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Challenges in Correspondent Banking in the Small States of the Pacific

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Abstract

Access to financial services in the small states of the Pacific is being eroded. Weaknesses in Anti-Money Laundering and Combating the Financing of Terrorism compliance in the context of high levels of remittances are contributing to banks' decisions to withdraw corresponding banking relationships and close bank accounts of money transfer operators. In this paper, we gather evidence on these developments in the small states of the Pacific, discuss the main drivers, and the potentially negative impact on the financial sector and macroeconomy. We then identify the collective efforts needed to address the consequences of withdrawal of corresponding banking relationships and outline policy measures to help the affected countries mitigate the impact.

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Keywords: Pacific islands, small states, correspondent banking, remittances, AML/CFT, digital economy

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ACRONYMS

AML/CFT	Anti-Money Laundering and Combating the Financing of Terrorism
ANZ	Australia and New Zealand Banking Group
APG	Asia/Pacific Group on Money Laundering
AUSTRAC	Australian Transaction Reports and Analysis Centre
BIS	Bank for International Settlements
BOMI	Bank of the Marshall Islands
CBR	Correspondent Banking Relationship
CBS	Central Bank of Samoa
FATCA	Foreign Account Tax Compliance Act
IGA	Intergovernmental Agreement
IPO	Initial Public Offering
KYC	Know Your Customer
KYCC	Know Your Customer’s Customer
MTOs	Money Transfer Operators
PICs	Pacific Island Countries
RSP	Remittance Service Provider
SFIU	Samoa Financial Intelligence Unit
SWIFT	Society for the Worldwide Interbank Financial Telecommunication
TCSP	Trust and Company Service Providers

I. INTRODUCTION[2]

1. **A large-scale withdrawal of correspondent banking relationships (CBRs) is occurring in many regions and jurisdictions, including the small states of the Pacific**. The termination of corresponding banking relationships, or, in some cases, pressures on existing ones, is contributing to the closure of bank accounts of money transfer operators (MTOs), particularly for those heavily engaged in remittance transfers.[3] As Erbenová and others (2016) note, banks' decisions are driven by several considerations, including cost-benefit analysis; re-evaluation of business models amid an evolving regulatory and enforcement landscape with regard to prudential requirements; economic and trade sanctions; policies to combat money laundering and the financing of terrorism (Anti-Money Laundering and Combating the Financing of Terrorism, AML/CFT); and tax transparency.

2. **Several features of small states heighten their vulnerability to the withdrawal of CBRs and the reduction in other banking services.** The main causes are weaknesses in AML/CFT regimes and poor compliance by some money transfer operators in small states that rely heavily on remittances (originating in Australia, New Zealand, and the United States).[4] CBRs are under strain where there are direct linkages with global banks, and where linkages are more indirect, correspondent banks have stepped up their scrutiny of respondent banks' interaction with the remittance sector (Box 1). This added scrutiny has led banks to close MTO bank accounts in both sender and receiver countries. The presence of offshore financial centers in some jurisdictions is also adding to CBR strains. In some instances, non-compliance with the U.S. Foreign Account Tax Compliance Act (FATCA) has led to the withdrawal of CBRs.[5]

3. **The consequences of CBR withdrawal can be serious.** The typically small number of banks and other financial service providers in the domestic banking sectors of small states implies that reduced financial services by one entity can give rise to increased concentration in the provision of services. This could raise systemic risks for the financial sector and heighten the risk of disruption to remittance flows. Loss of CBRs can also limit other financial services, such as those facilitating trade. Furthermore, reduced competition is likely to raise the already-high cost of financial services, including remittances.

4. **In the small states of the Pacific, the consequences of CBR withdrawal show up mainly in the remittance sector, increasing the fragility of remittance systems.** In many of the small states, MTOs are an important channel for remittances but many MTOs have had their bank accounts unilaterally closed by banks. As a result, some MTOs are now operating with a

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[2] The Pacific island nations examined in this paper includes Fiji, Kiribati, the Marshall Islands, Micronesia, Palau, Papua New Guinea, Samoa, the Solomon Islands, Tonga, Tuvalu, and Vanuatu.

[3] Money transfer operators are an important part of shadow banking in the Pacific islands.

[4] While high levels of remittances per se do not pose an AML/CFT risk, the large volume of typically small transactions increases the monitoring costs. In a number of instances, the remittance sector has been associated with terrorism financing; in applying the risk-based approach banks are subjecting the remittance sector to enhanced scrutiny.

[5] The Foreign Account Tax Compliance Act (FATCA) is a U.S. law designed to prevent tax evasion by U.S. citizens using offshore banking facilities.

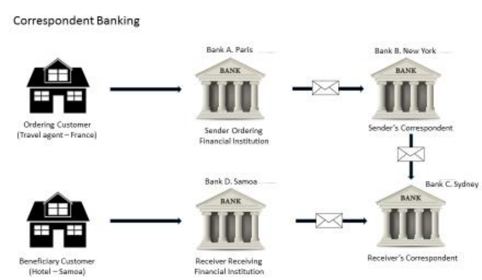
single bank account or, in some instances, with no bank accounts. Looking ahead, MTOs could cease operating entirely or shift operations outside formal banking channels: indeed, remittances are already being diverted to less transparent hand-carry of cash across borders or to costlier banking channels. Efforts to increase financial inclusion across the small states of the Pacific were bearing fruit but are now facing setbacks. Closure of MTOs could leave parts of the population without ready access to financial services. The broader macroeconomic impacts have been limited so far, as payment flows can still be re-directed. But without corrective policy actions, the consequences of continued withdrawal of CBRs could undermine the functioning of the financial system, weaken growth prospects, and reduce resilience to shocks.

Box 1. Correspondent Banking Relationships

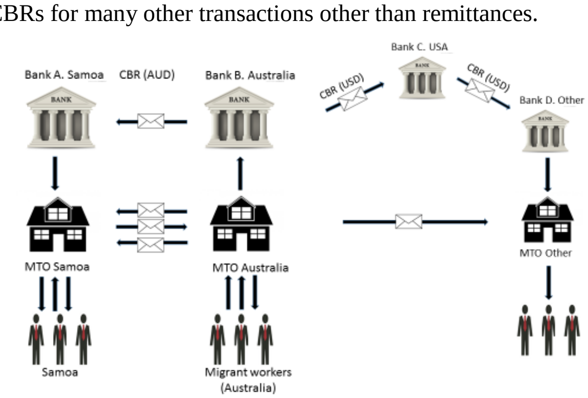
Correspondent banking is a bilateral arrangement, often involving a reciprocal cross-border relationship in multiple currencies. A correspondent banking arrangement involves one bank (the *correspondent*) providing a deposit account or other liability accounts, and related services, to another bank (the *respondent*), often including its affiliates. The arrangement requires the exchange of messages to settle transactions by crediting and debiting those accounts.

Correspondent banking enables domestic and cross-border payments. These relationships facilitate a range of transactions and services, including the execution of third-party payments, trade finance, the banks' own cash clearing, liquidity management and short-term borrowing, or funding investment needs in a particular currency.

In the most traditional form of correspondent banking, a respondent bank enters into an agreement with the correspondent bank to execute payments on behalf of the respondent bank and its customers (see diagram). For example, a French travel agent needs to send a payment to a hotel operator in Samoa. This payment could be sent in several ways but in the diagram the payment is sent from a French bank to a US bank, on to an Australian bank, and then to a bank in Samoa.



A second example illustrates the interaction between migrants' remittances, MTOs, domestic banks in the sender and receiver markets, and correspondent banks. In this example, migrants based in Australia bring their remittances to the MTO, which has an account with an Australian bank. Similarly, small businesses in Samoa use the MTO to send payments for imports, and Samoan families send money to university students. The MTO nets out these amounts and transfers between Australian and Samoan bank accounts in Australian dollars, using a CBR. The MTO may also make transfers elsewhere in the world and these flows could be transmitted using a US CBR relationship. In addition, the Australian banks will use their U.S.-based CBRs for many other transactions other than remittances.



5. Section II of this paper begin by reviewing the evidence to date in the small states of the Pacific. We examine recent developments in CBRs and focus on the consequences of strained CBRs for remittance channels. We draw on findings from extensive discussions in Australia, New Zealand, and Samoa with regulators, banks and banking associations, and MTOs. In Section III, we discuss the impact to date—and the potential effects—on the financial system and the economies of the small states of the Pacific. In the policy discussion in Section IV, we review the main strategy, emphasizing the need for collective action and steps by global, regional, and domestic regulators and standard-setters. We also identify measures that affected countries can adopt to help maintain and ease the strain on CBRs. These measures, however, may not be sufficient. Therefore, we explore options for alternative remittance systems and discuss the prospects for a combination of "blockchain" technology, a Know-Your-Customer utility, and mobile phone networks.[6] Although the digital economy, through new financial-sector technologies, can be part of the solution, the timeframe for implementation is likely to be lengthy and a key challenge will be avoiding macroeconomic disruption in the interim.

