Correspondent Banking in the South Pacific

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Abstract

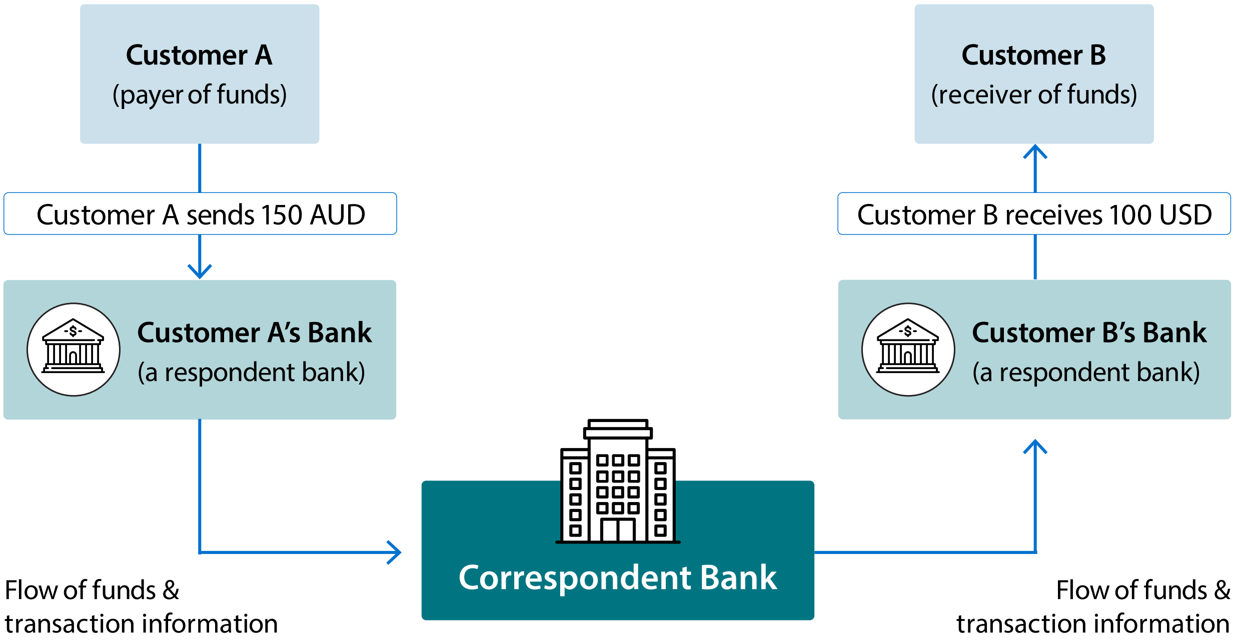
Worldwide, many financial institutions make use of correspondent banking services to connect to the global financial system. This article examines the withdrawal of global financial institutions from the provision of correspondent banking services to the South Pacific and the implications for countries in the region. The available evidence suggests that South Pacific nations, like many small island economies globally, have seen a larger-than-average decline in the provision of these services. The decrease in the availability of correspondent banking services appears to be most pronounced for smaller local banks and in the major global currencies. While the available evidence suggests that South Pacific countries have been able to manage this decline thus far, the remaining correspondent banking services are becoming increasingly stretched and further withdrawal may cause financial sector disruption.

Introduction

Correspondent banking involves a financial institution (the 'correspondent') providing a deposit account and related payment services to another financial institution (the 'respondent') for the purposes of currency exchange, the execution of third-party payments, trade finance and cross-border money transfers. The correspondent bank executes payments on behalf of the respondent bank and its customers (Figure 1).

Correspondent banks are important for all countries, but they can be particularly vital in smaller open economies. These economies often rely heavily on foreign currency inflows, such as remittances to households, official development assistance and tourism receipts. Their local banks are often relatively small or do not have offices abroad to

Figure 1: Simple Cross-border Payment Using a Correspondent Bank



Note: This is a simple cross-border transaction. Sometimes cross-border payments need to go through multiple correspondent banks or domestic payments infrastructure in either the origination or destination country.

offer cross-border payment services themselves. In these situations, international banks offer account services – 'correspondent banking services' – to local banks (Boulton and Winton 2018).

This article examines recent trends in the provision of correspondent banking services in the South Pacific and the impact on countries in the region. At a global level, international banks have historically provided correspondent banking services to a large number of banks; however, over the past decade, the number of correspondent banking relationships has shrunk significantly. The available evidence suggests that smaller countries have been most affected by this reduction, at least in part because the risk/return profile for correspondent banks servicing these countries is often not as attractive as it is in larger or more developed economies.

