funds.

The number of linkages between banks has been declining in recent years, largely because the industry has been consolidating (see chart). Yet now it is the big international banks that are cutting back. The exact size of the retreat is difficult to gauge because of a dearth of recent global data, but executives at such firms say they are dropping as many as a third of their correspondent relationships. One big firm says it is cutting or scaling back about 1,000 linkages; another, 1,800. Such ruthlessness will have a dramatic impact because these institutions are the main nodes through which the world's banks link up with one another. The four biggest correspondent banks for euro-denominated

transactions accounted for 81% of the total, for example.

The spark that ignited this bonfire of banking relationships was a series of prosecutions of big international banks in America for lapses in their controls relating to money-laundering, sanctions and the financing of terrorism. These included a $1.9 billion fine paid by HSBC and substantial fines meted out to Standard Chartered, ING and Barclays. BNP Paribas, France's biggest bank, is said to face a fine of as much as $10 billion related to breaches of American sanctions against Cuba, Iran and Sudan.

Bankers have drawn two lessons from this. The first is that American prosecutors and regulators seem to be unilaterally applying a stiffer standard than that agreed to by the Financial Action Task Force (FATF), an intergovernmental body that since 2001 has overseen the implementation of international rules on money-laundering and terrorist finance. These sensibly require, in essence, that banks know who their customers are and what they plan to do with their money.

American regulators, in contrast, seem to be demanding that banks know who their customers' customers are. Hardest hit are banks in countries judged as high-risk by the FATF, including Ethiopia, Indonesia, Myanmar and Pakistan. Last year JPMorgan Chase terminated its relationship with Al-Rajhi Bank, Saudi Arabia's biggest publicly traded bank. Only one large Western bank still has significant retail banking operations in Pakistan.

In most cases banks are not ending relationships because they have evidence of malfeasance. They are doing so simply because the costs and hassle of checking on their correspondents outweigh the measly profits they generate. Ambiguity around the rules does not help. Senior bankers say the goalposts keep getting moved, if they are discernible at all. Dealings with Cuba, for instance, seem less troublesome than those with Iran.

To be sure, tougher enforcement of the rules is generating some positive results. Many banks in poor countries are adopting rich-world controls on money-laundering to avoid being cut off from global finance. But this comes at a high price. The cost of doing business has risen steeply for exporters in Indonesia and cotton farmers in Mali, among others. The starkest example is in remittances to Africa. The cost of these had fallen from about €8 ($11) per transaction a few years ago to as little as €1. Now fees have reverted to their prior levels in many markets as the small, local remittance firms that had introduced competition and driven prices down have lost access to banking services in the rich world.

It is not just in distant and benighted places that the consequences of this severity are being felt. In Britain students from Iran, Sudan and Syria cannot open bank accounts. In America, foreign diplomats and embassies complain that they too are being denied access to banking.

Do-gooders are being caught in the net, too. Charities such as Save the Children, the Red Cross and Christian Aid have struggled to transfer funds to places like Syria due to sanctions. Even after obtaining explicit approval from American regulators, some have found it difficult to convince banks to send money.

Technology may offer a partial solution. Mobile-money systems such as Kenya's M-PESA, for instance, provide a clear record of when money was received and where it was spent. In Afghanistan it is used to pay policemen their salaries directly, reducing corruption.

Most needed, however, is for politicians to weigh not just the benefits but also the costs of their rules. Left unchecked, the process of derisking may leave some countries with absolutely no access to international finance, frets one industry insider. That, in turn, is likely to exacerbate the conditions of poverty and exclusion that fuel the terrorism and

crime these rules were designed to prevent.

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