II. Vulnerabilities, Drivers, and Evidence in the Small States of the Pacific

A. Survey Results and Overview of Drivers

6. The consequences and challenges posed by CBR withdrawal in the small states of the Pacific are becoming apparent, according to a survey of IMF country teams and the authorities of the Asia and Pacific region, carried out in June-October 2016 (and summarized in Table 1). Survey responses suggest that many countries are having greater difficulty in either maintaining CBRs, or are experiencing rising costs and complexities in transferring money and repatriating remittances, or all of these things. The increased complexity and cost of money transfers and remittances reflect the closure of bank accounts of MTOs, not only in the small states but also in migrant host countries, including Australia and New Zealand. MTO account closures in Fiji, Samoa, and Tonga, both at home and in Australia and New Zealand, are increasing. In other countries—such as Kiribati, the Marshall Islands, Samoa, Tonga, and Tuvalu—survey responses indicate that CBRs have been withdrawn or are increasingly strained.

B. Vulnerabilities and Drivers

7. The relative importance of the remittance sector and the linkages with global banks help explain difference in recent experiences across the small states and provides insights as to the causes. In countries with higher integration with the global financial system strains in the CBRs appear more likely to occur. In other Pacific small states with stronger financial linkages to Australia and New Zealand, and where remittances are sizable, MTOs are

[6] A blockchain is a data structure that makes it possible to create a digital ledger of transactions and share it among a distributed network of computers. It uses cryptography to allow each participant on the network to manipulate the ledger in a secure way without the need for a central authority. A Know Your Customer utility is a central repository or database that stores the data and documents needed for a financial institution's customer due diligence procedures.

Table 1. Survey on the Consequences of CBR Withdrawal: Authorities' Views

	Are relationships with correspondent banks becoming more difficult?	Are money transfers becoming more costly and complex to execute? 1/	Is repatriation of remittances to your country becoming more costly and burdensome?
Fiji	CBRs have remained broadly intact. The main challenge lies in the local banks' ability to generate sufficient transaction volumes to warrant a continuation of CBRs.	Pricing and execution of money transfers have remained reasonable despite the termination of relationships with remittance agents by the two major banks.	The cost of remittances to Fiji, especially from New Zealand, has increased since mid-2015.
Kiribati	No, but anecdotal evidence points to increased compliance costs.	No	No
Marshall Islands	The country's sole domestic commercial bank is at risk of losing its US correspondent banking relationship.	No, but the loss of the CBR will have strong negative consequences as the MTO operators rely on the domestic bank for remittances.	No
Palau	The loss of CBRs has not been an issue in Palau as the three U.S. FDIC-insured banks conduct all foreign transactions in the country.	No	No. The remittance sector is very small in Palau.
Papua New Guinea	The level of compliance to maintain CBRs is increasing and continues to do so annually, hence, the higher costs. Certain institutions lost CBRs, others have had difficulties securing them, and others had to close or impose stringent requirements on remittance service providers to maintain their CBRs.	Money transfers are mainly done by commercial banks and authorized dealers and are becoming costly. This is due to costs associated with compliance requirements as CBRs and compliance requirements by the local regulator. Also, remittance services are provided by two commercial banks and apply stringent requirements.	The amount of remittances coming into PNG would be less than outbound payments and not considered costly.
Samoa	Although CBRs have largely been maintained, they are increasingly at risk. Non-compliance with FATCA has also led to loss of a CBR for one local bank.	The environment for money transfer operators has become more difficult, with MTOs facing account closures and imposition of complex requirements by banks.	Yes, the cost of remittance has increased recently. MTOs whose accounts have been closed are unable to serve their customers as quickly or as cost effectively as before.
Solomon Islands	The number of CBRs has declined. In addition, a major regional bank exited and was subsumed by a local bank, which increased CBR concentration.	A few small money transfer operators have ceased operations.	The closure of some MTOs is beginning to affect the cost of sending remittances.
Tonga	Establishing CBRs with U.S. banks has become more difficult. One Australian bank has agreed to open US dollar correspondent bank accounts for local banks.	Most of the bank accounts of money remitters' agents in Australia and New Zealand have been closed.	The cost of remittances from New Zealand to Tonga has risen.
Tuvalu	Tuvalu's largest bank, the NBT, has maintained the key working international CBRs, but access to some currency clearing services is complicated.	Yes	No
Vanuatu	Though the loss of CBRs is not a serious issue, inclusion in the FATF list may pose some difficulties in cross-border payments and trade finance.	The cost of money transfers had been increasing until ANZ lowered the cost. But the cost remains high as receiving banks also charge some fees.	The repatriation of remittances to Vanuatu has been costly for seasonal workers and those providing financial assistance to families in Vanuatu.

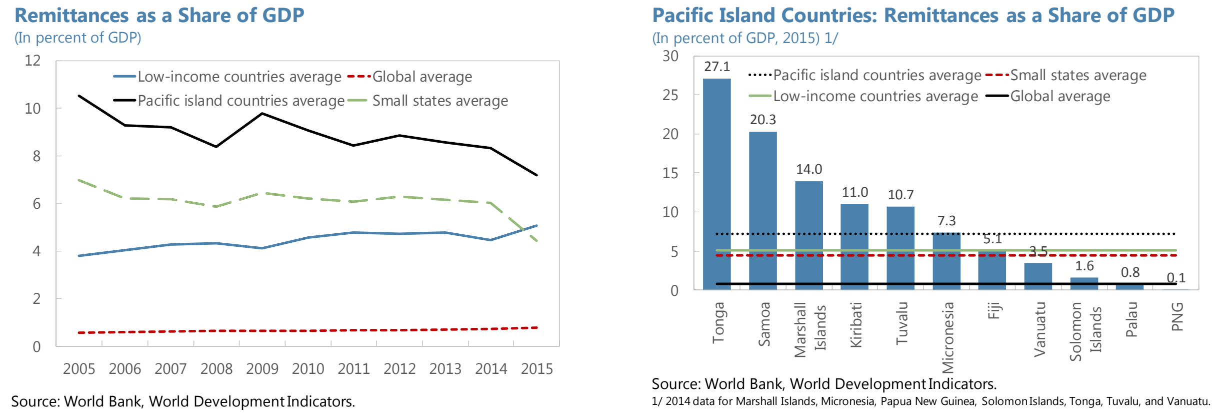
1/ Refers to all money transfers, including trade-related transfers and remittances.
Sources and Methodology: IMF survey of country authorities, including discussions with IMF surveillance teams during Article IV consultations and missions.

facing account closures in both sender and receiver markets. Weaknesses in AML/CFT frameworks and compliance are also contributing to strains in CBRs and to the closure of MTO accounts. In addition, the presence of offshore financial sectors in several jurisdictions heightens perceived AML/CFT risks. Non-compliance with the U.S. Foreign Account Tax Compliance Act has also contributed to the termination of CBRs.

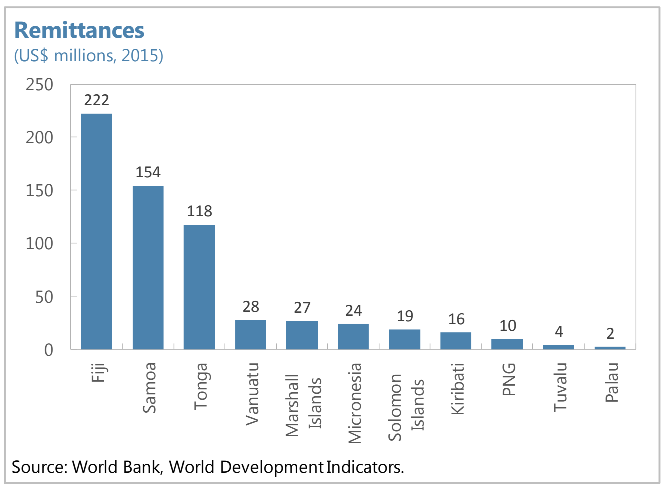
Figure 1. The Role of Remittances in the Small States of the Pacific

The Pacific island countries are heavily dependent on remittances ….

…. with the highest dependency in Tonga and Samoa.