The article concludes by outlining some of the work being undertaken by the central banks and government agencies of countries in the South Pacific to support correspondent banking in the region.

Importance of correspondent banking in the South Pacific

It is important for all countries to have robust links to the global financial system to facilitate efficient cross-border payments services. However, these links are particularly fragile for small, open countries like those in the South Pacific. This article focuses on the South Pacific Central Bank Governors Meeting (SPGM) member countries of Fiji, Papua New Guinea, Samoa, Solomon Islands, Timor-Leste, Tonga and Vanuatu, which are subsequently referred to as 'SPGM member countries' – noting that the two member countries of Australia and New Zealand are excluded from this reference unless specified. The high degree of economic openness, reliance on remittances, tourism and the inflow of official development assistance that characterises many SPGM member countries underscores the importance of retaining correspondent banking services (Wilkins 2023).

Table 1: Changes in Correspondent Banking Relationships in SPGM Member Countries (excluding Australia and New Zealand)

Percentage change over 2011–2022

	CBRs	Annual transaction volume	Annual transaction value
Fiji	–66	43	61
Papua New Guinea	–56	126	–26
Samoa	–52	39	278
Solomon Islands	–57	30	641
Timor-Leste	–78	74	149
Tonga	–49	28	–33
Vanuatu	–65	38	14

Sources: National Bank of Belgium; SWIFT BI Watch.

Trends in correspondent banking networks

The number of correspondent banking relationships (CBRs) is shrinking globally. Available data show that the number of CBRs declined by about 30 per cent between 2011 and 2022 and by 4 per cent in 2022 alone (BIS 2023). This is despite the total volume and value of transactions processed through these networks increasing by 61 per cent and 37 per cent, respectively, over the 12 years to 2022. International research suggests that the decline in CBRs globally reflects a range of interrelated factors, including:[1]

- International banks are looking to simplify and streamline their operations, which puts pressure on geographically dispersed business services such as correspondent banking.
- Banks are increasingly focused on regulatory, reputational and financial risks from anti-money laundering (AML) and combating the financing of terrorism (CFT) compliance, which is in part due to the sizeable penalties levied by regulators in a range of countries.
- Compliance costs have increased for correspondent banks as they enhance their systems and processes to identify and verify their customers (respondent banks as well as other customers).
- Banks now have a greater focus on risk/return for the provision of correspondent banking services, with these businesses often seen as lower return and hence less attractive. In smaller countries, there are also often fewer opportunities for correspondent banks to sell other services to support the costs associated with providing correspondent banking services. There is a renewed focus by banks on ensuring that individual correspondent banking relationships generate sufficient revenue or profit.
- There are actual or perceived shortcomings in the AML/CFT, sanctions, tax and broader regulatory arrangements in some countries, which disincentivise the provision of correspondent banking services.

The South Pacific has been one of the more heavily affected regions, with the number of active correspondents[2] decreasing by about 60 per cent between 2011 and 2022 – a decline almost twice as severe as that seen globally (Graph 1). Moreover, the number of remaining active correspondents in some South Pacific countries is quite low.

Large declines in the number of CBRs have occurred in all SPGM member countries, despite most having rising transaction volumes and values (Table 1). The available evidence suggests that the pressures are most acute for US dollar (USD) and euro (EUR) denominated services, with services denominated in Australian dollars (AUD) and other currencies less affected.

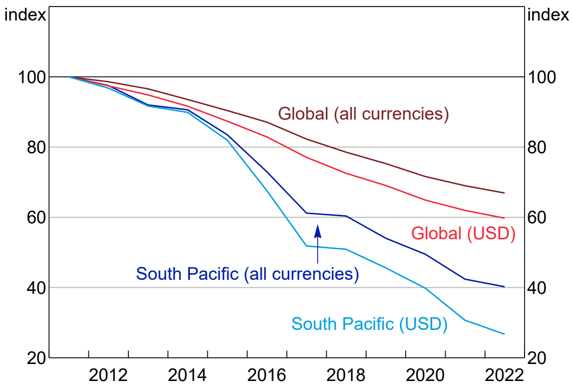
The larger-than-average decline in CBRs in the South Pacific is consistent with international research, which suggests that, globally, the countries that have been most affected by the reduction in the provision of CBRs are: smaller countries (which often have smaller transaction volumes and hence less revenue for correspondent banks); countries that are perceived as having higher risks around AML/CFT compliance, international sanctions, corruption or tax havens/ offshore centres; and countries that have transaction flows that are viewed by banks as inherently riskier, such as wire transfers, cheque clearing, remittances and trade finance.[3]

Industry reports suggest that in SPGM member countries, local banks (i.e. banks headquartered and operating in a single country) have been more heavily affected by the loss of CBRs than regional banks (i.e. banks headquartered in a SPGM member country with operations in multiple countries) and international banks operating in those countries. Many of the international banks operating in the Pacific are headquartered in France or Australia, reflecting these countries' close ties to the region.