8. The high volume of remittance transfers adds to concerns about AML/CFT risks and associated reputational risks for banks. In 2015, remittances averaged about 10 percent of GDP in the Pacific islands relative to 5 percent on average for low-income countries (Figure 1). Among the small Pacific states, Kiribati, Marshall Islands, Samoa, Tonga, and Tuvalu depend heavily on remittances—this dependency peaked at 27 percent of GDP in Tonga. In terms of US dollars—relevant from the perspective of assessing risks by the global banks—total remittances to the small states are about US$600 million annually, with Fiji, Samoa, and Tonga representing the largest markets. In remittance markets dominated by banks, CBRs are strained. But where MTOs dominate the remittance market, concerns by both correspondent and respondent banks about MTOs' AML/CFT compliance are triggering the closure of MTO bank accounts. For example, in the Marshall Islands, where remittances are sent mainly through the domestic bank, its CBR relationships with global banks are under pressure (Box 2). In other such countries as Fiji and Samoa, where MTOs are important for remittances, MTO bank accounts are facing closure both in the domestic economy and in remittance-source countries (Australia and New Zealand).



9. Differences in the source of remittances also help explain divergent recent experiences. The main sources of remittances are Australia, New Zealand, and the United States, with about 25 percent for each country on average (Figure 2, left-hand side). Some countries (e.g., the Fiji, Solomon Islands, Samoa, and Tonga), are more dependent on remittances from Australia and New Zealand, while others (e.g., Kiribati, Marshall Islands, Micronesia, and Palau) receive more remittances from other countries, including the United States (Figure 2, right-hand side). Respondent Banks appear to face CBR challenges with regional correspondents that have closer connections with Global Banks.

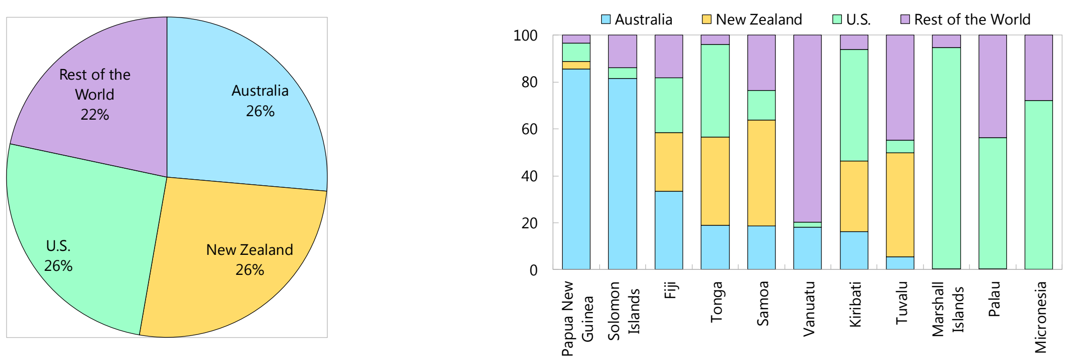
Figure 2. Remittance Source Countries for the Small States of the Pacific

Remittances come primarily from Australia, New Zealand, and the United States ....

(In percent of total)

.... with large differences across countries

(In percent of total)



Source: World Bank, migration and remittances data.

Source: World Bank, migration and remittances data.

10. Weak compliance by some MTOs with AML/CFT requirements also contributes to banks' decisions to close accounts. At times, MTOs' compliance with formal Know- Your-Customer (KYC) requirements is weak or absent. But in small communities, customers are often known personally to the proprietor of the small MTO. KYC compliance is also hampered by the lack of formal means of identification in many small states that do not issue national IDs and many individuals do not have driver's licenses or passports.

11. The operational structural of some MTOs also raises AML/CFT compliance concerns. MTOs vary widely in operational models, size, and level of sophistication, both across and within the small states. But in some markets, MTOs are very small and the only employee may be the owner who operates in partnership with another single operator in a different country, implying no separate compliance officer. The MTO business model also raises concerns: MTOs accumulate a large number of two-way transfers that are then netted out; a low fee is charged to the customer and profits are determined by the volume of transactions. For example, in Samoa, MTOs handle just over half a million inward money transfers a year, with an average size of just US$270. Typically, an MTO uses its bank accounts for bank-to-bank cross-border transfers of the net amounts (first shopping around for the lowest cost transfer on any given day). From the banks' perspective, the bundling of cross-border transfers into a single transaction complicates monitoring. Banks are not required to perform due diligence on their customer's customer, referred to as Know Your Customers' Customer (KYCC).[7] But in applying the risk-based approach, and with uncertainty about the strength of an MTO's systems, a given bank may be concerned about its ability to respond to requests for information. Banks have argued that KYCC is, for all intents and purposes, a requirement. This perceived obligation is the result of banks' understanding of the consequences of U.S. regulatory requirements; their concerns about reputational risks; the increased oversight by correspondent banks; or the need to satisfy domestic legislation. Rather than take this risk or bear the compliance cost, banks opt to close MTO bank accounts.

Box 2. Marshall Islands: Correspondent Banking Relationship Challenges[1/]

The Marshall Islands' sole domestic commercial bank has faced the risk of losing its CBR with a U.S.-based bank. Losing this relationship could result in loss of access to U.S. payment and settlement services, which could disrupt economic activity in the Marshall Islands, given the use of the U.S. dollar as legal tender.

Background. The Marshall Islands' only domestic commercial bank, Bank of the Marshall Islands (BOMI), has a CBR with a U.S.-based bank (First Hawaiian Bank, a subsidiary of BNP Paribas). Through this relationship, BOMI has access to U.S. settlement and payment services. In 2015, the U.S.-based bank notified BOMI that it may terminate its correspondent banking accounts with BOMI by end-2016, owing to concerns about the cost of complying with new U.S. regulations, especially after penalties stemming from the violations of U.S. sanctions laws by BNP Paribas (its parent company). The authorities informed the IMF 2016 Article IV mission team that the U.S.-based bank had agreed to continue its CBR with BOMI until BOMI finds a new U.S.-based correspondent bank or resolves outstanding compliance issues.

Marshall Island Banks: Corresponding Banking Relations

Currency	Bank of Marshall Islands	Bank of Guam
USD	First Hawaiian Bank	
AUD	Westpac Banking	
EUR		Wells Fargo
GBP		Wells Fargo

Remittances. The cost of transferring remittances to the Marshall Islands has not been affected, as almost all the remittances come through two large operators (MoneyGram and Western Union) that have partnerships with domestic banks. Small money MTOs are not active in the Marshall Islands, unlike in other Pacific islands.

Authorities' response. The authorities are drafting a new AML legislation in line with FATF standards and United Nations Convention Against Corruption rules. Deficiencies identified in the 2011 Mutual Evaluation Report for the Marshall Islands conducted by the Asia-Pacific Group are also being reviewed and rectified, including strengthening the Domestic Financial Intelligence Unit (DFIU). The authorities have begun working with a team of consultants from the U.S. Financial Services Volunteer Corps, which is helping draft the new legislation. The authorities have also met with relevant U.S. regulators—including the U.S. Federal Reserve in April 2016—to seek guidance on how to strengthen their bank supervisory framework. Furthermore, senior managers of the Banking Commission have attended a workshop on implementing the international AML/CFT standards in April 2016, organized jointly by the IMF's Legal Department and the Singapore Training Institute.

Policy advice. During the 2016 Article IV consultation mission, IMF staff encouraged the authorities to strengthen their AML/CFT framework, particularly relative to Know-Your-Customer (KYC) requirements. Staff also urged the authorities to have an open and regular dialogue with U.S. regulators to flag any new concerns on AML/CFT risks (IMF 2016a).

1/ Prepared by Serkan Arslanalp.

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[7] The US authorities clarified this position and issued the joint Foreign Correspondent Banking Factsheet in August 30, 2016.

12. The Pacific is home to many foreign-owned banks, including from the United States and Australia. The outsized role of foreign banks in the financial sector in many Pacific small states heightens their vulnerability to operational decisions of global and regional banks (Table 2).[8] Marshall Islands, Micronesia, and Palau have direct banking relationships with the U.S. banking sector through U.S.-owned banks. In the Marshall Islands, the country's sole domestic commercial bank faced the risk of losing its U.S. correspondent banking relationship. The Marshall Islands depends heavily on remittances, which are channeled through two large MTOs that have partnerships with the domestic bank (Box 2). CBRs in Palau appear to be less affected, probably because of the lower level of remittances. In other countries, Australian banks play a key role and among those with significant remittances flows—Fiji, Samoa, and Tonga—MTOs based in these countries are facing account closures both at home and in remittance-source countries.

Table 2. Commercial Banks in the Small States of the Pacific

Country	Australian Banks	U.S. Banks[1]	Other Foreign Banks	Domestic Banks
Fiji	ANZ Westpac		Bank of Baroda (India) Bank South Pacific (Papua New Guinea) Bred Bank (Banque Populaire, France)	Home Finance Company
Kiribati	ANZ			
Marshall Islands		Bank of Guam		Bank of Marshall Islands
Micronesia		Bank of Guam		Bank of the FSM[2]
Nauru	Bendigo Bank			
Palau		Bank of Guam Bank of Hawaii Bank Pacific		Asia Pacific Commercial Bank Palau Construction Bank
Papua New Guinea	ANZ Westpac			Bank South Pacific Kina Bank
Samoa	ANZ		Bank South Pacific (Papua New Guinea)	National Bank of Samoa Samoa Commercial Bank
Solomon Islands	ANZ		Bank South Pacific (Papua New Guinea)	Pan Oceanic Bank
Timor-Leste	ANZ		Caixa (Portugal) Bank Mandiri (Indonesia)	National Commercial Bank of Timor-Leste
Tonga	ANZ		Bank South Pacific (Papua New Guinea) MBf (Malaysia)	Tonga Development Bank
Tuvalu				National Bank of Tuvalu Development Bank of Tuvalu
Vanuatu	ANZ		Bred Bank (Banque Populaire, France) Bank South Pacific (Papua New Guinea)	National Bank of Vanuatu

Sources: Jamaludin, Sheridan, Tumbarello and others (2016) and authors' adaptation.
[1]Covers banks with physical presence in the respective countries.
[2]Insured under the Federal Deposit Insurance Corporation scheme.

[8] See Jamaludin and others (2016) for more information on the banking system in the small states of the Pacific.

13. Weaknesses in AML/CFT compliance is straining CBR relationships and leading to withdrawal, as is the presence of offshore financial centers (located in the Marshall Islands, Samoa, and Vanuatu). In many of the small states, AML/CFT regimes are lagging both in terms of framework and effectiveness. Mutual Evaluation Reports for Samoa (Box 3) and Vanuatu were published in 2015 by the Asia/Pacific Group on Money Laundering (APG). Other small states face similar shortcomings. The authorities in many of the small states are making progress in addressing deficiencies, including through by establishing and strengthening financial intelligence units.[9] In Papua New Guinea, legislation has been passed that has substantially addressed the AML/CFT deficiencies and has facilitated removal from the Financial Action Task Force's (FATF's) gray list.

14. Although the consequences of CBR withdrawal vary across the small states, regional banks cite pressure from global correspondent banks as the main cause (Box 4). The remittance sector is generally viewed as high risk from the perspective of AML/CFT, and, in addition to penalties for non-compliance, global banks are concerned about reputational risk. Australian and New Zealand banks report that U.S. correspondent banks have increased the frequency and intensity of their due diligence of Australian banks, and the operations of MTOs and remittances are an important focus of their surveillance. The response of banks in Australia is differentiated; at least one bank cut services to remitters across the board while other banks, taking a more risk-based approach, are making decisions on a case-by-case basis. However, Australian banks view the risk-based approach as giving them a pseudo-regulatory role, which is costly from a compliance perspective; they also argue that a risk-based approach transfers non-compliance risks to the banks. The Reserve Bank of New Zealand has responded to closure of MTO accounts by clarifying that compliance with AML/CFT obligations does not require banks to cease providing services to an entire category of customer.[10] The Reserve Bank has emphasized that "if banks are de-risking to avoid rather than manage and mitigate those risks, then that would be inconsistent with the intended effect of the AML/CFT Act. It seems unlikely, but if banks are using blanket de-risking itself to manage and mitigate those risks, then the Reserve Bank would consider that an inadequate means of complying with their obligations under the AML/CFT Act."

[9] See Box 2 for recent activities taken by the Marshallese authorities.

[10] See Reserve Bank of New Zealand (2015), Statement about Banks Closing Accounts of Money Remitters.

Box 3: Samoa Anti-Money Laundering and Counter-Terrorist Financing Measures[1]

Overview. Samoa has improved its AML/CFT framework since the 2006 assessment, including through the Money Laundering Prevent Act 2007 and subsequent regulations in 2009. These better align Samoa's framework with the FATF's recommendations under the third round of mutual evaluations. The FATF recommendations were revised for the fourth round in 2012 and, in 2015, Samoa's AML/CFT regime was assessed by the Asia Pacific Group on Money Laundering (APG) under the revised 2012 FATF standard. APG assessors found significant shortcomings in Samoa's AML/CFT regime, rating it low or moderately effective in 10 out of 11 immediate outcomes assessing effectiveness, and non-compliant or partially compliant with more than half of the 40 FATF recommendations. Hence, the authorities were encouraged to work toward substantial improvements of the AML/CFT framework, both on strategic and operational levels.

Money laundering risks. Samoa faces a range of money laundering risks but terrorist financing risks appear relatively low. Money laundering risks are related mainly to its international (offshore) sector, although domestic risks include the large remittance sector, cross-border movement of cash, and the domestic banking sector.

- **The international (offshore) sector presents the main money laundering risk**, given its relative anonymity, concerns regarding transparency of ownership and control information, complexity, and tax-exempt status. At the end of 2014, there were 34,000 international business companies, along with 155 international trusts and 7 international banks. Samoan international business companies are created only through Samoan trust and company service providers (TCSPs), which capture beneficial ownership information when the international business company is created. The international trusts are domiciled in Asia, including Hong Kong SAR, China, and Singapore, primarily for asset protection and tax advantages. Samoa's TCSPs have limited ability to detect and report suspicious transactions and supervision of TCSPs is limited in depth and scope. Information on beneficial ownership is not publically available, except with the permission of the client. While there is little evidence of the proceeds for foreign predicate crimes being laundered through Samoa or its offshore sector, lack of evidence may reflect a system unable to detect money laundering, rather than the absence of it. Steps have been taken to mitigate risks; strengthened provisions implemented at the end of 2015 should significantly increase the capacity of TCSPs to conduct ongoing due diligence.
- **The MTO sector is largely responsible for channeling remittances, which, from a global perspective, are generally viewed as a high risk area for money laundering and terrorism financing.** Nevertheless, the MTO sector is reasonably aware of money laundering/terrorist financing risks. Large MTOs have implemented reasonably robust measures to identify and verify customer identity, obtain originator and beneficiary information, and scrutinize transactions. The level of suspicious-transaction-reporting is lower than expected given the size of the sector. The government does not require financial institutions to include full beneficiary information with cross-border wire transfer messages; but ordering financial institutions are required to obtain and retain the originator information with the wire transfer.

Note: This box summarizes the key findings of the Asia Pacific Group on Anti-Money Laundering Mutual Evaluation Report on Anti-Money Laundering and Counter-terrorist Financing Measures, September 2015.

Box 3: Samoa Anti-Money Laundering and Counter-Terrorist Financing Measures (concluded)

- **Cross-border movement of cash is also identified as an area of risk**. Customs is responsible mainly for enforcing the border declaration regime, which is broadly sound in technical terms. The SFIU, Customs, and Immigration coordinate on border currency reports but further coordination—including with police—would improve monitoring and the ability to investigate and prosecute predicate crimes and money laundering.
- **Money laundering risks associated with the domestic banking system arise mainly out of its materiality.** Domestic proceeds-generating crimes appear to be low.

The high-priority recommended actions include:

- *Offshore Sector*. Amend International Companies Act, Trust Act, Companies Act, Money Laundering Prevention Act and regulations to address the technical deficiencies and issue additional, updated guidance; Increase the scope and intensity of AML/CFT supervision of the offshore sector, including international banks and insurance companies and TCSPs; Enhance the accuracy and timeliness of beneficial ownership information held by trust and company service providers for international business companies.
- *AML/CFT Supervision*. Ensure that AML/CFT supervision of financial institutions (i.e., banks and MTOs) and designated non-financial businesses and professions is based on risk; Strengthen the frequency and intensity of on-site inspections of key financial sectors; Increase engagement by supervisors with financial institutions and designated non-financial businesses and professions.
- *Enhanced Implementation*. Strengthen resources of the Central Bank of Samoa and Samoa Financial Intelligence Unit to undertake AML/CFT supervision; Pursue money laundering investigations as a matter of policy and pursue confiscation action in more serious/complex cases; Improve the effectiveness of the cross-border declaration system.

C. Evidence: Withdrawal of Correspondent Banking Relationships

15. Information gained by the IMF through its bilateral surveillance points to the withdrawal of correspondent banking relationships for some Asia-Pacific small states. The Marshall Islands' sole domestic commercial has faced the risk of losing its CBR with a U.S.-based bank (Box 2). In Tonga, the authorities have reported that establishing CBRs with U.S. banks has become more difficult. But one Australian bank has agreed to open USD correspondent accounts for the local banks. On the other hand, other small states in the Pacific—including Fiji, Kiribati, and Palau—have reported limited impact on CBRs to date. Non-compliance with FATCA resulted in termination of a CBR in Samoa.