The presence of foreign-owned banks in the South Pacific has both advantages and disadvantages for these countries. One disadvantage is that the larger size of the international banks together with the small size of the Pacific countries, heightens these countries' vulnerability to adverse operational decisions by international banks about the countries and market segments in which they operate. On the other hand, these foreign-owned banks are better able to maintain their correspondent bank accounts as they typically have larger scale, more developed AML/CFT systems and processes, the capacity to offer other business or reciprocal correspondent bank accounts to other international banks, and the ability to provide CBRs in major currencies via their parent bank or other banking subsidiaries.

Graph 1

Number of Active Correspondents



Sources: National Bank of Belgium; SWIFT BI Watch.

The available evidence from IMF Article IV reports suggests that the extent of pressures on CBRs varies across the SPGM member countries. The information below focuses mainly on AML and other regulatory risks, but the broader factors affecting trends in correspondent banking relationships globally described above are also relevant in the Pacific:

- **Fiji** does not appear to be facing significant pressure on its CBRs. This is partly because most banks operating in Fiji are large foreign banks, and the banking sector has strict licensing, prudential and regulatory requirements (IMF 2021b).
- **Papua New Guinea** authorities are working to minimise risks of possible future disruptions to correspondent banking services by strengthening their AML/CFT framework and broader regulatory arrangements; they are also taking regulatory action against a local bank to demonstrate the importance of compliance with AML/CFT rules (IMF 2022b).
- **Samoa** continues to experience pressures on the CBRs of its domestic banks, with factors including low profitability, weaknesses around AML/CFT supervision, and reputational risks from Samoa's offshore sector weighing on the provision of these services (IMF 2023a). Samoan authorities are working to address these issues.
- **Solomon Islands** has experienced relatively muted pressure on its CBRs so far, in part because most commercial banks are subsidiaries of foreign banks (IMF 2023c). Authorities are working to strengthen the country's AML/CFT framework and compliance arrangements, and to address other correspondent banking relationship pressures.

- **Timor-Leste** does not appear to be facing any CBR pressures at present (IMF 2022c).
- **Tonga** has experienced some CBR pressures, with two small banks recently losing their USD accounts (IMF 2022a). Tonga has several initiatives in progress to reinforce its AML/CFT framework and supervision of financial institutions.
- **Vanuatu** continues to experience some pressure on CBRs, with domestic banks most affected (IMF 2023b). Factors that are weighing on the provision of CBRs are concerns around the economic citizenship program, AML/CFT framework, offshore financial centre dealings and tax transparency.[4] Vanuatu is working with international agencies to strengthen its AML/CFT arrangements.

Risks of reduced CBRs in the region

To date, SPGM member countries have been able to ensure that their banks maintain enough CBRs to retain their access to global cross-border payments services. However, anecdotal evidence suggests that the CBRs in the region are now costlier than they were previously and may come with additional restrictions on the types of customers or transactions that can be processed through them. Moreover, over time, as fewer international banks are willing to maintain their breadth and depth of correspondent banking services, it may become increasingly difficult for banks in smaller countries to maintain their CBRs.

This raises several potential risks for SPGM member countries, including:

- *Increased cost of cross-border payments* – Reduced availability of correspondent banking services may make cross-border payments slower and more expensive for households, firms and governments by: increasing transaction costs as banks pass on the costs of their more expensive correspondent banking arrangements to customers; lengthening payment chains as transfers are routed via third countries; and incurring more foreign exchange costs as the transfers move via intermediary currencies. This may have negative implications for important economic activities such as tourism, trade and foreign direct investment.
- *Increased cost of remittances* – Within the context of broader cross-border payments, more costly remittances is a key issue. Remittance flows into SPGM member countries have been holding up fairly well over recent years, despite the derisking pressures on banks and money remitters; remittance flows have grown, the cost of sending remittances has slowly declined, and there are several active money remitters servicing each country corridor. However, the cost of sending remittances to the Pacific remains relatively high by global standards and will not be assisted by further consolidation of correspondent banking services.
- *Greater use of informal payment channels* – The continuing decline in correspondent banking services may see customers resort to unregulated and potentially less safe 'shadow payments'. Examples of this include: the use of informal Hawala payment networks; transporting cash between jurisdictions; or paying with crypto currencies.[5] There have been anecdotal reports of money transfer organisations transferring funds to the Pacific in cash (Fonseka 2022; Alwazir *et al* 2017).
- *Increased financial frailties* – Over the medium-to-long term, reduced availability of correspondent banking services increases the operating costs for respondent banks by raising the cost, processing time and/or scrutiny of these relationships. This could have implications for the cost of doing business, or on the scope of financial services these banks provide. There may also be market structure and competition implications, as smaller, local banks appear to be more affected by the withdrawal of correspondent banking accounts than larger regional banks.