16. SWIFT data indicate the trends in CBRs but some caveats suggest caution in using these data to draw firm conclusions about their termination (Bank for International Settlements, Committee on Payments and Market Infrastructures, 2016). From a global perspective, these data show that the number of active correspondents declined between 2012 and 2015 while at the same time the volume of transactions grew and, as a result, the concentration in CBRs increased. Changes in global, regional, and local volumes of CBR

Box 4. Key Findings from IMF Staff Discussion Note "The Withdrawal of Correspondent Banking Relationships: A Case for Policy Action"

Correspondent banking relationships enabling the provision of domestic and cross-border payments were terminated in some jurisdictions after the 2008 financial crisis. In recent years, several countries have reported a reduction in CBRs by global banks. Pressure on CBRs has been associated with restricted access to financial services by certain categories of customers, business lines, jurisdictions, or regions. Survey and other available evidence indicates that smaller emerging markets and developing economies in Africa, the Caribbean, Central Asia, Europe, and the Pacific, as well as countries under sanctions, may be the most affected.

Individual banks may decide to withdraw CBRs for a number of reasons. Generally, such decisions reflect banks' cost-benefit analysis, shaped by the re-evaluation of business models in the new macroeconomic environment and changes in the regulatory and enforcement landscape--notably with respect to more rigorous prudential requirements, economic and trade sanctions, anti-money laundering, and combating the financing of terrorism (AML/CFT) and tax transparency. These factors inform banks' risk and reputational cost perceptions. Further pressures to withdraw CBRs may arise where regulatory expectations are unclear, risks cannot be mitigated, or legal impediments interfere with cross-border information sharing. These factors operate concurrently, although their relative significance varies case-by-case.

While the withdrawal of CBRs has reached a critical level in some countries--and can have a systemic impact if unaddressed--macroeconomic consequences have yet to be identified at the global level. Pressure on CBRs could disrupt financial services and cross-border flows (including trade finance and remittances), potentially undermining financial stability, inclusion, growth, and development. The current limited economic consequences partly reflect the ability of affected banks to rely on other CBRs, find replacements, or use alternative means to transfer funds. Still, in a few jurisdictions, pressure on CBRs can become systemic in nature if unaddressed.

Coordinated efforts by the public and private sectors are needed to mitigate the risk of financial exclusion and the potential negative impact on financial stability. An enhanced understanding of the phenomenon, improved data collection, and continued dialogue among stakeholders are imperative to developing appropriate responses tailored to individual country circumstances. Timely implementation of the Financial Stability Board's 2015 action plan endorsed by the G20 Summit will be critical. Home authorities of global banks should communicate their regulatory expectations and affected countries should continue strengthening their regulatory and supervisory frameworks to meet relevant international standards--with the help of technical assistance where needed. Clarifying these standards, including on AML/CFT, could help promote a baseline for regulatory expectations. Industry initiatives could be pursued to facilitate customer due diligence and help reduce compliance costs. In countries facing a severe loss of CBRs and diminishing access to the global financial system, the public sector may consider the feasibility of temporary mechanisms ranging from regional arrangements to public-backed vehicles to provide payment clearing services. IMF staff has been supporting member countries in addressing the CBR withdrawal to promote financial inclusion and ensure financial stability.

Source: Erbenová and others (2016).

transactions can have many causes, including fluctuations in economic activity and other financial sector developments. Furthermore, increases in volumes could still be consistent with strains in CBRs as payments are diverted to other channels following account closures. For example, if payments are rerouted through a third country, correspondent banking activity increases (by creating two transactions instead of one). If two-way remittances and money transfers were previously channeled through MTOs (which then transfer only net amounts through the banks), increased use of banks by migrants and for money transfers could raise the volume and value of CBR transactions. In addition, as these data compare 2015 with 2012, the full impact is likely to be underestimated. Discussions with country authorities in some of the small states suggests that withdrawals of CBRs, and their consequences, began in the latter half of the sample and continued to escalate in 2016.

17. Bearing these caveats in mind, the BIS-CMPI analysis of the SWIFT data suggests that the sharpest fall in active correspondents has occurred in Oceania. The BIS evidence (using BIS country grouping classifications)[11] shows that between 2012 through 2015, Melanesia, Micronesia, and Polynesia experienced declines in active CBRs in almost all years, with net losses of more than 10 percent in 2012 in Australia and New Zealand, and in Melanesia, and Micronesia. Analysis of country-by-country data for the small states of the Pacific (Table 3) shows that the loss of CBRs is largest in Papua New Guinea, the Solomon Islands, and Tuvalu, with smaller losses in Fiji, Tonga, and Vanuatu. Interpreting the data on transactions value and volume is not straighforward, and in some small states, the volume and value of transactions have actually increased. For example, in Samoa, the rise in transactions volume and value partly reflect improvements in domestic macroeconomic conditions but also the diversion of remittances into bank-to-bank transfers. In Fiji, although the number of CBRs fell marginally, the relaxation of exchange controls has contributed to large gains in the volume and value of transactions.

Table 3. Trends in CBRs and Transactions in Selected Small States of the Pacific (2012–15)

Country	Change in number of active correspondents	Change in transaction volume	Change in transaction value
Fiji	-1.5	18.8	114.2
Kiribati	10.6	8.3	8.5
Papua New Guinea	-11.6	31.6	-13.4
Samoa	4.5	25.5	44.5
Solomon Islands	-18.3	8.7	-8.7
Tonga	-8.3	3.2	-15.9
Tuvalu	-15.5	47.7	12.0
Vanuatu	-4.2	-1.7	-33.2

Sources: Bank for International Settlement Committee on Payments and Market Infrastructure (2016), Correspondent Banking, Table 1.

[11] IMF member countries in the Melanesia region are Fiji, Papua New Guinea, the Solomon Islands, and Vanuatu; Micronesian members are: Kiribati, the Marshall Islands, Federated States of Micronesia, and Palau; and Polynesian member countries are Samoa, Tonga, and Tuvalu.

D. Evidence: Disruption in Remittances

18. The closure of MTO bank accounts has added to the fragility of the remittance sector. Current account data for affected countries does not suggest a fall in remittances and a 2015 study by the Australian Transaction Reports and Analysis Centre (AUSTRAC) finds no overall reduction in remittance transfers. But evidence from several sources points to an increasingly fragile remittance sector in which the costs of remittances are once again rising, reversing an earlier declining trend. Other sources of evidence on MTO closure include IMF bilateral surveillance of country authorities; roundtable discussion with MTOs in Samoa; a World Bank survey; AUSTRAC; and a survey conducted by the Australian Remittance and Currency Providers Association. These sources all point to widespread closure of MTO accounts. Data on the cost of remittances, along with analysis of the cost structure, underscore the importance of MTOs in reducing the cost of remittances; they also highlight the potential for increased remittance costs.

19. The IMF survey of Asia-Pacific countries) shows that money transfers and remittances are becoming more expensive and complex (Table 2). Bilateral surveillance suggests that this is due largely to the closure of MTO bank accounts in both home and host countries. In Tonga, the authorities report that most bank accounts of MTOs in Australia and New Zealand have been closed, necessitating the use of other avenues. One Tongan money transfer operator has unsuccessfully taken a New Zealand bank to court after the closure of the operator's bank account. Similarly in Samoa, the authorities report major challenges facing MTOs in maintaining bank accounts. A roundtable discussion with Samoan-based MTO owners and managers (with 8 of the 11 MTOs that report to the Central Bank of Samoa) revealed that most now had at most one bank account, compared with several across many banks previously. Moreover, a few MTOs without a business bank account were using personal accounts. Other MTOs were facing new restrictions on account usage, including caps on amounts and frequency of transfers.

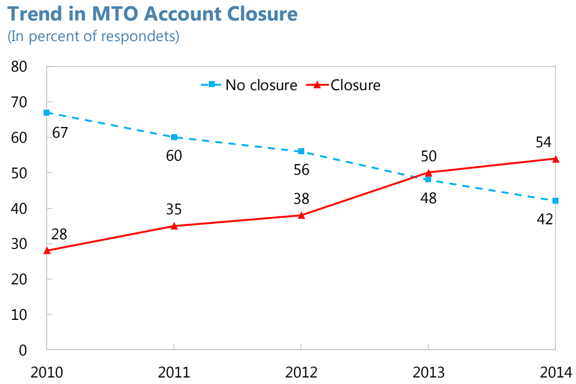
20. A World Bank survey shows that the closure of MTO accounts has intensified since 2010 (Figure 3). The survey on MTO account access was carried out at the request of the G20 Global Partnership for Financial Inclusion and the Development Working Group. A large share of the MTOs responding to the World Bank survey in both the United States and Australia report closure of at least one bank account. A survey conducted by the Australian Remittance and Currency Providers Association reveals the scale of stress in the remittance market. This small-scale survey was conducted in October 2015, with just 63 responses (compared with 538 independent remitter businesses at end-August 2015).[12] Of these, 60 percent now have just one account and 20 percent no accounts. This is consistent with data from the Australian Transaction

[12] Most respondents had been in operation for more than 5 years (65 percent); money transfers were their core activity (85 percent); had no adverse AUSTRAC opinion/conditions (94 percent); and had conducted an independent review of their business (63 percent).

Reports and Analysis Centre (AUSTRAC), which shows that at least 719 bank accounts belonging to remittance businesses were closed by banks in Australia between January 2014 and April 2015 (AUSTRAC, 2015). Together these surveys help illustrate the greater fragility of the remittance sector in the small states in the Pacific.[13]

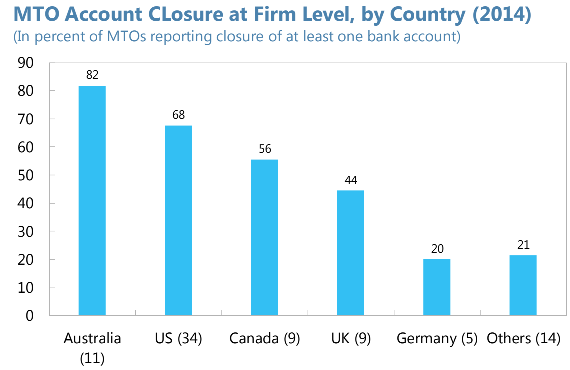
Figure 3. Closure of Money Transfer Operator Accounts

Closure of MTO accounts is increasing globally ….



Source: World Bank (2015b).

….and is concentrated in remittance source countries



Source: World Bank (2015b).
Note: The number of survey respondents is in parenthesis.

21. The cost of remittances seems to be rising again, reversing the trend of gradual decline owing to efforts by the authorities to lower costs. The cause of the recent uptick in the cost of remittances—which was already high—is not clear. The average cost for sending remittances to Pacific island countries from Australia has been about 12–13 percent, and from New Zealand, 10–11 percent. This is well above the G20 target of 5 percent by 2020 and is much higher relative to other Asian countries. The pricing of remittance transfers is not transparent, with fixed fees and foreign exchange margins that vary significantly depending on the destination, product, and whether the migrant is using a bank for transfers or a money transfer operator.

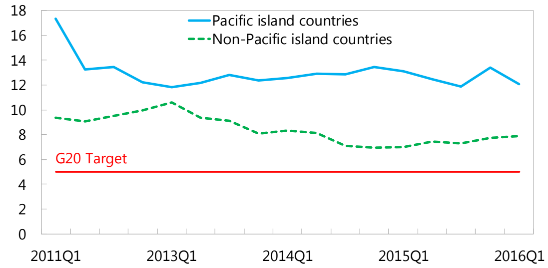
[13] Buckley and Ooi (2014) also point out that there is ample anecdotal evidence on the closure MTO accounts by banks across both Australia and PICs; and these account closures have been reported on and criticized by industry professionals, regulators, academics, and industry experts.

Figure 4. Cost of Sending US$200 to the Pacific Islands

Cost of sending remittances to the Pacific island countries is higher than to elsewhere and well above the G20 target

From Australia

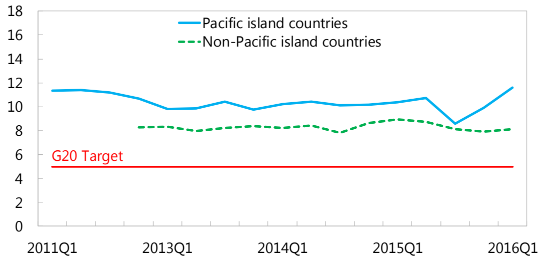
(In percent)



Note: Pacific island countries include Fiji, Samoa, Tonga, and Vanuatu; Non-Pacific island countries cover countries in East Asia and Pacific and South Asia excluding Pacific island countries.
Source: World Bank, Remittance Prices Worldwide database.

From New Zealand

(In percent)

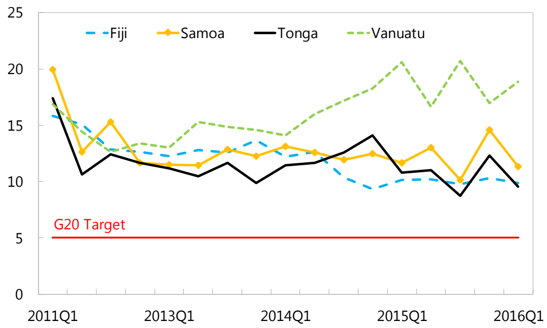


Note: Pacific island countries include Fiji, Samoa, Tonga, and Vanuatu; Non-Pacific island countries cover countries in East Asia and Pacific and South Asia excluding Pacific island countries.
Source: World Bank, Remittance Prices Worldwide database.

Despite having declined steadily, with an exception of Vanuatu, from a high base

From Australia

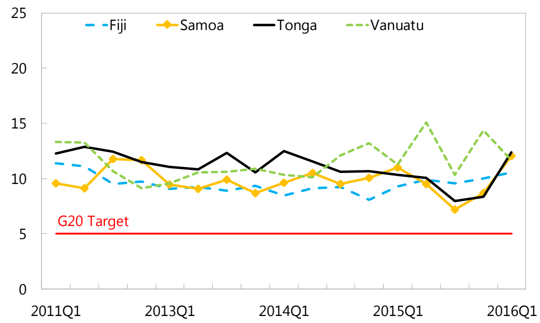
(In percent)



Source: World Bank, Remittance Prices Worldwide database.

From New Zealand

(In percent)

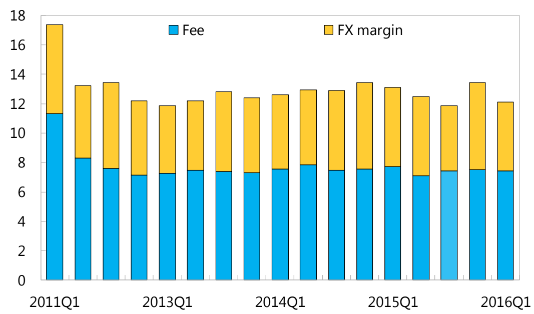


Source: World Bank, Remittance Prices Worldwide database.

High remittance costs are driven by both high fees and high foreign exchange (FX) margins

From Australia

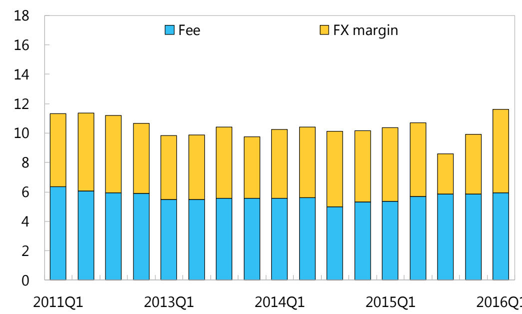
(In percent)



Note: Pacific island countries include Fiji, Samoa, Tonga, and Vanuatu.
Source: World Bank, Remittance Prices Worldwide database.

From New Zealand

(In percent)



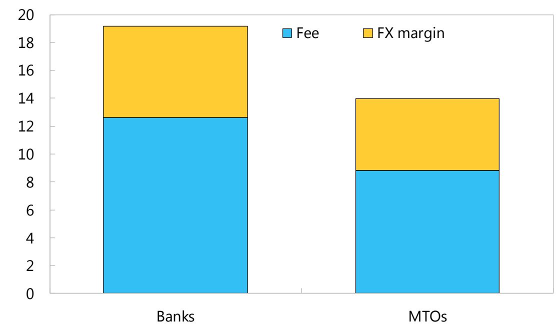
Note: Pacific island countries include Fiji, Samoa, Tonga, and Vanuatu.
Source: World Bank, Remittance Prices Worldwide database.

22. Costs are much lower for remittances by MTOs than those by banks, with lower fees and smaller foreign exchange margins.[14] The significance of this is that the closure of MTOs could push up the average cost of remittances if access to MTOs is reduced. Cost differences are also the result of the product used by the migrant. Account-to-account services are the most expensive means of transferring money. On the other hand, online, mobile, and card services charge much less to send remittances than other product types. These latter services are largely offered by MTOs. The authorities may wish to consider the feasibility of a payments cost study, which could help policymakers understand the relative costs of different payment systems and the main drivers of changes in charges for banking services.