Efforts to maintain CBRs in the South Pacific

Banks' decisions around whether to offer correspondent banking services are ultimately commercial ones that are mainly based on the balance of risk and return. Nonetheless, SPGM member countries (including Australia and New Zealand) and international organisations are undertaking a range of initiatives to support the provision of CBRs, including by: enhancing respondent banks' capacity to manage risks; increasing correspondent banks' appetite to manage risks associated with CBRs; and strengthening national regulatory frameworks and supporting their implementation.

Some of the initiatives that are being led by SPGM member countries are set out below:

- *Regional and national eKYC projects* – Given the importance of remittances for the region, the SPGM member central banks have been investigating the implementation of a regional electronic 'Know Your Customer' Facility (eKYC) since 2020. The intention of the eKYC Facility was to support the provision of correspondent banking services and remittances to the region via improvements to customer due diligence processes and AML/CFT compliance (RBA 2020). In June 2022, the central banks decided to prioritise developing individual countries' strategies for delivering their own eKYC capability over a regional facility (RBA 2022). Several countries in the region are currently working on or considering projects to develop national identity databases or eKYC facilities or both. The Reserve Bank has been providing support where requested.
- *Improvement of regulatory frameworks* – Several SPGM member countries have been working to strengthen their regulatory frameworks with support from international partners such as the International Monetary Fund.
- *AUSTRAC technical assistance* – The Australian Transaction Reports and Analysis Centre (AUSTRAC) is providing a range of technical assistance and training programs to help Pacific countries improve their financial intelligence and AML/CFT compliance arrangements (AUSTRAC 2021; AUSTRAC 2022). One key part of this support has been partnering with South Pacific financial intelligence units to implement the Australian-developed TAIPAN financial intelligence analytical system across the region. AUSTRAC's technical assistance is part of a broader effort by the Australian Government to support South Pacific countries.

Conclusion

The decline in the provision of correspondent banking services in SPGM member countries over the past decade has been significant – and larger than the average decline seen globally. Some banks in the region are finding it difficult and increasingly costly to maintain a sufficient network of correspondent banking relationships to make all their international payments in a cost-effective way.

While the available data suggest that SPGM member countries have thus far managed this decline, with their banks able to continue to process cross-border flows for themselves and their customers, further decreases in the availability of correspondent banking services would raise the risk of more serious financial sector disruption.

Various initiatives by SPGM member countries and multinational organisations seem to be somewhat supportive of maintaining effective cross-border payment arrangements. However, it is a difficult issue for the region to solve on its own, as the provision of correspondent banking services is a commercial matter for the relevant international banks and correspondent banking networks are consolidating globally.

Australia is aware of the challenges that some South Pacific countries are facing in maintaining their correspondent bank accounts and, as a member of SPGM, will continue to support member countries in their endeavours to secure and maintain these services.

Endnotes

[*] The author is from Business Services Group.

[1] See Erbenova *et al* (2016); Rice *et al* (2020); US Department of the Treasury (2023).

[2] The count of active correspondents measures, corridor by corridor, the number of banks that have sent or received messages. As a result, correspondents present in more than one corridor are counted several times.

[3] See Rice *et al* (2020); World Bank (2015); US Department of the Treasury (2023).

[4] Samoa, as well as Fiji and Vanuatu, were listed on the EU list of non-cooperative jurisdictions for tax purposes as at February 2023 (EU 2023).

[5] Hawala is a traditional money transfer system originating in Southeast Asia. It is an informal channel for transferring funds from one location to another through service providers known as hawaladars. While hawala transactions are mostly initiated by emigrant workers living in a developed country, the hawala system can also be used to send funds from a developing country. The hawala system is largely unregulated and is based on trust and relationships (El-Qorchi 2002).

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