Figure 5. Cost of Sending US$200 to the Pacific Islands by Firm and Product Type

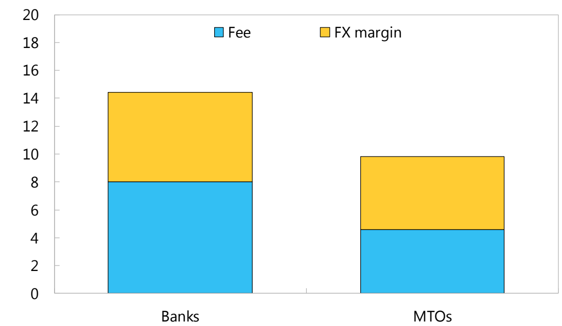
The cost of sending remittances using money transfer operators (MTOs) is lower than through banks

From Australia
(In percent; 2016Q1)



Note: Pacific island countries include Fiji, Samoa, Tonga, and Vanuatu.
Source: World Bank, Remittance Prices Worldwide database.

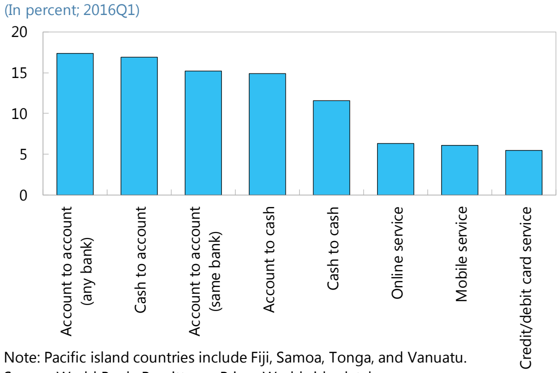
From New Zealand
(In percent; 2016Q1)



Note: Pacific island countries include Fiji, Samoa, Tonga, and Vanuatu.
Source: World Bank, Remittance Prices Worldwide database.

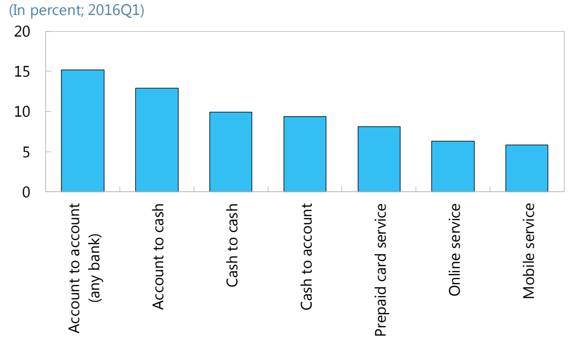
Account-to-account transfer using banks has the highest cost, whereas online services, mobile services, and prepaid debit card have the lowest cost

From Australia
(In percent; 2016Q1)



Note: Pacific island countries include Fiji, Samoa, Tonga, and Vanuatu.
Source: World Bank, Remittance Prices Worldwide database.

From New Zealand
(In percent; 2016Q1)



Note: Pacific island countries include Fiji, Samoa, Tonga, and Vanuatu.
Source: World Bank, Remittance Prices Worldwide database.

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[14] The analyses on remittance cost use the Remittance Prices Worldwide database (World Bank). More information available at http://remittanceprices.worldbank.org.

III. What are the Potential Consequences?

23. The potential consequences of withdrawal of CBRs or continued closure of MTO accounts on the small states of the Pacific are significant. At present, much of the strain is being felt in the remittance sector but further withdrawal of CBRs and the resulting exclusion from the global financial system could impact trade in goods and services. A potentially higher-cost, less transparent, and more fragile remittance sector could have far-reaching consequences for poverty, financial inclusion, and ultimately, macroeconomic resilience.

- *Increase in systemic risk in the financial system*. The small number of banks implies that losses of CBRs or closure of MTO bank accounts can quickly create a systemic risk as services become concentrated in a single entity. Furthermore, the banks are small and cannot provide a wide range of services and therefore rely on correspondent banks to offer clients a broader range of services. Loss of a CBR in this situation could leave local business without access to some types of financial services.
- *A more fragile remittance sector*. Closures of MTOs' bank accounts and ultimately of MTOs would increase the fragility of the remittance corridors to the Pacific islands. While the level of remittances is holding up, this metric is deceptively reassuring as remittances can be diverted through alternative channels, including through banks and other MTOs that remain operational. From the perspective of the resilience of the system, the number of MTOs has fallen and the ability of MTOs to offer reliable service has declined.
- *Increased use of more expensive or non-transparent remittance channels*. Looking ahead, an increasing share of remittances could also be sent through unregulated channels, which could reduce transparency and the authorities' ability to monitor and investigate transactions. Evidence suggests that there has been a shift in the methods used to transfer money to the Pacific islands, with less reliance on MTOs or increased hand-carry of cash as reported by MTOs.
- *Increase in the cost of remittances.* Without intervention, continued strains in CBRs could result in higher remittance costs. Weaker competition in the remitter market could further raise the already-high cost of remittances. In addition, closure of MTOs bank accounts limits their ability to find the lowest transfer cost, which pushes up their average cost. Furthermore, a shift in flows into the banks will further boost average costs.
- *Negative consequences for financial inclusion.* Enhancing financial inclusion to support growth is a key policy priority for the authorities in many of the small states in the Pacific Islands (Sahay and others, 2015). Closure or curtailment of MTOs could have a significant impact on financial inclusion. For example, Samoa is a cash-based society and about 85 percent of remittances are channeled through money transfer operators (MTOs). The MTOs reach into the community is much greater than that of banks, with the largest MTO having 30 branches outside of Apia, the capital city, compared with 15 for the four banks combined.

- *Decline in growth and reduced resilience to shocks.* Many of the small states are highly dependent on remittances, which play an important role in supporting household consumption. For example, in Samoa, where remittances amount to 20 percent of GDP, any decline could have a significant impact on GDP. Looking ahead, lower financial inclusion could reduce longer-term growth prospects. A well-functioning and inclusive financial system—now under threat—is essential for long-term growth. The role of remittances in bringing immediate assistance in the aftermath of natural disasters cannot be overstated.

IV. POLICY RECOMMENDATIONS

A. Broad Strategy and the Role of Collective Action

24. Collective action is needed to mitigate a breakdown in banking relationships. Addressing the withdrawal of CBRs to prevent detrimental macroeconomic impacts in the small states in the Pacific will entail policy actions by authorities in the small states, in remitter countries, and in the home of global correspondent banks. The small states of the Pacific are currently working to upgrade their AML/CFT frameworks to meet more stringent evaluation of the effectiveness in implementing international standards. But these efforts might not be sufficient to halt or reverse the consequences of withdrawal. Regulators and correspondent banks will also have a role to play. The collective efforts include:

- Affected countries must upgrade their regulatory and supervisory frameworks to comply with international standards with regard to both AML/CFT and tax transparency. Ongoing donor support will be needed in many cases to meet these objectives. Practical solutions are needed to maintain the flow of remittances while ensuring compliance with AML/CFT as the current business model of many MTOs may not be sustainable given the increased compliance requirements.
- Regulators can continue to play an important role through further outreach and dialogue with global banks and, in addition, regulators in affected jurisdictions (and with regulators in countries whose banks serve as intermediaries for affected jurisdictions). The objective of this outreach is for regulators in affected jurisdictions to continue to clarify their compliance framework and ease the concerns of correspondent banks, and for correspondent banks' home country regulators to consistently communicate their regulatory expectations. In particular, regulators should encourage correspondent banks to upgrade their information gathering to ensure that a well-informed risk-based assessment drives the termination of bank accounts.
- The financial industry could play a role in engaging with small countries (as outlined in Lagarde (2016)). New tools, such as KYC utilities, can be developed and deployed to help lower compliance costs for banks. Industry efforts to support the training of bankers in implementing AML/CFT in remote jurisdictions will help with consistent application of standards.

B. Policy Actions for Affected Countries

25. Policy advice focuses on measures to alleviate the concerns of correspondent banks in the short-term while at the same time, developing new remittance channels for countries that rely on remittances. Measures fall into several categories including upgrading legislation, improving implementation, and increasing capacity. Improved compliance is necessary but might not be sufficient: compliance cost considerations are also factoring into banks' decisions and it will be necessary to reduce these costs. Establishing a national database—a KYC utility—could go a long way to reduce costs, while at the same time enhance compliance. Looking to the future, the digital economy through new financial technologies may offer possible solutions to creating low-cost remittance channels while at the same time ensuring integrity of the payments system. Upgrading payments systems, along with the legal acceptance of electronic signatures, can help create an environment supportive of new financial innovations or Fintech. A payments cost study could also help identify key drivers of higher costs of some financial services in some small states of the Pacific and suggest ways to lower costs, especially in the remittance sector.

26. Efforts to upgrade the domestic compliance framework should focus on:

- *Address shortcoming in domestic AML/CFT frameworks and effectiveness*. For those countries that have completed a Mutual Evaluation Assessment by APG, a key priority will be to implement the recommendations in that report (Box 3). Improved compliance by MTOs is also needed.
- *Increase awareness and capabilities for AML/CFT compliance*. Many of the small states will need to develop a broad-based national approach to the AML/CFT regime and considerably scale up the number of AML/CFT specialists (including at the central bank, Ministry of Finance, Customs, the judiciary, the Attorney General's Office, police, financial sector, and MTOs). Local capacity AML/CFT Specialists Certification Program should be developed through cost-effective training-for-trainers program; donor assistance may also be needed. Such a program will help increase the effectiveness of AML/CFT compliance regimes, helping to ensure buy-in by other government departments, and raise national awareness.
- *Increase dialogue with key stakeholders.* The authorities should communicate with relevant foreign regulators, financial intelligence units, and correspondent banks on the progress made in the AML/CFT regime. In some cases, and where appropriate, the authorities should emphasize the limited links between the MTO remittance channel to small states and the off-shore financial sector and other companies. Such an assurance could help ease correspondent bank concern over MTO remittances.
- *Upgrade the sanctions regime*. Authorities will need to upgrade the legal framework, as needed, to ensure that UN Security Council resolutions and financial sanctions are properly enforced. The risks of terror financing in the Pacific Islands appear to be limited, for example, APG (2015) discusses the low risks of terrorism-related activities in Samoa. Nevertheless, implementing a terrorism financing sanctions framework could support foreign bank confidence in the jurisdiction with minimal effort and cost.

- *Ensure compliance with FATCA*. One option is for domestic authorities, namely, the central bank, to communicate with the U.S. government and negotiate an intergovernmental agreement (IGA) with the U.S. Treasury on FATCA implementation. FATCA compliance has become a prerequisite for global financial transactions and is essential to ensure continued correspondence relationships in U.S. dollars and to avoid, among other things, a 30 percent automatic withholding by U.S. banks of any non-compliant bank's U.S. dollar transfers. By signing an IGA, the domestic central bank could reduce the risks, complexity, and cost for local banks. Such a step will also help lower the risks of foreign bank exit and correspondence withdrawal. Samoa has begun negotiations on such an IGA.

27. Establishing a centralized national KYC utility by island authorities and actively seeking to KYC remittance recipients could be a viable option for small states to pursue. Collecting KYC Data on individuals receiving or sending remittances through money transfer operators and possibly including KYC data on bank customers as well beneficial ownership information for companies is possible given the relatively small population sizes of the islands. By having the utility within the Financial Intelligence Units, already established in many of these jurisdictions would help satisfactorily address correspondent banks AML/CFT compliance issues as well as address privacy protection concerns as the financial intelligence unit would have the necessary legal authority and responsibility to collect and protect the data. Recognizing that 'know your customers' customer' approach is not a regulatory requirement and noting recent clarifications by US regulators and FATF that it is not a requirement[15], the utility, nevertheless, could also serve as a tool for verifying bank customers' information and could potentially be an important component of financial inclusion efforts, contributing to credit extension, and support banking supervision. It could also serve as the building block for a national ID system.

28. Coupled with FATF compliant AML/CFT regime applied to MTOs, the utility would include verified KYC information on remittance recipients and senders easing correspondent bank concerns. The financial intelligence unit should take the lead in developing the database, and financial and technical assistance for the implementation of such a system by donors is likely to be needed. The database would help increase compliance and ease the cost of customer due diligence by improving the information available on the customer. This database along with other components of the CDD process, such as ongoing monitoring of the business relationship, will help reassure regulators and correspondent banks. Subject to existing legal requirements, access to the database could be provided to compliant sender and receiver MTOs, correspondent banks, and other financial intelligence units, thus reducing the cost of compliance to the MTOs and ensuring satisfactory AML/CFT vetting of beneficiaries in an electronically secured environment.

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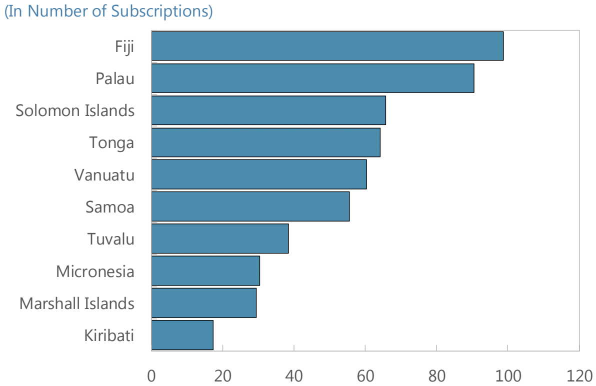
[15] See Joint Fact Sheet on Foreign Correspondent Banking, https://www.treasury.gov/press-center/press-releases/Documents/Foreign%20Correspondent%20Banking%20Fact%20Sheet.pdf
https://www.occ.gov/news-issuances/bulletins/2016/bulletin-2016-32.html

C. Can the Digital Economy Help? The Role of Fintech

29. Technology can be better leveraged to mitigate the consequences of CBR withdrawal on access to financial services, particularly for money transfers. Many technology-based solutions—with the exception of blockchain technology—still need to rely to some degree on existing banking infrastructure for the clearing and settlement of funds, and are thus not completely immune to further withdrawal of CBRs or account closures.[16] However, given the specific challenges faced by many small states of the Pacific, some technology-based solutions could provide viable alternatives. One potential option involves the combination of an adequate mobile phone network, a KYC utility, and blockchain technology.

30. Given the large distances and geographical dispersion that characterize many small states in the Pacific, wider use of mobile money can allow greater access to financial services and foster more financial inclusion. In contrast to mobile banking, which provides on-line access to an existing bank account, mobile money consists of customers' stored funds maintained by mobile network operators, obviating the need for an underlying bank account. Although large portions of the population in the Pacific small states remain unbanked, mobile telephone networks offer greater coverage, suggesting that mobile money can be a viable tool to further widen access to financial services, including in cross-border transactions.[17] Mobile money facilities can potentially be expanded to allow cross-border mobile money transfers as an alternative to traditional money transfer operators and banks, as demonstrated in some countries in West Africa.[18] This would provide alternatives to conventional channels of cross-border money transfers. In addition, the use of technology to connect with a KYC database would help ensure the integrity of the payments system.

Mobile Phone Subscriptions per 100 Inhabitants, 2014
(In Number of Subscriptions)



Source: International Telecommunication Union

31. Platforms for the transfer of funds using blockchain technology/distributed ledgers have the potential to reduce the reliance on the banking system for the clearing and settlement of financial transactions. Although still in its early stage of development, blockchain technology Fintech applications promise to reduce the time, cost, and complexity of financial transactions—including cross-border money transfers. Developments in Fintech and its potential disruption of existing banking models have not gone unnoticed by global banks, and

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[16] As discussed in Erbenová and others (2016).

[17] The Pacific islands registered the fastest growth rate in unique mobile telephone subscribers during 2009, at 13 percent, second only to Sub-Saharan Africa (15 percent). See GSMA Intelligence (2016).

[18] See Scharwatt and Williamson (2016).

many, including regional pacific banks, are partnering with Fintech companies to explore the use of blockchain distributed ledgers on their mobile banking platforms. The use of blockchain technology will need to take into account the technology gap in many small states of the Pacific as well as challenges posed for market supervision. Plans to tap blockchain technology will need to build on ongoing efforts to address gaps in access to mobile technology in some small states. Central banks and financial supervisors will also need to strengthen and adapt the regulatory framework accordingly in light of concerns about potential vulnerabilities arising from blockchain technology.[19]

D. Conclusions

32. Collective action will be needed to help mitigate the potentially negative consequences of correspondent banking relationship withdrawal on the small states of the Pacific. We have outlined measures for affected countries to implement that can help ease concerns of the correspondent banks in the short run while laying the foundation for a payments system in the small states that is more cost effective yet fully AML/CFT compliant. In many cases, donor support will be needed. But these measures may not be sufficient as cost-benefit analysis or risk assessment by correspondent banks could continue to limit their engagement with the small states of the Pacific. In such a scenario, a combination of blockchain technology, with a Know Your Customer utility for senders and receivers, along with the mobile phone networks, could provide a platform for cross-border transactions that would not rely on traditional correspondent banking.

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[19] Financial Stability Oversight Council 2016 Annual Report.

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